Annex 4: Review of the Swiss TBTF regime by international standards

Basis for an evaluation in accordance with Article 52 of the Banking Act

Contents

Management summary

The present report contains an analysis and evaluation of the Swiss approach to solving/alleviating the TBTF problem. For this purpose, the Swiss TBTF regime is compared with the corresponding regulations in other important financial centres with global systemically important banks (US, UK, EU) as well as with corresponding international standards. First, the issue is defined and evaluation criteria are set out. The international work of the relevant bodies such as the Financial Stability Board and the Basel Committee are taken into account, but also the criteria underlying the Swiss legislation.

After a detailed presentation of the major regulatory approaches in the most important relevant financial centres and Switzerland, the report focuses on an evaluation of the Swiss TBTF regime. The Swiss approach with a policy mix of different measures is given a positive assessment overall compared internationally. No fundamental reorientation is thus called for. However, the evaluation does show that even a complete implementation of the TBTF legislation will not fully solve the TBTF problem in Switzerland. Additional measures and adjustments to the overall Swiss package are necessary to further enhance the robustness of systemically important banks and to make recovery or orderly resolution possible without costs to taxpayers.

The report identifies various recommendations for action in order to further strengthen the Swiss TBTF measures. The report proposes making changes already today in the three areas where measures are necessary (prudential measures, organizational measures, and measures in the event of a crisis) and continuing to periodically review the effectiveness of the overall package in the coming years, as already envisaged by the Banking Act.

1 Goals and approaches of TBTF policy

1.1 What is the TBTF problem?

The most recent financial and economic crisis showed that the distress or failure of a systemically important financial institution (SIFI) may – due to its size, market significance, or interconnectedness – result in considerable upheaval in the financial system and negative consequences for the overall economy.

The affected government or governments cannot and therefore will not let a SIFI fail in the event of a crisis if the continuation of systemically important functions is not ensured: The financial institution is "too big to fail" and therefore implicitly enjoys a government guarantee that favours false incentives (moral hazard). Also from an economic perspective, this government guarantee is comparable to an implicit subsidy that distorts competition and entails costs to the national economy. The implicit government guarantee ultimately also is an obstacle to structural change that promotes prosperity, since poorly managed systemically important companies do not have to exit the market. But financial institutions may also be so large that they are too large for a state to rescue (too big to be rescued) without the state itself getting into trouble due to the costs of the rescue and in turn needing support from the international community.

Without countermeasures, the threat of default of an SIFI thus leaves the state authorities no other option than to rescue it with public funds in order to prevent financial instability and damage to the economy. The most important goal of a TBTF policy is therefore to prevent certain financial institutions from being so important to the functioning of the overall system that they cannot fail and therefore the government would have to employ taxpayer money to rescue such financial institutions.[1]

At the international level, the heads of state and government of the G20 at the summit in Seoul in 2010 approved the framework of the Financial Stability Board (FSB) for SIFIs to reduce the moral hazard risk posed by systemically important financial institutions (SIFI framework)[2] and confirmed that no company should be too big or too complex to fail.

The purpose of the SIFI framework is to reduce the probability of default of SIFIs and also the consequences, should such a default nevertheless occur. The framework contains requirements for the evaluation of the systemic importance of institutions, additional loss absorbing capacity, increased intensity of supervision, effective resolution mechanisms, and stronger financial market infrastructure. While the international debate initially focused on the reduction of risks emanating from SIFIs, the debate has recently shifted in the direction of resolution capacity, since especially cross-jurisdictional resolution still poses certain obstacles.[3] Nothing has changed about the general SIFI framework, however.

In order to implement the SIFI framework, the FSB and the various international standard-setters have developed specific standards for the global systemically important banks and insurers.

1.1.1. Global systemically important banks – Definitions and criteria of the FSB and BCBS:

According to the new Basel III rules, which were published by the Basel Committee on Banking Supervision (BCBS) at the end of 2010, all banks are to hold significantly more capital and liquidity in future. Beyond this, the FSB and the BCBS have issued additional standards that apply only to global systemically important banks.

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[1] See also "Dispatch on Amendment of the Banking Act (strengthening of stability in the financial sector; too big to fail)" of 20 April 2011.

[2] http://www.financialstabilityboard.org/publications/r_101111a.pdf.

[3] See, e.g. p.17 of the G20 Leaders' Declaration of September 2013.

The standards for global systemically important banks (G-SIBs) were issued by the BCBS on 4 November 2011.[4] These standards set out how G-SIBs are to be **identified**, what **additional loss absorbency requirements** they must meet (see Chapter 2.2.1.1) and how these requirements are implemented step by step.

The methodology of the BCBS to determine the systemic importance of G-SIBs relies on an indicator-based measurement approach.[5] Based on this approach, the FSB and the BCBS for the first time developed a list of G-SIBs in November 2011, which is updated annually. The current list from November 2014 contains 30 G-SIBs in 11 different countries (see Annex 1).

The individual indicators were selected in such a way that it takes account of different aspects of the factors that cause negative externalities and entail that a bank is relevant to the stability of the financial system. The advantage of this measurement approach, which incorporates several indicators, is that it takes account of a wide range of dimensions of systemic importance and therefore is more robust than model-based evaluation approaches and methods that only make use of a limited number of indicators or market variables. In principle, however, it must be taken into account that there is no perfect approach for measuring the global systemic importance of banks, since banks differ considerably in terms of their structures and activities – and therefore also in terms of the type and scope of the risks they pose to the international financial system.

The **method for identifying** the G-SIBs takes account of the characteristics of the potential candidates in 12 indicators in 5 categories. These categories and their weights are:

Category	Indicators	Weighting
Size	Total exposures (as defined for use in the Basel III leverage ratio)	20%
Cross-jurisdictional activity	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
Interconnectedness	Intra-financial system assets	6.67%
	Intra-financial system liabilities	6.67%
	Wholesale funding ratio	6.67%
Substitutability/ Financial institution infrastructure	Assets under custody	6.67%
	Payments cleared and settled through payment systems	6.67%
	Values of underwritten transactions in debt and equity markets	6.67%
Complexity	OTC derivatives notional value	6.67%
	Level 3 assets	6.67%
	Trading book value and Available for Sale value	6.67%

With a weight of 20%, the size of the bank plays a significant role in evaluating systemic importance. The reason for this is the determination by the BCBS that it is becoming increasingly difficult to quickly substitute the activities of a bank by other banks, the bigger the bank in distress is. Emergency situations or defaults of a big bank are also more likely to undermine confidence in the financial system as a whole.

1.1.2. Definition and criteria in the Swiss TBTF law:

In the Swiss TBTF law, the definition of systemic importance is likewise the starting point for the analysis of the TBTF problem. According to the Swiss TBTF regulation, a company is to be categorised as systemically important if:

(i) it performs services that are indispensable to the national economy, and

[4] See "*Global systemically important banks: Assessment methodology and the additional loss absorbency requirement", BCBS, 4 November 2011, at www.bis.org/publ/bcbs201.pdf*.

[5] See IMF/BIS/FSB, *Guidance to assess the systemic importance of financial institutions, markets and instruments: initial considerations* (October 2009) at www.bis.org/publ/othp07.pdf.

(ii) other market participants are unable to substitute these services within a period of time that is tolerable for the national economy.

Explicit criteria are necessary for the practical classification of a company as TBTF. Using these criteria, it can be verified whether the above conditions are met. Such a classification must be made on the basis of an overall view of all relevant criteria. Three criteria were used by the TBTF expert group[6] for the purpose of classification:

I. Size and market concentration: This criterion is met if the size or leading position within a market prevents the continuation of the indispensable activities of a company by other companies. To evaluate the size, the balance sheet total of a company in comparison with GDP can be used. The market shares in systemically important markets are a measure for the importance of individual companies.

II. Interconnectedness: A company may have diverse and complex business relationships with, e.g. clients, suppliers, and investors at both the national and international level. A default would therefore have serious consequences for a large number of other actors and might cause considerable damage to the entire economy through a process of contagion. The high degree of interconnectedness of SIFIs with each other, in conjunction with a lack of transparency of the counterparty positions of individual financial market participants, increases the risk that the default of a market participant might lead to chain reactions in the financial system.

III. Lack of substitutability: The substitutability of functions important to the national economy by the market tends to decrease with the size or interconnectedness of the company in question. Market-specific factors such as crises may make the takeover of a company or important components thereof even more difficult or even prevent it altogether. Or the transfer of the function to other service providers within a reasonable period of time may not be possible. Of particular importance for the evaluation of substitutability is the time period during which the company is no longer able to perform systemically important functions.

In its report dated 30 September 2010, the TBTF expert group determined that the TBTF problem in Switzerland is limited to the banking sector.[7] However, other areas of the financial sector (e.g. insurers, infrastructure, etc.) should not be excluded at the outset from the present analysis of the Swiss TBTF regulation. These areas are discussed in the report on *Systemic Stability in the Non-Big-Bank Sector*.

While there are also major companies in other areas whose insolvency would undoubtedly constitute a considerable burden, their systemically important functions can in general quickly be substituted by the market to a sufficient extent, or they can be ensured by a rescue company with reasonable effort. For this reason, a state rescue of these companies is not appropriate and certainly not mandatory from the perspective of the national economy – especially in order not to prevent structural change that is important to prosperity.

1.2 How can the different TBTF approaches be compared?

Due to the complexity of the TBTF problem, ultimately only a combination of measures can have an effective impact. The packages of measures adopted by different countries (policy mixes) have different starting points. In some cases, they have more of a preventive effect and are intended to prevent insolvency. In other cases, they have more of a curative effect and are intended to minimise the negative consequences of insolvency and at the same time ensure the continuation of the systemically important functions in the event of insolvency, in order to

[6] See *Final Report of the Expert Commission on the Limitation of Risks to the National Economy by Major Companies (September 2010).*

[7] See, e.g. *Final Report of the Expert Commission on the Limitation of Risks to the National Economy by Major Companies* Chapters 2.3.4., p. 21 (September 2010).

protect the state from the compulsion[8] to rescue the entire bank simply to ensure these functions.

In Switzerland, for example, concrete measures in four core areas have been implemented on the basis of the TBTF expert group's proposal:

I. Capital

II. Liquidity

III. Risk diversification

IV. Organisational structure

In order to compare the differing TBTF approaches or policy mixes of different countries, a common denominator must be found that allows these measures to be classified into clearly defined categories. These four core areas are therefore used as an analysis dimension for comparing the different policy mixes. Additionally, measures in the event of a crisis are used as a further core area.

The three core areas of capital, liquidity, and risk diversification can be classified as prudential and price-related measures, which have an impact on company costs via price effects. In contrast, the goal of structural measures is to steer the organisational structure. The measures in the event of a crisis must be distinguished from these two categories of measures.

1.3 Criteria for evaluating TBTF policy

In the report of the TBTF expert commission, the following criteria were used to evaluate the measures: **risk limitation; facilitated winding-up and restructuring of systemically important banks; functioning and efficiency of the financial system; competitive neutrality; simplicity; and non-fiscal objectives**. In the present report, these criteria are maintained for the evaluation of the five core areas, with the exception of the criterion "non-fiscal objectives", but they are combined as follows:

I. **Effectiveness/Risk limitation:** Does the measure contribute effectively to a limitation of risks in the financial system, and does it succeed in limiting the probability of default, systemic risks, and the consequential losses thereof to a reasonable level? The following characteristics can be distinguished in particular:

   i. Protection of taxpayers;

   ii. Lower market concentration;

   iii. Reduction of complexity;

   iv. Reduction of moral hazard;

   v. Principle of liability of the party causing the losses

II. **Efficiency/Impact on financial intermediation:** Is the measure compatible with a regulatory system that is as simple as possible? How high are the transaction costs for implementation? Is the measure able to make its contribution without preventing the banking and financial system from fulfilling its national economic responsibilities that are essential to economic welfare and growth? Does the measure also preserve the ability of the financial sector to innovate and develop? Is it compatible with efficient, competitive structures in the financial industry? Is government intervention limited to what is absolutely necessary? The following characteristics can be distinguished in particular:

   i. Subsidiarity principle;

[8] Issues: Moral hazard and implicit government guarantee.

ii. Simplicity;
iii. Supply of credit;
iv. Range of financial services

III. **Conformity with international best practices:** Are the international *standards* fulfilled that a country has to implement (i.e. need to have)? Are other *best practices* implemented that may be, but do not have to be, implemented (i.e. nice to have)? Is the measure compatible with a minimum of distortion of competition in the financial sector, both in terms of the domestic economy and in international terms (competitive neutrality)? Are the measures recognised internationally as compatible?

Finally, the overall evaluation of a package of measures (policy mix) must focus on its overall effect, i.e. the interplay of the various measures. The effectiveness of an individual measure may depend heavily on the total package in which it is embedded. Additionally, it is not decisive how strongly the individual measure attains the objectives, but rather to what extent the total package attains them. Figure 1 below provides an overview of the various measures.

Figure 1: Overview of packages of measures (policy mix)

	Prudential measures				Organisational measures		Measures in the event of a crisis
	Capital		Liquidity	Risk diversification	Organisational structure/Continuation of systemically important functions/Recovery or resolution		
Evaluation criteria:	Risk-weighted assets (RWA)	Leverage ratio (LR)	Liquidity coverage ratio (LCR)		Models for improving winding-up and restructuring capacity[9]	Models with structural requirements governing the prohibition of certain activities without an impact on winding-up and restructuring capacity[10]	
I. Effectiveness/Risk limitation							
II. Efficiency/Impact on financial intermediation							
III. Conformity with international best practices							

[9] E.g. the Swiss TBTF regulation requires that systemically important banks organise themselves in such a way that continuation of systemically important functions must be ensured in view of a crisis and that they have an emergency plan. But if the bank is unable to demonstrate the capacity to continue the systemically important functions, the supervisory authority must order the necessary organisational measures. Another example of models to improve the winding-up and restructuring capacity can be seen in parts of the Vickers Rule in the UK.

[10] E.g. the Volcker Rule.

2 Description of the international implementation

2.1 Introduction: International TBTF measures

Due to the experiences gained in the 2008/2009 financial crisis, the reduction and ultimately elimination of the TBTF problem enjoys a high priority in the post-crisis reform of the financial system, both within the G20 and the FSB but also in individual countries. This is true at both the national and global level.

Already at its first summit in 2009, the G20 commissioned the elaboration of measures to eliminate systemic risks in the financial sector and has since reconfirmed the thrust of the reforms several times. On behalf of the G20, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) have taken the lead in issuing various regulatory measures to strengthen the financial system – these measures are considered international minimum standards.[11] These standards are not binding, but they do have effect through the political backing of the international community and the international review mechanisms.

Schematically, the international measures to contain the systemic risks in the banking sector may roughly be divided into two parts: Firstly, the BCBS developed the Basel III framework, which increases the crisis resistance of all internationally active banks regardless of their size and has a positive impact on the stability of the financial system. Secondly, special regulatory and supervisory measures were developed under the aegis of the FSB for global systemically important banks (G-SIBs). The FSB framework applies to a limited number of systemically important banks (see Chapter 1.1.1 and Annex 1), the default of which would constitute a special risk to the worldwide financial system.

These two frameworks represent the starting point for a comparison of the different measures to increase the robustness of financial market participants and to contain systemic risks in the United States, the European Union, the United Kingdom, and Switzerland. The comparison is limited to these countries, since that is where G-SIBs are located which have similar structures as the major Swiss banks. This is not the case for the G-SIBs in China and Japan. Other countries do not have G-SIBs.

2.1.1 Basel III framework

With the Basel III framework, the BCBS fulfilled the mandate of the G20 heads of state and government to improve the capital adequacy and liquidity supply of internationally active financial institutions, as a lesson learnt from the 2008/2009 financial and economic crisis. The main goal of Basel III is to make the international banking system more stable, so that it will be able to manage major financial crises in the future without significant damage to the national economy and without losses to taxpayers.

The starting point of Basel III consisted in deficits identified in the predecessor regulations. The most important reforms can be summarised with the following points:

- Increase in the quality and consistency of the capital used
- Increase in the minimum requirements for capital needed
- Introduction of a leverage ratio
- Introduction of macroprudential instruments such as the countercyclical capital buffer
- Binding international liquidity standards

[11] The analysis of the various manifestations of the TBTF measures is limited to the banking sector, in accordance with the mandate of the Subgroup on Risks to the National Economy.

- o Limitation (and, as a longer-term goal, elimination) of the risks arising from systemic financial institutions, in cooperation with the FSB

Already in July 2009, initial urgent reforms (known as Basel II.5) were adopted, and the Basel III followed in December 2010. Some parts, such as the leverage ratio, were defined in detail only in the following years. The Basel framework applies at the consolidated group level.

Basel III provides for transition periods to fulfil the standards until the beginning of 2019, as can be seen in the following table.

Figure 2: Basel III implementation phases

	Phases	2013	2014	2015	2016	2017	2018	**2019**
Capital	Leverage Ratio		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to Pillar 1	
	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%				**4.5%**
	Capital Conservation Buffer				0.625%	1.25%	1.875%	**2.5%**
	Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	**7.0%**
	Phase-in of deductions from CET1*		20%	40%	60%	80%	100%	**100%**
	Minimum Tier 1 Capital	4.5%	5.5%	6.0%				**6.0%**
	Minimum Total Capital		8.0%					**8.0%**
	Minimum Total Capital plus conservation buffer		8.0%		8.625%	9.25%	9.875%	**10.5%**
	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2013					
Liquidity	Liquidity coverage ratio – minimum requirement			60%	70%	80%	90%	**100%**
	Net stable funding ratio						Introduce minimum standard	

Source: Basel Committee on Banking Supervision

The Basel framework has established itself as a global standard not only in the OECD countries but also in emerging countries and important financial centres such as Singapore and Hong Kong. Implementation of the Basel rules is periodically monitored by the BCBS in terms of time and content, with the assistance of international experts in the context of the Regulatory Consistency Assessment Program (RCAP). The RCAP verifies three aspects in this regard: i) timely adoption, ii) regulatory consistency, and iii) consistency of outcomes. Switzerland underwent the RCAP review in 2013 and completed the assessment with the best rating (fully compliant) in 11 out of 14 categories. Both the EU and the US have so far undergone *draft assessments*. The final evaluations should be expected in the course of 2014. In the EU, the preliminary conclusion so far is "materially non-compliant" (see also remarks under 2.2.1.3.1). The preliminary result in the US is "largely compliant".

2.1.2 FSB G-SIB framework

On behalf of the G20, the FSB developed a concept to reduce systemic risks and moral hazard in connection with systemically important financial institutions. Banks that are especially important to the stability of the financial system (G-SIBs) must meet requirements that exceed Basel III. The FSB framework was approved at the G20 summit in 2010 and contains four main elements:

1. *Additional loss absorbency requirements:* G-SIBs are required to hold additional equity capital. This takes account of the higher risks they represent for the global financial system. This measure increases the crisis resistance of a G-SIB and reduces the probability of a collapse. The capital adequacy requirements continuously increase as the level of systemic importance rises.

2. *Development of a resolution standard:*[12] So that all financial institutions can be wound up in an orderly manner without destabilising the financial system and without constituting a burden on taxpayers, an international standard for the design of resolution rules has been adopted (Key Attributes of Effective Resolution Regimes: abbreviated as "key attributes"). These key attributes provide instruments for recovery and resolution planning (RRP), the participation of creditors in losses, and international cooperation.
3. *Stricter supervision:* Financial institutions that entail systemic risks should be subject to stricter supervision by supervisory authorities. Especially important in this regard are sufficient resources, a clear mandate without conflicts of interest or objectives, and unrestricted independence of the supervisory bodies.
4. *Financial market infrastructure:* A more robust financial market infrastructure, for the purpose of minimising contagion risks that might result from the default of individual institutions.

These measures apply to G-SIBs. G-SIBs are determined each year by the FSB on the basis of an indicator-based calculation method (cross-jurisdictional activity; size; interconnectedness; substitutability/financial institution infrastructure; complexity; see Chapter 1.1.1 and Annex 1). This was the case for the first time at the end of 2011. The most recent list was published in November 2013. The G-SIBs include UBS and Credit Suisse. They also include eight banks from the United States, four from the UK, and ten from the rest of Europe.[13]

2.1.3 Framework for domestic systemically important banks

Apart from G-SIBs, the G20 also called for a framework for banks that are systemically important not at the international level, but rather at the domestic level (domestic systemically important banks, D-SIBs). In cooperation with the FSB, the BCBS developed fundamental requirements in this regard and published them in October 2012.

Determining D-SIBs is the responsibility of the national authorities. Unlike the G-SIB regime, the character of the D-SIB regulatory framework tends to be based on principles and is thus more flexible. By giving supervisors in the individual countries more leeway to formulate their regulations, national particularities are to be taken into account more effectively. D-SIBs should also be determined according to a method based on the criteria of size, interconnectedness, substitutability, and complexity, but this time in relation to the national economy. Additionally, other country-specific indicators can be used.

The only regulatory measure explicitly mentioned by the regulatory text is the capital surcharge (additional loss absorbency requirement), which will henceforth also apply to D-SIBs. The regulatory text formulates the calculation of these additional capital requirements only as guidelines. However, the banks must provide the capital surcharge fully as common equity Tier 1 capital (CET1) in order to ensure comparability with the G-SIB capital rules. If an institution is subject to both a G-SIB and D-SIB capital surcharge, the higher of the two shall apply. Beyond this, the national supervisor may apply additional regulatory measures for D-SIBs at its own discretion.

The FSB will commence its review of the national implementation of the D-SIB regime in 2015. The Swiss TBTF rules encompass both G-SIBs and D-SIBs.

[12] The term "resolution" encompasses restructuring and winding-up.

[13] Plus three Japanese and three Chinese institutions (see Annex 1).

2.2 Prudential measures

2.2.1 Capital[14]

2.2.1.1 International (BCBS/FSB)

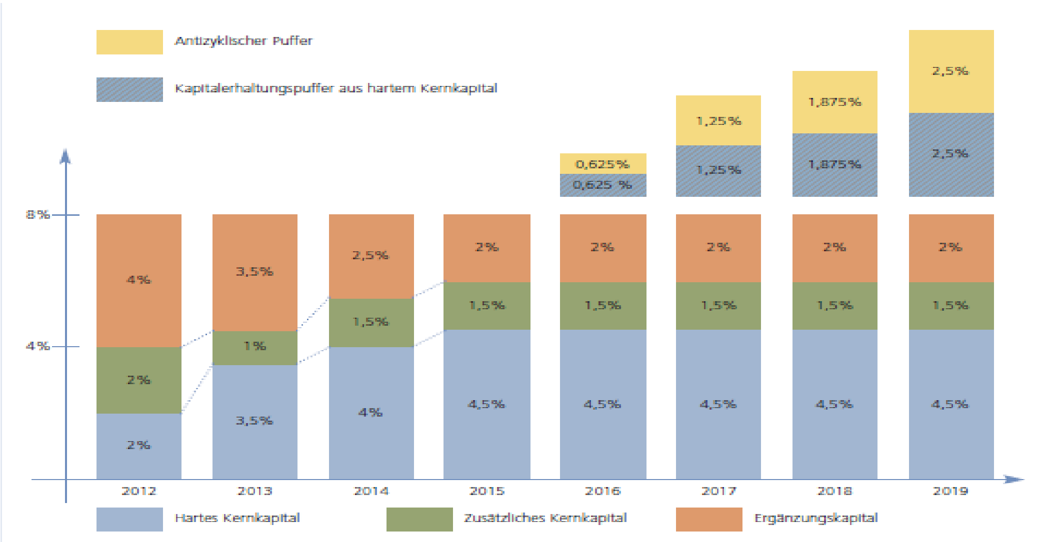
2.2.1.1.1 Risk-weighted capital requirements under Basel III

Basel III provides for minimum requirements of 10.5% of risk-weighted assets (RWA). At least 7% have to be held in the form of common equity Tier 1 capital (CET1). This capital requirement of 7% is divided into minimum common equity of 4.5% and a capital conservation buffer of 2.5%. This buffer serves to buffer against volatilities. The remaining 3.5% may consist of supplementary capital in the form of subordinated debt. For this purpose, deeply subordinated, perpetual bonds on which interest payments may be suspended can be counted as core capital (additional Tier 1). Subordinated bonds with maturities of more than 5 years are counted as Tier 2 capital. The BCBS also explicitly provides for the possibility that domestic authorities may issue farther-reaching requirements as soon as they become necessary given the risks in the domestic financial sector.

Implementation status – Adopted, effective from 2013 (implementation 2013 to 2019)

Basel III provides for a phased implementation of the capital measures in order to make the transition period as manageable as possible for banks and for the economy as a whole. Full implementation will be effective 1 January 2019. Currently, banks are required to increase their CET1 holdings. The following table provides an overview of the schedule for implementation of Basel III. All member countries of the BCBS have already implemented the new capital standards or are currently implementing them.

Figure 3: Introduction of new minimum requirements and establishment of capital buffers



Source: Federal Ministry of Finance

Additionally, the individual supervisory authorities must define a customised countercyclical buffer at the domestic level intended to prevent an overheating of the banking system. This countercyclical buffer should be built up during times of excessive credit growth likewise using CET1 capital, in order to limit potential later losses due to a downswing and to prevent a contagion in the real economy resulting from restrictions on lending.

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[14] Unless otherwise noted, the following comparison refers to regulatory equity capital. Beyond this there are efforts both internationally and in important jurisdictions to impose minimum requirements on the amount of loss-absorbing capital (including borrowed capital), which should ensure the orderly recovery of the bank and stability of the system in the event of recovery and resolution (see Chapter 2.4).

2.2.1.1.2 FSB surcharge for systemic importance

Due to their importance for the financial system, G-SIBs must meet additional minimum capital requirements. Depending on their degree of systemic importance, G-SIBs must hold additional capital in the amount of 1% to 3.5%. This surcharge for systemic importance must be held in the form of CET1.

Depending on their degree of systemic importance, G-SIBs are assigned to one of five tiered buckets (CET1 surcharge of 1%, 1.5%, 2%, 2.5% and 3.5%). According to the most recent provisions of the FSB from November 2014, the two major Swiss banks end up in buckets 1 and 2 and must accordingly hold additional CET1 in the amount of 1% and 1.5%, respectively (see Annex 1). The top-most bucket with requirements of 3.5% is currently empty. It is intended to have a negative incentive effect by keeping G-SIBs from further increasing their systemic importance. If a bank should one day end up in the top-most bucket, the FSB intends to introduce another bucket above it with requirements of 4.5%.

In summary, the international minimum requirements in regard to risk-weighted capital requirements for G-SIBs are between 11.5% and 14% (without the countercyclical buffers), depending on the degree of systemic importance. Of that amount, 8% to 10.5% must consist of CET1.

Implementation status – Adopted, effective from 2016 (implementation 2016 to 2019)

The additional loss absorbency requirement for G-SIBs will be phased in starting in 2016 over a time period of three years. The starting point will be the G-SIB list issued in November 2014.

2.2.1.1.3 Leverage ratio[15]

The risk-weighted requirements are supplemented by a leverage ratio. The leverage ratio according to Basel III is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), with this ratio expressed as a percentage. The capital measure is currently defined as the core capital (Tier 1), and the leverage ratio must be at least 3%.

The BCBS will continue to observe the data on banks' debt levels to determine whether the design and calibration of the leverage ratio is appropriate. Apart from the amount of the leverage ratio, this also includes the question of the impact of using either hard core capital or the entire regulatory capital as the capital measure.

The introduction of an international standard leads to harmonisation of the calculation basis for leverage ratios.

Implementation status – Adopted, effective from 2018

The complete version of the framework regulation and the disclosure requirements for the Basel III leverage ratio were presented in January 2014. The implementation of the leverage ratio began with reports of the debt levels of banks and the corresponding components to the responsible national authorities and will be continued starting 1 January 2015 with disclosure reports. The BCBS will take a close look at the results and, if necessary, will make changes to the calibration or definition in 2017. Starting January 2018, the leverage ratio will then be included as a binding requirement in the Basel regulatory framework.

2.2.1.2 Capital requirements in the United States

The US authorities (Federal Reserve, Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC)) implemented Basel III into national law in

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[15] Currently, only a limited international comparison of the leverage ratio is possible due to:
- Different calculation methods (e.g. in Switzerland and the United States)
- Differences in accounting standards
- Structural differences in the capital and mortgage markets

July 2013. The implementation does not yet include the special requirements of the FSB for systemically important institutions. The Fed Board has so far only issued rules governing capital planning, recovery and resolution planning, and the stress test for US G-SIBs.

One peculiarity in the US is that regulators also impose special requirements on major foreign banks that are important to US financial stability. UBS and CS are affected by these requirements.

2.2.1.2.1 Risk-weighted capital requirements

In designing their risk-weighted capital requirements, the US authorities are complying with the international rules. For instance, the US rules provide for a minimum capital requirement of 4.5% and a capital conservation buffer of 2.5%, both in the form of best capital quality. An additional 3.5% can be held in the form of additional core capital or supplementary capital. A total requirement of 10.5% thus applies in conformity with Basel III. For small domestic banks, the US provides for certain exceptions, especially in regard to composition of the capital. Moreover, the rules for small banks enter into effect only one year later.

The US also plans to introduce higher requirements than provided by the FSB/BCBS for US G-SIBs. Firstly, the systemic importance surcharge is to be higher, significantly so for some of the institutions. Secondly, the amount will depend directly on the degree of dependency of short-term financing.[16]

One special feature in the United States is the Collins Amendment, which is part of the Dodd Frank Act (DFA) and prescribes a uniform capital rule for all US banks. For the implementation of this provision, the US Federal Reserve has decided that banks whose risk weighting uses internal models must in parallel calculate their capital ratios according to the standard approach. To determine whether the minimum requirements are met, the lower of the two ratios is then used. This rule is intended to prevent lower capital ratios for larger banks due to changes to their internal risk modelling.

Implementation status – Adopted, effective from 2014 (implementation 2014 to 2019)

The US rules provide the same transition periods as Basel III. The phase-in period started at the beginning of 2014. The proposals on the systemic importance surcharge will follow in the coming months.

2.2.1.2.2 Leverage Ratio

In the United States, a distinction between smaller and larger banks must be made with respect to the leverage ratio:

- For all US banks, irrespective of their size, a special US leverage ratio applies. This ratio must be 4% (financial institutions accepting insured deposits must achieve a value of 5% to be considered "well capitalized"). In this connection, it is important to emphasise that the calculation method of the US leverage ratio is not the same as under Basel III. Unlike Basel III, the US leverage ratio does not consider off-balance sheet liabilities, for instance.
- For all advanced approaches banks,[17] a leverage ratio of 3% applies according to the BCBS definition.

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[16] See testimonial by Fed Governor Tarullo before the US Congress, 9 September 2014

[17] An advanced approaches banking organization is one that:
- has ≥ $250 billion in total consolidated assets;
- has ≥ $10 billion of on-balance sheet foreign exposures; or

chooses, with approval by its primary federal banking regulator, to use the advanced approaches to calculate RWA.

- For US G-SIBs, a surcharge on the Basel III leverage ratio is introduced (referred to as the "leverage surcharge" in the US). Accordingly, US G-SIBs must fulfil a leverage ratio under Basel III of 5% in order to be considered "well capitalized". If the financial institutions fall below the buffer of 2% compared with Basel III, proportional restrictions for dividend and bonus payments apply, as they do for risk-weighted assets. Additionally, subsidiaries accepting insured deposits from clients must maintain a leverage ratio under Basel III of 6%. This ratio must be fulfilled irrespective of the size of the insured deposits.

The US authorities argue that the implementation of Basel III disproportionately increased the risk-weighted requirements in relation to the leverage ratio. Both measures should be in a more realistic relationship to each other, and the leverage ratio should fulfil its function as a safety net. In contrast, the US banks argue that given this calibration, the leverage ratio would in any event be the binding restriction.

The US leverage surcharge will furthermore largely be based on the most recent definitions of the BCBS leverage ratio. In particular, the numerator must be Tier 1 capital, as it is under Basel III.

The US system also contains a further provision on the leverage ratio: If the newly created Financial Stability Oversight Council (FSOC) concludes that a financial institution represents a serious threat to financial stability, the US Federal Reserve is required to introduce a leverage ratio of 15-to-1[18] for this institution. No information is available on the calculation method.

Implementation status – Varies

The US leverage ratio has already applied to US banks for quite some time.

The Basel III leverage ratio for advanced approaches banks has been adopted and will become valid in accordance with the Basel III timetable starting in 2018. In regard to the definition of the benchmarks in both the numerator and the denominator, the revised requirements of the BCBS of January 2014 must still be taken over.

The rules on the leverage surcharge were published in April 2014. Compliance is mandatory starting at the beginning of 2018.

2.2.1.2.3 Special requirements for foreign banks

In February 2014, the US Federal Reserve announced rules for stronger regulatory and supervisory standards for foreign banks with US business. According to these rules, foreign banks with a US balance sheet total of more than USD 50 billion must consolidate their US business under a US intermediate holding company (IHC). For the IHC, the same rules apply in terms of capital requirements (Basel III) and liquidity as for US banks. Depending on the corporate group structure, this may result in significantly higher capital requirements in the US and therefore overall.

The US Federal Reserve has also issued new rules even for institutions with less weight in the United States. For instance, they must perform annual stress tests and confirm that they have appointed a risk committee to monitor US business. In total, the Fed says that the new rules affect about 100 foreign banks.

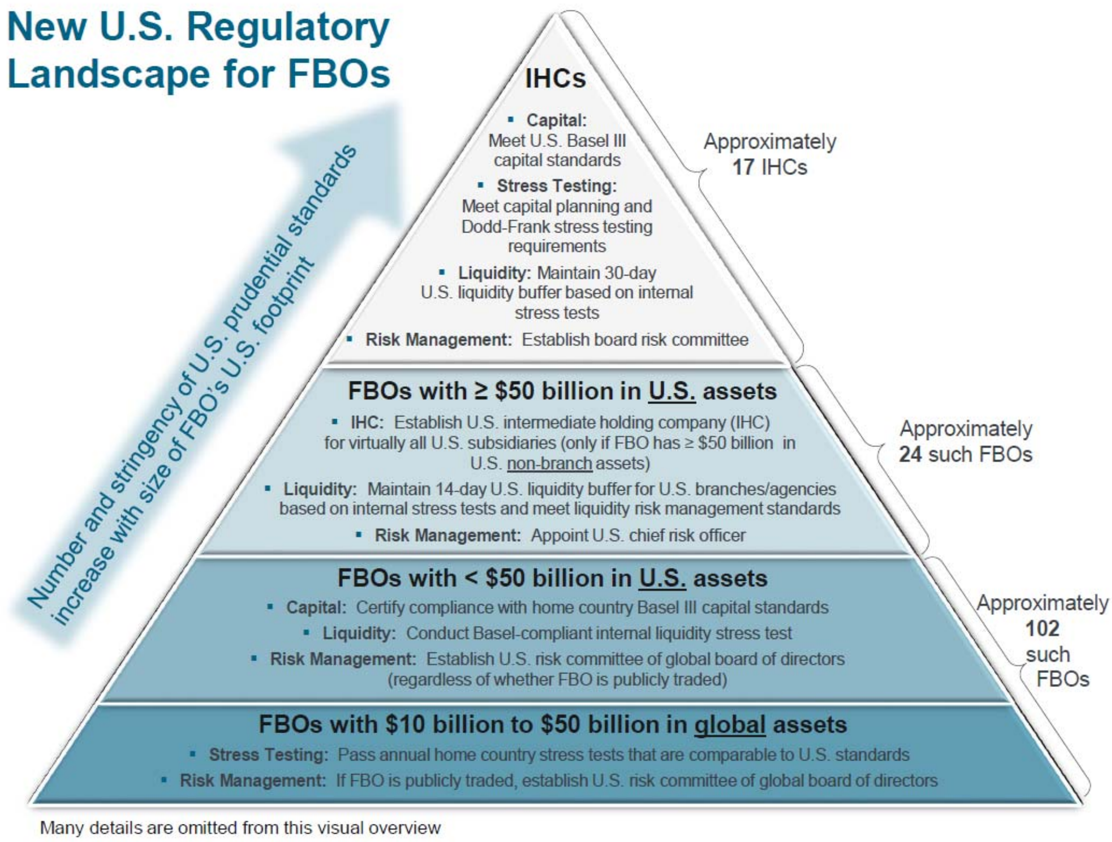
The background for these rules is the considerable financial assistance foreign banks received from the United States during the financial crisis. Foreign banks have in recent years obtained an increasing amount of funds on the short-term USD interbank market and, consequently, required such assistance during the crisis. Additionally, US banks complained of competitive disadvantages. Resolution is accordingly simpler if all stakes must be bundled within a US holding company.

[18] 15-to-1 debt-to-equity limit (DFA section 165).

Implementation status – Adopted, effective from 2016

The affected foreign banks have until July 2016 to implement the requirements. The leverage ratio requirements (both the US leverage ratio and the Basel III leverage ratio) apply to the affected banks starting in 2018.

Figure 4:



Source: Davis Polk & Wardwell LLP, davispolk.com

2.2.1.2.4 Other measures

There is also a US proposal according to which big banks obtaining a lot of funding through large short-term loans, for instance on the interbank market, must hold additional capital surcharges. This source of funding is especially vulnerable to turbulences such as fire sales, which can quickly depress capital resources to a dangerously low level. A capital surcharge would create incentives for large financial institutions to give preference to longer-term forms of refinancing.

Implementation status – Proposed

2.2.1.3 European Union

In the European Union, the capital and liquidity requirements (known together as the CRD IV package) are implemented in two legal acts: a directly applicable regulation (Capital Requirements Regulation: CRR) and a directive (Capital Requirements Directive: CRD). Major parts of Basel III are implemented via the directly applicable regulation, where there is no need for implementation in domestic law. This serves the purpose of stronger harmonisation via uniform rules in the single market. The CRD IV package is intended to make a contribution to the creation of a solid, harmonised, and secure European financial system.

The regulation contains qualitative and quantitative capital requirements and requirements on the maximum debt ratio, the minimum liquidity buffer, and the reduction of counterparty risk.

The directive provides leeway for implementation in national law. It provides the possibility of introducing additional domestic capital buffers, especially for systemically important banks. As examined in the next section, however, there are limits to the design of the buffers.

2.2.1.3.1 Risk-weighted capital requirements

Both quantitatively and in terms of scheduling, the EU is taking over the BCBS requirements. The minimum requirements are 10.5%, 7% of which must be met with CET1.

Although the content of CRD IV is based on the Basel rules, some of its requirements lag behind. The deviations from Basel III concern, among other areas, the treatment of silent partnership contributions (as CET1) and the treatment of stakes in insurance companies. Accordingly, the evaluation to review compliance with the Basel III requirements (RCAP) concludes that the EU is *materially non-compliant* in certain subareas. A final evaluation, including final marks, will be delivered before the end of 2014.

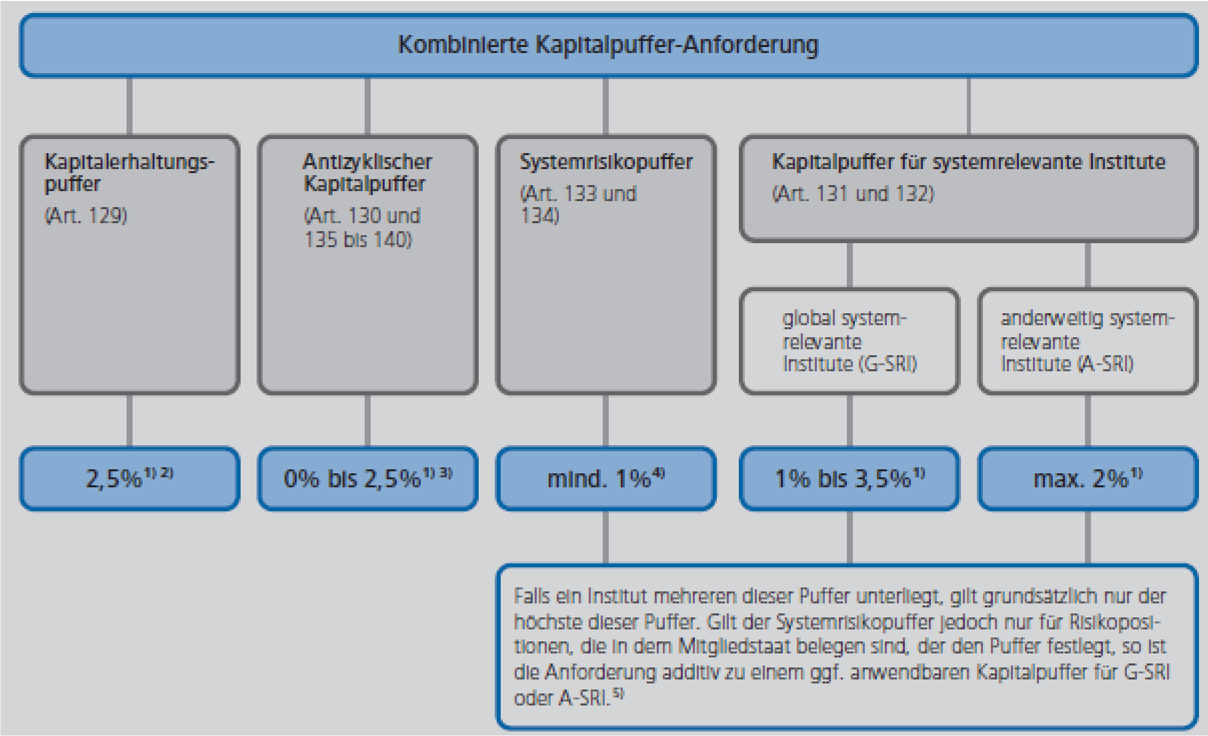
Provisions on the special capital requirements for systemically important banks are, as mentioned, also contained in the directive. The directive gives member states a certain degree of autonomy in their implementation and design. To prevent a strong divergence of requirements, however, maximum numbers are at the same time also defined.

The European Union is taking over the FSB surcharge for systemic importance. In accordance with the international requirements, this surcharge will be built up step by step between 2016 and 2019. In addition to the G-SIB surcharge, the EU legislation provides for two additional capital buffers to reduce systemic risks:

1. National supervisory authorities may demand an additional capital buffer for other systemically important banks. The focus is especially on domestic systemically important banks and institutions of systemic importance to the EU. To prevent diverging rules within the EU single market, the directive sets out criteria for identifying such banks and provides reporting and justification procedures vis-à-vis the European Commission, the European Banking Authority (EBA), and the European Systemic Risk Board (ESRB). The directive also defines a cap of 2% for the RWA buffer. The buffer must be held in the form of CET1.
2. The directive also provides for a systemic risk buffer. This buffer must also be held in the form of CET1 and must take account of non-cyclical or macroprudential risks. The directive defines a floor of at least 1% for the systemic risk buffer. Upper limits are also provided for the buffer to prevent individual countries from imposing requirements that are too strict, thus contradicting the goal of the harmonised single market with uniform rules. Buffers of more than 5% accordingly require approval by the European Commission (until 2015, the cap was 3%). For buffers of 3-5%, the European Commission, the EBA, and the ESRB must be informed. Supervisory authorities have the option to recognise the buffer ratios defined in other member states.

If an institution is subject to several of these buffers (G-SIB, domestic buffer, systemic risk buffer), the higher buffer applies in principle. The buffers are therefore not cumulative.

Figure 5: Capital buffers in the Capital Requirements Directive IV



Source: Deutsche Bundesbank, Monthly Report for June 2013

This means that depending on the national design, very different capital requirements may apply to systemically important banks in the EU. It is therefore difficult to undertake an across-the-board comparison. The highest possible capital ratio in the EU is 15.5%, 12% of which may consist of CET1.

Sweden and Norway, for instance, have decided in favour of the maximum permissible requirement. Major Swedish banks, for example, must already today hold at least 10% CET1. This requirement will be increased to 12% at the beginning of 2015 (in Norway starting in mid-2016). On top of this, there is the requirement of 3.5% capital of lesser quality.

Implementation status – Adopted, effective from 2019 (implementation 2014 to 2019)

The rules were adopted on 27 July 2013. Implementation of the capital requirements follows the Basel III requirements (phased until 2019).

2.2.1.3.2 Leverage ratio

So far, the European Union has not set up any binding minimum requirements for a leverage ratio. European banks are merely required to publish their leverage ratio and the components thereof starting in 2015. This means that at the current time, the leverage ratio merely plays the role of a monitoring instrument in the EU.

During an observation phase until January 2017, the functioning of this new ratio will be analysed in more detail. This review is being carried out by the European Commission and the EBA. Subsequently, the EU will decide if and to what extent a binding minimum value for the leverage ratio will be implemented at the European level. Introduction as a binding Pillar 1 requirement would be possible beginning 1 January 2018.

Implementation status – Not yet adopted

2.2.1.4 United Kingdom

In 2010, the UK government mandated an expert group (Independent Commission on Banking: ICB) to consider structural reforms for the UK financial sector. The expert group then published various proposals to strengthen capital adequacy, the large majority of which were adopted by the government. After the Libor affair, a parliamentary committee was also appointed to think about a general reform of the UK financial system.

2.2.1.4.1 Risk-weighted capital requirements

The European CRR has direct legal effect in the UK. Consequently, the authorities must take over the European rules on minimum capital requirements, and their autonomy is restricted by the EU rules. Compared to Basel III, the UK is introducing three additional requirements.

1. Ring-fence buffer: The Vickers expert group proposed that entities falling under the ring-fence requirement (separation of systemically important functions from trading activities – see 2.3.4) must hold an additional capital buffer of up to 3%. The amount of this ring-fence buffer varies as a function of the relation between the risk-weighted assets and GDP. If RWA amount to more than 3% of GDP, the full buffer of 3% would apply. If the amount of RWA is between 1-3% of GDP, a linear scale of 0-3% would apply to calculate the capital surcharge. The ring-fence buffer and the G-SIB capital surcharge of the FSB are not cumulative; the higher of the two amounts applies. This additional requirement is implemented via the systemic risk buffer provided in the CRD IV. This means that in the UK, a minimum requirement of 10% CET1 applies for larger banks.

   For entities not subject to the ring-fence requirement, no CET1 surcharge above the international minimum is introduced – under the condition that they have credible recovery and resolution plans as well as sufficient loss absorbing capacity.

2. Primary loss absorbing capacity: The government also supports the ICB recommendations to introduce a minimum level of primary loss absorbing capacity (PLAC). PLAC consists of regulatory capital and bail-in debt (long-term (maturity over 1 year) senior unsecured bonds). Banks are in principle free to compose the PLAC out of different capital instruments. At a minimum, however, 3% must consist of CET1. The 17% requirement applies to all ring-fence banks and UK G-SIBs that end up in the highest bucket on the basis of the FSB evaluation (G-SIB CET1 surcharge of 2.5%). For G-SIBs in other buckets, lower requirements apply accordingly.

3. Additionally, the UK provides for two "management buffers": a 1% surcharge on the CET1 requirement and a 2% surcharge on the loss absorbing capacity.

In the UK, consideration of the capital requirements must therefore distinguish between banks that provide systemically important services and those that do not. The former must, compared with other banks internationally, meet higher requirements. For the largest banks, for instance, a minimum CET1 requirement of 11% applies, and a total capital ratio of 14.5% (CRR + ring-fence buffer + management buffer). For banks not providing systemically important services, the Basel III requirements apply. For the largest G-SIBs, the capital ratios would therefore be 10.5% CET1 and 14% total capital. Depending on the size, the primary loss absorbing capacity reaches up to 19%.

Figure 6:

Loss-absorbency:

Issue	Modelling assumption for this IA
Regulatory capital and PLAC requirements: general	RFBs to meet regulatory minimum capital and PLAC requirements on a solo basis. Banks free to meet capital or PLAC requirements using higher-quality instruments if they choose (e.g. meeting total capital requirement with CET1 only; meeting PLAC requirement using regulatory capital only).
Regulatory capital requirements: RFBs	Minimum Common Equity Tier 1 (CET1): 11% RWAs *(=4.5% Basel III minimum; plus 2.5% Basel III capital conservation buffer; plus 3% Ring-Fence Buffer; plus 1% management buffer)* Minimum Tier 1: 12.5% RWAs *(=11% CET1 plus 1.5% Alternative Tier 1 (AT1) capital)* Minimum Regulatory Capital: 14.5% RWAs *(=12.5% Tier 1 plus 2% Tier 2 capital)* Minimum Tier 1 Leverage Ratio: 3% Total Exposures.
Regulatory capital requirements: non-RFBs	Minimum Common Equity Tier 1 (CET1): 10.5% RWAs *(=4.5% Basel III minimum; plus 2.5% Basel III capital conservation buffer; plus 2.5% G-SIB surcharge; plus 1% management buffer)* Minimum Tier 1: 12% RWAs *(=10.5% CET1 plus 1.5% Alternative Tier 1 (AT1) capital)* Minimum Regulatory Capital: 14% RWAs *(=12% Tier 1 plus 2% Tier 2 capital)* Minimum Tier 1 Leverage Ratio: 3% Total Exposures.
PLAC Requirement: RFBs and non-RFBs	Minimum Primary Loss-Absorbing Capacity (PLAC): 19% RWAs *(=17% regulatory minimum; plus 2% management buffer)*
Instruments Eligible to meet PLAC requirement	Regulatory Capital, plus long-term (=term greater than 1 year) senior unsecured bonds.
Group-level PLAC for UK headquartered G-SIBs	Group-level PLAC requirement to apply to all group RWAs where groups assume a 'single point of entry' (SPE) resolution strategies. Group-level PLAC requirement excludes non-EEA entities where groups assume a credible 'multiple point of entry' (MPE) resolution strategies.

Source: HM Treasury, Banking Reform, February 2013

Implementation status – Adopted, in part already effective

The Banking Reform Bill was adopted in December 2013. In a Supervisory Statement, the Bank of England stated that it expects eight enumerated large banks to fulfil a CET1 ratio of 7% already at the beginning of 2014 (the Basel III timetable does not require this until 2019).

The government says that the total capital measures (including PLAC) will obtain their final form by 2015. A draft law is currently available; however, compatibility with EU law must always be kept in mind in regard to the UK.

2.2.1.4.2 Leverage ratio

After extended domestic policy discussions, the Bank of England announced the design of the leverage ratio in the UK at the end of October 2014.[19] A three-tier system applies:

1. A minimum leverage ratio of 3% applies for all UK banks

[19] http://www.bankofengland.co.uk/financialstability/Documents/fpc/fs_lrr.pdf

2. A leverage ratio surcharge similar to that in the US (supplementary leverage ratio) applies to systemically important banks. The surcharge is 35% of the risk-weighted risk buffer and therefore is between 3.35% and 4.05% for individual institutions[20]

3. A countercyclical leverage ratio applies when the countercyclical capital buffer is activated (currently inactive, up to 2.5% of the risk-weighted requirements), which applies to all banks. This buffer also amounts to 35% of the risk-weighted requirements.

Table A Summary of FPC requests for leverage ratio direction powers and proposed application of direction powers

Component	Population of firms	Timing	Proposed calibration
Minimum leverage ratio requirement	G-SIBs and other major domestic UK banks and building societies	Immediately	3%
	All PRA-regulated banks, building societies and investment firms	From 2018, subject to a 2017 review	3%
Supplementary leverage ratio buffer	G-SIBs and other major domestic UK banks and building societies	In parallel with corresponding risk-weighted buffer, hence phased from 2016 for G-SIBs and introduced in 2019 for other major domestic UK banks and building societies	35% of the corresponding risk-weighted systemic buffer rates
Countercyclical leverage ratio buffer (CCLB)	G-SIBs and other major domestic UK banks and building societies	Immediately	35% of the risk-weighted countercyclical capital buffer rate
	All PRA-regulated banks, building societies and investment firms	From 2018, subject to a 2017 review	35% of the risk-weighted countercyclical capital buffer rate

Source: Bank of England

The leverage ratio requirements for systemically important banks therefore vary, but they certainly go beyond the international minimum standards. The requirements for systemically important banks will be within a range of 3.35% to 4.95%.

Figure 7: Examples of the components and calibration of the FPC's leverage ratio framework

Source: Bank of England

The numerator of the leverage ratio is based on the BCBS definitions. Up to 25% of the denominator of the basic requirement may consist of Tier 1 capital. The remaining 75% and 100% of all buffers must be composed of hard core capital (CET1).

[20] The exact amount of the systemic risk buffer is not yet known. The UK government has indicated, however, that this buffer will be 1-3%.

Implementation status – Adopted, already in force

The government will submit the legal foundations to Parliament. Eight major UK banks have had to fulfil a leverage ratio of 3% since the beginning of 2014 (Supervisory Statement of the Bank of England).

2.2.1.5 Switzerland

Over the course of 2012, Switzerland implemented the Basel III requirements into national law. The capital requirements for a systemically important bank are different from those for other banks. Higher loss absorbency requirements have been defined. In addition to weighted capital requirements, the prudential measures also include unweighted capital requirements. In both cases, three requirements each have to be met: the basic requirement, the capital buffer, and the progressive component. While the basic requirement and the capital buffer are fixed, the progressive component is variable. It is determined by the size and market share of a systemically important bank. These banks accordingly have incentives to reduce their size in order to be subject to lower capital requirements, all other things being equal. FINMA may also grant easements on the progressive component, provided the systemically important bank improves its recovery and resolution capacity in Switzerland and abroad with a high level of probability (see remarks under 2.4.5.1).

2.2.1.5.1 Risk-weighted capital requirements and leverage ratio

Requirement	Weighted capital requirement in % RWA	Unweighted capital requirement (leverage ratio) in % total exposure
Basic requirement	4.5%	1.04%
Capital buffer	8.5%	2.08%
Progressive component	6.0%	1.44%
TOTAL	**19.0%**	**4.56%**

A special feature of the Swiss TBTF regulation is the built-in incentive system with a variable design of the progressive component. The original calibration to 19% of the total requirement was based on market shares and the size in 2009.[21] The total requirements are therefore subject to upward and downward fluctuations. On the other hand, the total requirements may also fall below 19% if market shares and the leverage exposure are reduced, as is the case for Credit Suisse today. In its 2013 annual report, UBS wrote: "We expect our requirement for this progressive component in 2019 to fall to 4.5% from 6.0% due to our planned reduction in balance sheet size related to the accelerated implementation of our strategy announced in October 2012 and the resulting reduction in total exposure," which would result in a total capital requirement of 17.5%.[22]

The basic requirement must be met with CET1. The same is true of the capital buffer, although 35% of that buffer may consist of "high triggering CoCos". High triggering CoCos are convertible capital that is converted into hard core capital if the available hard core capital falls

[21] Balance sheet total of CHF 1,500 billion and market share of 20% in the case of systemically important functions.

[22] See also the FINMA press release of 7 May 2014 (http://www.finma.ch/e/aktuell/pages/mm-finma-informiert-ueber-tbtf-verfuegungen-20140507.aspx).

below 7% of the risk-weighted positions. In total, this amounts to loss absorbing capital of 13% (4.5%+8.5%) under the going concern assumption.

Finally, the progressive component must be held in the form of convertible capital, which is converted into equity capital at the latest when the available core capital falls below 5% of the risk-weighted positions. The capital resulting in this way should – alongside other (capital) measures – serve to make the recovery or orderly resolution of systemically important banks possible (see 2.4.5.2). The amount of the progressive component depends on the balance sheet total and market share of the systemically important functions and one half each is determined by the two components:

- Market share: If the market share of domestic systemically important business is less than 10%, no surcharge applies. For every half percentage point by which the market share exceeds 10%, the surcharge rises by 0.15 percentage points. The higher of the average market shares of domestic credit business and domestic deposit business applies.
- Size: If the total exposure is less than CHF 250 billion, no surcharge applies. For every unit of CHF 25 billion exceeding CHF 250 billion, the surcharge rises by 0.06 percentage points.

For the two big banks, a binding leverage ratio was already introduced in 2008 to supplement the risk-based capital requirement (SFBC decree). The leverage ratio requirement adopted as part of the TBTF legislation in 2012 is defined as a percentage of the risk-weighted requirements (24% of the requirement according to RWA). As is the case under Basel III, the TBTF legislation is conceived such that the leverage ratio acts not as a binding benchmark but rather as an additional safety net. Unlike under Basel III, not only a single leverage ratio is required in Switzerland, but rather numerous leverage ratios, i.e. on every capital component (basic requirement, capital buffer, and progressive component) and at every consolidation level.

Implementation status – Adopted, effective from 2013 (implementation 2013 to 2019)

All amendments to the relevant laws (Banking Act) and ordinances (Banking Ordinance, CAO) have been made, and the provisions entered into force on 1 January 2013 at the latest.

2.2.2 Liquidity

2.2.2.1 International

The Basel III framework provides that, in addition to stricter capital requirements, banks must now also fulfil internationally harmonised, quantitative liquidity requirements. The BCBS has developed two liquidity ratios. These two standards have effect for all internationally active banks. The international standard-setters do not provide any specific quantitative liquidity rules for systemically important banks.

<u>Liquidity coverage ratio (LCR)</u>

The liquidity coverage ratio (LCR) is intended to ensure that banks have sufficient first-class liquid assets to survive a 30-day liquidity stress scenario. This stress scenario is defined by the supervisory bodies. Specifically, the ratio ensures that a bank has a sufficient quantity of unencumbered first-class liquid assets (high quality liquid assets: HQLAs) that can immediately be made liquid without any difficulties on private markets. In this way, the liquidity needs can be covered in a liquidity stress scenario lasting 30 days. The LCR of Basel III refers primarily to the group level of internationally active banks.

Implementation status – Adopted, effective from 2015 (implementation 2015 to 2019)

The final version of the LCR was published by the BCBS in January 2013 and is intended to enter into force as planned on 1 January 2015. To alleviate concerns that the ongoing efforts to strengthen the banking systems might interfere with the financing of economic activities, the minimum requirement starts at 60% and is then increased by 10 percentage points each year until it reaches 100% on 1 January 2019.

Structural liquidity ratio

Supplementing the short-term orientation of the LCR, the structural liquidity ratio (net stable funding ratio; NSFR) targets the longer-term borrowed capital structure of the bank. It is intended to limit the excessive dependency of banks on short-term capital market financing, so that a sustainable maturity structure of assets and liabilities can be achieved. It covers the entire balance sheet and offers incentives to banks to identify stable sources of refinancing. According to the NSFR, the sum of liabilities weighted according to their permanent availability (actual stable refinancing) must exceed the sum of assets weighted according to their proximity to liquidity plus medium-term financing needs arising from off-balance sheet positions (required stable refinancing).

Figure 8: Liquidity standards

Stresstest-Kennziffer (bis 30 Tage)		
Liquidity Coverage Ratio =	$\frac{\text{Bestand an hochliquiden Aktiva}}{\text{Nettozahlungsabgang unter Stress}}$	**≥ 1**
Strukturkennziffer (bis 1 Jahr)		
Net Stable Funding Ratio =	$\frac{\text{Tatsächliche stabile Refinanzierung}}{\text{Erforderliche stabile Refinanzierung}}$	**> 1**
Beobachtungskennziffern („Monitoring tools")		
Ablaufbilanz, Refinanzierungskonzentrationen, Möglichkeiten zur besicherten Finanzierung		

Source: FINMA

Implementation status – Proposed

Important elements of the NSFR are still open, and implementation is only intended for 2018. The BCBS has defined the development of the NSFR as a priority in its two-year planning. The revision and verification of the stable funding ratio will probably last until mid-2016. It is thus too early for a comparison.

Transparency and disclosure

By targeting the liquidity reserve and the sustainable maturity structure, these two standards focus on two central aspects of liquidity management. The liquidity status of banks is too complex, however, to be represented sufficiently with the help of only two ratios. For this reason, the minimum standards are being flanked by several observation ratios in order to ensure additional international harmonisation and a uniform information basis for home and host country supervisory authorities in the case of institutions operating across jurisdictions.

For this reason, the quantitative requirements are supplemented by stronger disclosure obligations, which the BCBS finalised at the beginning of 2014. They are intended to ensure more transparency and market discipline. Compliance is mandatory starting 1 January 2015.

2.2.2.2 United States

The US authorities, in this case the US Federal Reserve, the FDIC, and the OCC, presented a concept proposal to implement the Basel III liquidity coverage ratio in October 2013. The proposal envisages a three-stage introduction in the United States, depending on the size of the financial institution.

For large banks with assets exceeding USD 250 billion or foreign exposure of more than USD 10 billion, the US proposal envisages certain stricter rules compared to the Basel minimum standard.[23] For banks exceeding these thresholds, the minimum liquidity requirement would be fully applicable already at the beginning of 2017. For the calculation of liquid assets, bonds issued below the national level would not be allowable, and the outflow scenarios would also be stricter. The LCR is applicable at both the consolidated level and at the individual level.

For financial institutions with assets between USD 50 billion and 250 billion, the LCR would be less strict. For institutions with less than USD 50 billion in assets, the provisions would not apply.

Implementation status – Adopted, effective from 2015 (implementation 2015 to 2017)

The proposed entry into force is on 1 January 2015 with a two-year transition period.

2.2.2.3 European Union

In the European Union, the LCR is implemented via the CRR, which was adopted in the summer of 2013. The final design of the LCR is to be set out by the European Commission only by 30 June 2014 in the form of a delegated legal act. Within the BCBS, the resistance of continental EU states to the LCR was always high, which indicates that these states will try within the EU legislative procedure to further dilute the standard. Especially the definition of HQLAs provides room for manoeuvre.

The LCR will become binding only at the beginning of 2015. Member states are free in how they approach the transition period. It is required only that a compliance level of at least 60% upon entry into force and 100% by 2018 at the latest is provided. As in the United States, the LCR must in principle be complied with at the level of individual institutions and at the group level.

Implementation status – Proposed, decision by June 2014, effective from 2015 (implementation 2015 to 2018)

The LCR will be introduced step by step as a binding minimum standard between 2015 and 2018.

2.2.2.4 United Kingdom

Since the LCR is part of the CRR, it has direct legal effect in the UK. The UK-internal liquidity regime will continue until the LCR is introduced in Europe.

The Prudential Regulation Authority (PRA) recently announced that it is easing the liquidity requirements for banks that already fulfil a minimum capital ratio of 7% CET1. This reduction happened pursuant to a proposal by the Financial Policy Committee (FPC). The hope of the FPC is that this will contribute to an economic upswing. The PRA subsequently announced that it would reduce the liquidity requirement for banks in the UK to an LCR-equivalent ratio of 80% (under the old UK liquidity standard). The LCR would then increase successively to 100% until 2018.

Implementation status

The EU will introduce the LCR at the beginning of 2015. The PRA will in due time provide information on the transition from the current liquidity regime to the new one.

2.2.2.5 Switzerland

In the wake of the UBS crisis, a specific liquidity regime was introduced in March 2010 for the two big banks as an "emergency measure" to prevent short-term liquidity shortages ("Swiss big bank regime"). This regime had the form of a bilateral agreement between FINMA and the two big banks.

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[23] Fed Governor Tarullo speaks of "super-equivalent" implementation.

These (quantitative) liquidity requirements at the time far exceeded the existing requirements for total liquidity and in some ways anticipated the ongoing work of the BCBS on the LCR. With the entry into force of the new Liquidity Ordinance at the beginning of 2013 and in mid-July 2013, these bilateral agreements between FINMA and the two big banks were integrated into the Liquidity Ordinance as Chapter 4, "Special provisions for systemically important banks".

Starting 1 January 2015, systemically important banks must fulfil both the LCR and the requirements set out in Chapter 4 of the Liquidity Ordinance for systemically important banks. In sum, the prudential TBTF measures on liquidity set out the following requirements:

TBTF requirement:		
	Swiss big bank regime[24]	since March 2010, a positive balance sheet has been required in the 7- and 30-day stress scenario
	Liquidity coverage ratio (starting at the beginning of 2015)	100%-compliant starting 1 January 2015

The Swiss big banks have to fully comply with the LCR already beginning in January 2015.[25] In its definition of HQLAs, Switzerland's provisions are slightly stricter than the current state of the BCBS discussions. Starting in 2015, the "Swiss big bank regime" and the LCR will be applied in parallel. Due to the different scenario assumptions, the LCR does not replace the Swiss big bank regime. Comparisons of the LCR requirements and the requirements of the Swiss big bank regime so far show that the latter does not necessarily entail higher requirements in all cases. A continuation of the two different approaches thus increases the probability that potential liquidity shortages will be recognised at an early stage.

During the two years following entry into effect of the LCR, FINMA will analyse the liquidity requirements under the LCR and the Swiss big bank regime in order to examine whether the latter guarantees a higher absorbing capacity in the liquidity stress test. Depending on the outcome of the analysis, a request would then be submitted to the Federal Council to adjust the Liquidity Ordinance.

Implementation status – Adopted, effective from 2015 (LCR), effective (big bank regime).

2.2.3 Risk diversification and concentration risks

Risk diversification aims to limit the consequences that a credit default might have for a bank.

2.2.3.1 International (BCBS / FSB)

The BCBS has also presented rules for reducing concentration risks, the aim of which is to limit the overall counterparty risk of a bank vis-à-vis a single counterparty and thus to prevent negative domino effects within the financial system. The rules provide that exposure must be limited to 25% of Tier 1 capital for all banks.

Due to the higher contagion risk, a limitation of exposure to 15% of Tier 1 capital applies to G-SIBs. It is recommended that domestic supervisory authorities extend this stricter standard to exposures of D-SIBs and to exposures of smaller banks vis-à-vis G-SIBs and also D-SIBs.

Implementation standard – Proposed

The definitive rules were published in April 2014. Compliance with the provisions by the banks is provided for in conformity with all other provisions of the Basel framework from the beginning of 2019.

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[24] Liquidity inflows + amount of regulatory liquidity buffer + central bank standing facilities > liquidity outflows.

[25] For all other banks, the same transitional provisions apply as under Basel III.

2.2.3.2 United States

As part of the DFA legislation, the US Federal Reserve presented rules for limiting counterparty risks. The US system provides for a tiered limitation. For relationships among "major covered companies" or foreign banks with assets exceeding USD 500 billion, a limit of 10% applies. For all others, the limit is 25%. Unlike the BCBS rules, the calculation is based on total capital and not [hard] core capital. This means the US rules are less strict than those of the BCBS.

Additionally, the US provides for a concentration limit for financial institutions. This limit prohibits the merger of institutions if together they make up more than 10% of all the obligations of financial service providers.

Implementation status – Effective

The rules on counterparty risks entered into force at the beginning of October 2013. The final rules on the concentration limit are expected in the near future.

2.2.3.3 European Union

In the CRD IV package and the Bank Recovery and Resolution Directive (BRRD), the EU also provides limits to counterparty risks. The exposure to other individual financial institutions is limited to 25% of the total capital, and the total exposure to financial institutions in general is limited to 200% of the total capital.

As part of the EU structural reform (see 2.3.3.1), it is also stipulated that the exposure of the "core group" to the ring-fenced trading entity may not exceed 25%.

Implementation status – Effective, effective from 2015

The CRD IV package was adopted in June 2013. The provisions became applicable at the beginning of 2014. The European Parliament and Council agreed on a joint proposal regarding the BRRD in December 2013. The BRRD has not yet been formally adopted. Its entry into force is scheduled for the beginning of 2015.

2.2.3.4 United Kingdom

The EU rules apply.

2.2.3.5 Switzerland

In Switzerland, credits may not exceed 25% of the bank's equity capital. In the prudential TBTF measures, this limitation is tightened in that the 25% do not refer to the total capital, but rather only to CET1.

The prudential risk diversification measures do not extend only to the TBTF institutions themselves, however. They also cover non-TBTF institutions. This is accomplished in that the maximum permissible credit amount of a bank vis-à-vis a TBTF bank is limited more strongly than vis-à-vis a non-TBTF bank. In this way, the previous concentration of interbank credits vis-à-vis TBTF banks is reduced, and diversification in the interbank lending business is promoted.

Implementation status – Effective

2.2.4 Summary of prudential measures

Strengthening the prudential requirements is a key component of the TBTF measures in all jurisdictions. The purpose is to strengthen the crisis resistance of banks and thus of the financial system as a whole. Some of the individual requirements differ considerably depending on the institution. Most measures have already been adopted, but they will enter into effect only in one or two years and will also be introduced in stages over a longer time period.

2.2.4.1 Capital

What is common to all the analysed countries is that they comply with the minimum requirements of Basel III and the FSB in regard to the surcharge for systemic importance. The EU is the only jurisdiction that has not yet planned a binding introduction of the Basel III leverage ratio. Otherwise, there is no jurisdiction lagging behind the international minimum standard. Rather, several jurisdictions have in fact decided to go beyond the international minimum. In terms of the risk-weighted ratio, Switzerland, the Scandinavian countries, and the United Kingdom are at the forefront. *In terms of the leverage ratio, it is foreseeable that the United States will be the strictest for G-SIBs. However, the precise rules for the planned leverage surcharge have not yet been defined.*

The binding minimum framework in the European Union is congruent with the international minimum, but the EU is granting its member states a certain leeway to introduce higher requirements that take account of national circumstances. As mentioned, this does not yet apply to the leverage ratio.

Compared with the international rules, the United Kingdom in particular requires a substantial surcharge in regard to hard core capital for entities that include systemically important functions. Also, it is the only country so far to have defined quantitative requirements governing total loss absorbing capacity (including bail-in liabilities in the event of insolvency) in its draft legislation. Also in terms of the timetable, the United Kingdom is acting very quickly (at least in areas not governed by the EU timetable).

For its risk-weighted requirements, the United States is adopting the international requirements, but it is going beyond the Basel III rules for systemically important banks for the leverage ratio. The US is also requiring major foreign banks to consolidate their US business in an intermediary holding. This intermediary holding is subject to the same prudential requirements in the US as domestic financial institutions.

In terms of its capital requirements, Switzerland also exceeds the international standards; its risk-weighted ratio is even the strictest internationally. In terms of hard core capital, however, Sweden for instance goes farther, and the UK is at the same level as Switzerland. In the US, the risk-weighted ratios are also planned to exceed the international standard. What is unique about the Swiss rules is that there is no ceiling for the total requirement. The difference arises from the progressive capital component of the Swiss TBTF regulation, which is automatically adjusted upward (downward) as the market share and leverage exposure rise (fall). Conversely, the Swiss TBTF regulation provides incentives to reduce market shares and leverage exposure, since this also automatically reduces the total requirements. Accordingly, comparability is only meaningful at a given cut-off date. Also in terms of the leverage ratio, Switzerland exceeds the international minimum, although it lags behind the rules in the US and the UK. It must also be taken into account that the TBTF leverage ratio is coupled directly to the amount of the risk-weighted requirements and therefore is also subject to fluctuations.

The implementation speed of the capital measures varies considerably. While some jurisdictions are taking full advantage of the leeway afforded by the Basel III transitional period (EU), others are moving faster (UK). Switzerland is the only country to have already adopted all final measures.

2.2.4.2 Liquidity

All peer jurisdictions are following the Basel III LCR concept. However, certain differences exist in regard to scheduling. For the systemically important banks in Switzerland, a compliance level of at least 100% is already effective starting in 2015, while this compliance level has to be achieved in the US only starting in 2017 and in the EU and the UK only starting in 2018.

Implementation of the minimum liquidity ratio has been decided already, with the exception of the EU. For large financial institutions, Switzerland and the US are pursuing slightly stricter requirements than the international minimum. Another special feature in Switzerland is the continuation of a parallel regime for the big banks for a period of at least two years.

2.2.4.3 Risk diversification

The design of the concentration risk requirements is similar internationally; differences emerge in regard to the calculation method and the definition of allowable capital. An international minimum standard is currently under development. The US has already adopted stricter requirements for systemically important banks.

2.2.4.4 Conclusion

The comparison of the international variations on the prudential measures also illustrates the different priorities in TBTF regulation in the examined jurisdictions. When addressing TBTF, Switzerland is focusing on capital requirements, and hence the Swiss minimum requirements in some respects go beyond the international standards as well as the requirements in other jurisdictions. By comparison, the corresponding requirements in the EU are not as strongly developed, which is one of the explanations for the greater focus on organisational measures, as will be discussed in more detail immediately below.

2.3 Organisational[26] measures

The experiences from the most recent crisis have revived the discussions about regulatory requirements governing the organisational and legal structure of banks as measures to weaken systemic risks. Organisational measures are in general considered to supplement the traditional prudential regulations that were strengthened in the wake of the recent financial crisis. In this respect, the goals of structural measures are possibly also complementary to those of the increased requirements governing capital, liquidity, and financing as well as crisis management and resolution. The organisational measures aim, firstly, to limit the contagion risk among different areas within the same bank. This is generally accompanied by the prohibition or outsourcing of certain activities that are deemed especially high-risk. Secondly, organisational measures aim to achieve a financial and organisational disentanglement within a banking group in order to improve the resolution capacity of an institution, so that a rapid separation of systemically important services is possible in the event of a crisis.

A line separating different banking services is in principle intended to reduce the risk of contagion. In daily business, however, artificial dividing lines also increase the volatility and restrictions of free flows of capital and liquidity and increase the vulnerability of the individual parts of a banking group. The proposals to separate banking functions in various countries distinguish services involving risks that are not easily calculable from services that are central to the functioning of a national economy. The latter are especially worthy of protection. They include deposit banking and payment systems. Determining and demarcating high-risk activities is much more difficult, however. Proprietary trading activities are certainly included, although a demarcation from market making[27] is already difficult. Accordingly, not all jurisdictions make this distinction, as discussed in more detail below. Moreover, the dividing line can also be drawn in different places.[28]

A dividing line may be strict, so that the services to be separated cannot even be offered within the same banking group. This is referred to as a separation of ownership. Often, however, no absolute separation is required. It suffices when systemically important and high-risk services are organised into separate entities, but within the same group. This organisational and legal

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26 With a view to the "further development" of the Swiss TBTF concept, the term "organisational measures" is used here. This term in particular also includes structural measures.

27 Market making refers to ensuring the tradability of securities through continuous quoting of buy and sell prices, thus evening out the temporary imbalances between supply and demand in less liquid securities.

28 "A fence to protect the deer from the lions is the same as a fence to keep the lions away from the deer." (John Vickers).

separation is intended to facilitate a rapid detachment of the systemically important services in the event of a crisis. For this reason, these units must also be endowed with sufficient capital and liquidity as well as support functions such as IT and HR so that services can be offered without interruption ("self-sufficiency"). With a separate financing of the different areas, an undesirable cross-subsidisation of the individual areas and accordingly of excessive risk assumption can also be prevented.

2.3.1 International (BCBS / FSB)

The FSB framework recognises that organisational measures may reduce the risks of systemically important financial institutions. Both the fact that structural measures can limit high-risk behaviour and also the contribution to improving resolution capacity are seen as positive points. However, the FSB also warns of the negative consequences for global and regional financial markets due to diverging national structural measures. Careful attention must also be paid to cross-jurisdictional consequences.

Because of a lack of international consensus within the G20, there are accordingly no recommendations or international minimum standards regarding organisational measures that might serve as guidelines for national implementation. The individual national measures are accordingly designed in different ways.

2.3.2 United States

The US authorities are using two different organisational concepts to try to reduce the risks in the financial system and improve financial stability. One measure introduces a prohibition of proprietary trading and other high-risk activities for banks, while a second measure aims at the corporate structure of foreign banks in the US.

2.3.2.1 Volcker Rule

The Volcker Rule prohibits US banks from engaging in proprietary trading and other high-risk activities. The Volcker Rule is part of the Dodd-Frank Act (DFA). It took several years until the five involved authorities[29] were able to agree on implementing rules, which cover more than 1,000 pages. The Volcker Rule applies to all banks, not only systemically important banks.

Simply put, the Volcker Rule prohibits deposit-financed, licensed commercial banks or bank holding companies with US branch companies or subsidiaries from engaging in proprietary trading or investing in or sponsoring hedge funds and private equity funds (less than 3% of core capital is allowed). The Volcker Rule thus provides for a complete separation of ownership. The proprietary trading business (with the following exceptions) and the deposit business may not be part of the same holding company. Other trading activities are not affected by the prohibition, however.

Proprietary trading encompasses any purchase or sale of securities, derivatives, or forward transactions as well as options on such transactions. The Volcker Rule does, however, provide numerous exceptions to the prohibition, for instance on i) eligible securities (US government, agency, state, and municipal obligations), ii) foreign government bonds (to a limited extent), iii) transactions in connection with the assumption of securities issuance for clients (underwriting), iv) market making activities for clients, v) hedging, vi) transactions on behalf of clients or in connection with the securitisation/sale of loans, and vii) proprietary trading carried out by non-US branches or subsidiaries. There are also numerous exceptions to the prohibition governing hedge funds and private equity funds, for instance in regard to underwriting and market making.

Overall, the Volcker Rule is thus significantly less restrictive than the old Glass-Steagall Act, which from 1933 to 1999 required an institutional separation between deposits and lending on the one side and securities transactions on the other side for certain banks in the United States.

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[29] FRB, CFTC, FDIC, OCC and SEC.

Implementation status – Adopted, effective from 2015

The final rules were published by the authorities in December 2013 and entered into effect on 1 April 2014. The implementation period runs until 15 July 2015, one year longer than provided by the DFA. Banks are required to institute a compliance programme that corresponds to their activities in these areas and to submit numbers reports to the supervisory authorities.

2.3.2.2 Organisational measures for foreign banks

As the second organisational measure, the US Federal Reserve issued rules on stronger regulatory and supervisory standards for foreign banks with US business (see also 2.2.1.2). According to these rules, foreign banks with a US balance sheet total of more than USD 50 billion must bundle their US business in an intermediate holding company (IHC). According to the US Federal Reserve, 15 to 20 foreign banks are thus being treated the same as US big banks. This intermediate holding company must then – just like a regulated US big bank – meet the relevant capital and liquidity requirements, undertake stress tests, and fulfil other prudential requirements.

This requirement was included by the Federal Reserve and was not provided as such in the DFA. The requirements must be seen against the backdrop that in the recent financial crisis, many foreign banks received substantial public support in the United States. These measures are intended to facilitate consistent and stronger supervision and regulation of the activities of the foreign banks in the United States, in order to increase financial stability in the US on the whole. Concerns of foreign countries and banks were largely not taken into account.

Implementation status – Adopted, effective from 2016

The US Federal Reserve presented the final rules in February 2014. The affected foreign banks have time until July 2016 to implement the requirements. Moreover, the largest foreign banks will have to comply with certain debt limits (leverage ratio) only starting in January 2018.

2.3.3 European Union

The European Union appointed an expert group (named after its chairman, Erkki Liikanen) to examine whether structural reforms were urgent in the wake of the financial crisis and to supplement regulation that had already been initiated. The expert group published its report in October 2012. In this report, the expert group proposes an outsourcing of proprietary trading and other significant trading activities for big banks. Both parts must be legally separate and individually financed and capitalised but – unlike the Volcker Rule – they may remain part of the same holding company.

2.3.3.1 European Commission proposal on structural reform

Based on the recommendations of the Liikanen Group, the European Commission published a draft regulation on structural measures in the EU banking sector at the beginning of 2014. The proposal encompasses two core elements:

1. The prohibition of proprietary trading in financial instruments and goods for the group or individual entities of the group. Proprietary trading in this context is defined narrowly as trading on the bank's own account for the exclusive purpose of making a profit for the bank without any connection to a client's activities or to hedging of corporate risks. Affected institutions are also prohibited from making investments in most types of hedge funds with the exclusive goal of making a profit for their own account. The Commission observes that European banks are currently engaged in only few activities that fall within the scope of such a prohibition. However, it fears that these business activities might rise again to the level before the crisis, as soon as the environment improves. The Commission also recognises the problems involved in demarcating proprietary trading and market making and it therefore relies on a narrow definition of proprietary trading. Trading with bonds of EU governments is explicitly not covered.

2. The power and in certain cases the obligation of the supervisory authorities to shift the transfer of other specified trading activities such as market making, trading in complex derivatives, and securitisation to separate trading companies within the group. The banks do not have to separate out their activities if they are able to demonstrate credibly to their supervisory authorities that the risks in question can be reduced in other ways. Institutions accepting deposits may consequently carry out these trading activities within the same legal entity only if the supervisory authority does not decide that the activities must be outsourced to a separate entity. This "trading entity" is subject to certain restrictions. It is not allowed to accept deposits that are covered by deposit guarantees, and it may not offer payment transaction services to retail clients. Supervisory authorities must coordinate with resolution authorities, since the BRRD also provides that resolution authorities may order structural changes (of a legal and organisational nature) if there are obstacles to effective resolution.

This proposal mainly provides a minimum common framework; the individual member states are free to take more far-reaching measures. A separation of other high-risk activities in addition to the narrow prohibition of proprietary trading is left to the decision of the domestic supervisory authorities.

The new rules apply only to big banks, namely European G-SIBs (according to the FSB) and banks reporting total assets of more than EUR 30 billion three years in a row and whose trading activities and liabilities exceed EUR 70 billion or 10% of their total assets. The foreign subsidiaries and branch companies of EU banks in third countries as well as subsidiaries and branch companies of foreign banks in the EU also fall within the scope of the rules, provided that these thresholds are exceeded. Exceptions are possible if equivalent structural measures apply in other countries.

The provisions do not apply to member states which, at the time of the decision (January 2014), already have legislation that provides for a similar separation. Germany, France, Belgium, and the UK might be able to avail themselves of this exception clause.

Implementation status – Proposed, planned implementation from 2017 and 2018

This is a proposal by the European Commission which must be confirmed in the trilogue procedure by the Parliament and the Council of Ministers as well. The timetable envisages adoption by mid-2015 at the latest. The draft provides that the prohibition of proprietary trading will take effect at the beginning of 2017 and the requirements to separate trading activities in mid-2018.

2.3.3.2 Germany and France

Within the EU, Germany and France were the strongest advocates of rules on organisational measures. Already before the European Commission, they adopted legislation to this effect.

<u>Germany</u>

Based on the Liikanen recommendations, a draft Act on Ring-fencing and Recovery and Resolution Planning for Credit Institutions and Financial Groups was presented in Germany in February 2013. The ring-fencing of high-risk business from business with clients is intended to secure client business. Big banks are required to separate trading and client business functionally. In the event of a crisis, this facilitates the detachment and resolution of trading business that is not related to clients. The legislation thus simultaneously pursues the goals of reducing the risk of contagion through high-risk business and to make provisions for the event of a crisis.

Deposit-taking banks and groups to which deposit-taking banks belong may no longer simultaneously engage in deposit business and proprietary business, i.e. the acquisition or sale of financial instruments on their own account within the same entity. They must instead outsource proprietary trading to a legally, economically, and organisationally autonomous company. Loans and guarantees for hedge funds and comparable companies with high levels of borrowed capital may now only be granted by the autonomous company engaging in proprietary trading. Based on the recommendations of the Liikanen expert group, the rules apply only if the trading activities of the institution exceed 20% of the balance sheet total or EUR 100 billion.

Deposit-taking institutions, however, are still allowed to engage in proprietary trading relating to clients, i.e. the acquisition and sale of financial instruments on their own account as a service for others. This includes market making. To make allowances for special cases, however, the Federal Financial Supervisory Authority is authorised in individual cases to demand separation of market making activities as well.

Implementation status – Adopted, effective from 2015

The decision on the Ring-fencing Act was taken in August 2013. Most of the decision entered into effect at the beginning of 2014. The prohibitions apply from 1 July 2015.

France

In France, a new law aims to protect banking clients better, to limit speculation, and to strengthen financing for the real economy. In regard to organisational measures, the law requires the outsourcing of speculative activities (proprietary trading, credit business with hedge funds) into separate entities (certain exceptions apply e.g. for market making) as well as an increase in equity capital by 2015. The separate entity is not allowed to accept client deposits. The size of the entity is limited in relation to the overall financial group, and the group must comply with risk limits vis-à-vis the risky entity.

France is also introducing a prohibition of highly speculative activities, including especially fast transactions in high-frequency trading and the trade in derivatives based on agricultural products.

Implementation status – Adopted, effective from 2015

The Law on the Separation and Regulation of Banking Activities entered into force in July 2013. The law will become effective from 2015.

2.3.4 United Kingdom

In the UK, an Independent Commission on Banking (ICB) published recommendations in September 2011 on the structure of the UK banking system; these recommendations were implemented in the Financial Services (Banking Reform) Act in December 2013. As a key element, the legislation requires the creation of a separate entity within the corporate group, consolidating the services that are worthy of protection for the benefit of the national economy. As described above (2.1.4), this entity is subject to higher capital requirements.

The term "ring-fence" refers to the protection of key banking services which, in the event of a temporary interruption, would have a significant direct impact on the UK economy, especially private households and small and medium enterprises. "Key banking services" refers specifically to the acceptance of deposits and the execution of payments from bank accounts. These activities must be consolidated within a special entity. The ring-fencing rule does not apply, however, to the deposits of large companies (turnover exceeding GBP 6.5 million), wealthy private individuals, and non-EEA institutions and non-EEA countries (UK mandatory, EEA countries voluntary). The provisions are addressed to banks and banking groups domiciled in the United Kingdom. There is a de minimis exception: Banks with ring-fence deposits of less than GBP 25 billion are not subject to the ring-fence rules. The ring-fence requirement is intended to apply only to large banks, thus avoiding market entry barriers and excessive costs for small institutions.

The ring-fenced entity is prohibited from engaging in certain activities. In principle, no investments in proprietary trading and other investment banking activities may be undertaken ("dealing in investments as principal"). This includes lending to financial institutions. HM

Treasury also stipulated in a supplement that trading in physical commodities is likewise prohibited. The following are exempted from these restrictions, however: i) simple derivatives for clients (forward transactions, futures, and swaps limited to currencies, interest, or raw materials), ii) securitisation of own shares, iii) debt/equity swaps, and iv) hedging of own risks.

Implementation status – Adopted, effective from 2019

The law was adopted in December 2013. The government has announced implementing provisions by 2015. Implementation of these steps is envisaged by 2019.

2.3.5 Switzerland

Emergency planning, stabilisation, and resolution play an important role in Switzerland as part of the framework to strengthen the stability of the financial sector. These measures provide certain requirements relating to the organisational structure of the bank. The TBTF legislation, on the other hand, does not contain specific requirements on group structure or organisation. According to the principle of subsidiarity, the TBTF legislation stipulates the goal that an emergency plan must be used to ensure continuation of systemically important functions. But design and implementation fall within the responsibility of the bank in question. Only if the goal is not achieved can FINMA set out specific requirements that may also include a change to the group structure or organisation. Switzerland deliberately refrains from direct intervention in the corporate structure and business models of the banks concerned.

Switzerland's requirements therefore focus strongly on improving the resolution capacity of a TBTF institution and refrain from specific organisational requirements or business prohibitions. In Switzerland, the organisational measures stand in a clear relationship to the plans for the crisis management and resolution of systemically important banks (see also 2.4.5.1).

2.3.5.1 Emergency planning

Article 9(2d) of the Banking Act provides that a systemically important bank must provide *emergency planning with regard to structure, infrastructure, management and control as well as group-internal liquidity and capital flows* in such a way that the emergency plan can be implemented immediately and, in the event of the threat of insolvency, the continuation of its systemically important functions is safeguarded. The *emergency planning* required by the Banking Act is further specified in Articles 21 to 21c of the Banking Ordinance. The systemically important bank must accordingly ensure that its systemically important functions as referred to in Article 8 of the Banking Act can be continued in the event of the threat of insolvency *independently of the other parts of the bank* and without interruption. To the extent necessary for the uninterrupted continuation of the systemically important functions, the measures of the emergency plan must be *implemented on a preparatory basis*.

According to the Commentary on Amendment of the Banking Ordinance and the Capital Adequacy Ordinance,[30] the bank essentially has the choice among three options: Firstly, it may establish an autonomous, functional legal entity domiciled in Switzerland with a licence to operate banking activities, to which the systemically important functions are transferred in the event of the threat of insolvency. Secondly, it may consolidate the systemically important functions already in advance, i.e. as part of its existing business model, within a legal entity domiciled in Switzerland. The advantage of this is that the systemically important functions have already proven themselves in daily business and there is accordingly certainty that they will continue to function when necessary. Finally, the bank may conclude bankruptcy-resistant agreements with a third party, according to which it will transfer the systemically important functions to that third party in the event of the threat of insolvency.

[30] Commentary on Amendment of the Banking Ordinance and the Capital Adequacy Ordinance – Implementation of Amendment of the Banking Act of 30 September 2011 (strengthening of stability in the financial sector; too big to fail), of 20 June 2012.

If the emergency plan does not fulfil the requirements showing that the systemically important functions can be continued in the event of a threat of insolvency, FINMA may – after setting a deadline twice and determining the deficiencies – demand a *legal entity for the systemically important functions in Switzerland* or the *adjustment of the legal and operational structure* to make outsourcing of these functions possible in a short period of time. The supervisory authority therefore intervenes only on a subsidiary basis in regard to the organisational and structural measures required by law in Switzerland. By refraining from pre-defined, structural requirements, the Swiss model ensures more flexibility compared with the other international approaches and can be tailored to the different business models of the systemically important banks. Both UBS and CS have announced that they will outsource the functions deemed systemically important in Switzerland to an autonomous legal entity.

The Swiss approach also provides a strong incentive for banks to further adjust their organisational structure. If the measures of the bank are very likely to improve their recovery and resolution capacity beyond the legally required emergency plan (see also 2.4.5.1), FINMA may grant easements of the progressive capital adequacy components. If a bank therefore exceeds the minimum organisational requirements applicable to it, this is rewarded with easements in regard to the capital adequacy requirements. The granting of these rebates is, however, subject to strict requirements, which ensures an appropriate level of capital adequacy.

This approach has no equal internationally, but it is interesting in that, to a certain extent, it permits the exchangeability of organisational adjustments by the bank and the special capital adequacy requirements. The logic of this is that the remaining risk for the state can be reduced by both kinds of measures. Additional capital adequacy reduces the probability of insolvency, while structural measures reduce their impact. So if appropriate organisational measures are met, the justification for the capital surcharge is lost to some extent. This genuinely Swiss solution therefore facilitates an overall solution that is well-balanced at all times.

2.3.6 Summary of organisational measures

As a lesson of the crisis, the United States, the United Kingdom, Germany, France, and in future possibly the European Union are demanding organisational measures from the systemically important banks in one form or another. Internationally, however, no overarching international standard recognised by the G20 has emerged so far, in contrast to the prudential measures and the subsequent measures in the event of a crisis. Consequently, there is no anchor for a comparative analysis of the various measures. The individual measures indeed differ considerably, and they are difficult to categorise.

The US and to a lesser extent the rules proposed by the European Commission demand an ownership separation of proprietary trading and other high-risk business. It is not possible for a bank to engage in both deposit business and proprietary trading. In the UK, however, this continues to be possible – until the possible entry into effect of EU rules – because while such a prohibition applies to the ring-fenced entity, it does not apply to the bank's trading entity.

The definitions of what is permissible also vary considerably, and many exceptions apply. In the United States, for instance, market making is excluded from the prohibition. Under the EU proposal, the permissible activities are largely at the discretion of the respective supervisory authorities. What both have in common is that bond issues of the respective states are not subject to the prohibition.

The structural measures in the US apply to all banks regardless of their size and risk profile. In the European Union and the United Kingdom, only larger institutions are affected. In Switzerland, the organisational measures only affect the banks classified as systemically important.

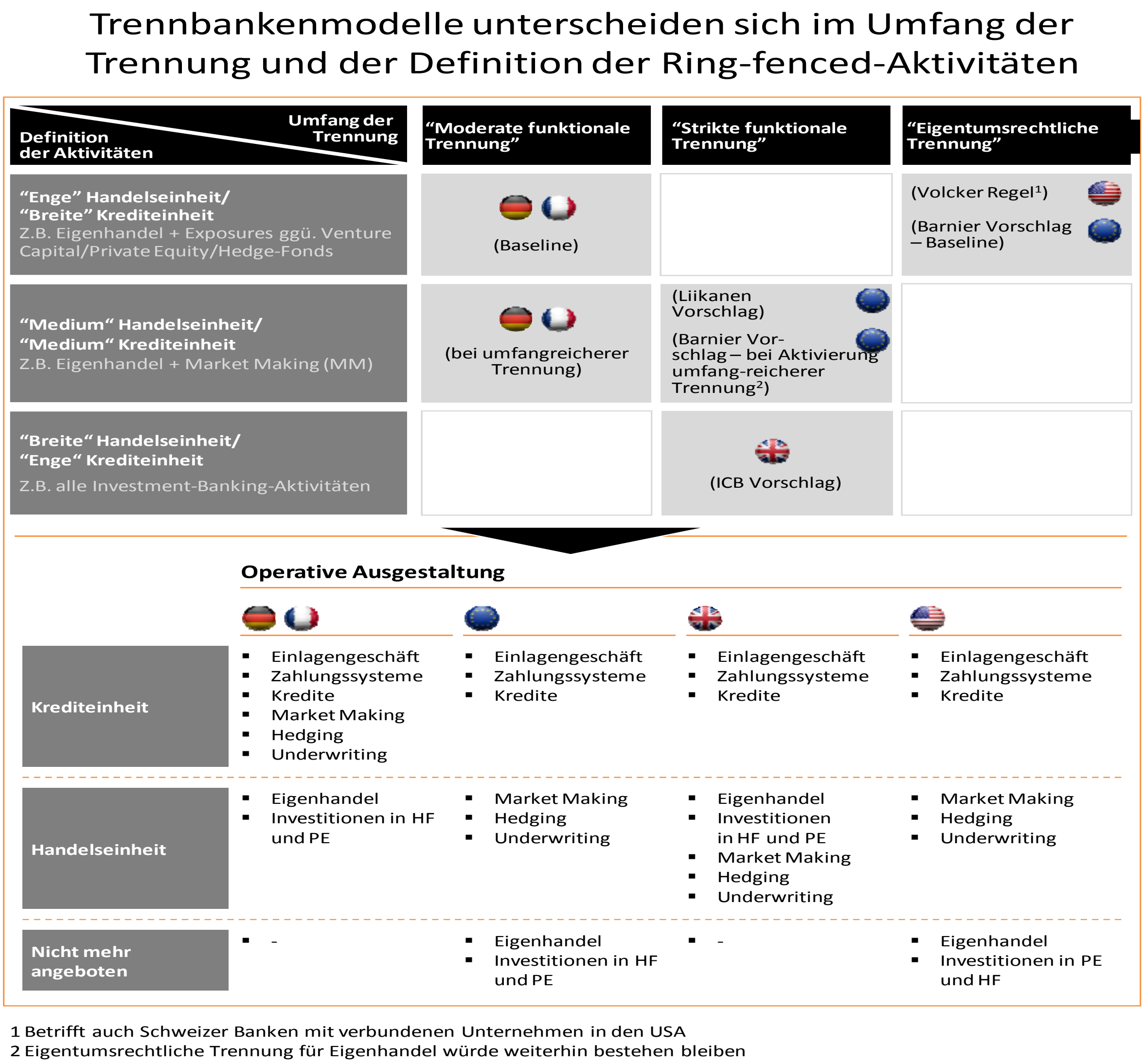
While the EU and the US prohibit proprietary trading as an especially risky activity, the UK in contrast defines the services especially worthy of protection and requires outsourcing of these functions within the group. The definition here thus does not focus on the high-risk activities, but rather on the functions to be protected. There is also no complete separation of the two areas. Both parts of the banks have different capital requirements, however. This functional separation of the systemically important functions also facilitates their survival in the event of a crisis. The Volcker Rule in the US, in contrast, aims solely to curtail risks of contagion within a group. It does nothing to improve recovery and resolution capacity, because it does not make any demands on the financial or operational disentanglement of the bank. Unlike the US, the UK does not try to draw a dividing line between the different types of trading.

The overarching goal of the organisational measures under the Swiss rules is to continue systemically important functions and to improve resolution capacity. Other countries also draw attention to the usefulness of these measures for those purposes (for instance ring-fencing in the UK), but the connection is not as strong. Unlike the Volcker Rule and the European Commission proposal, the Swiss model does not focus on the separation of proprietary trading and high-risk activities, however.

A special feature in Switzerland is the principle of subsidiarity. After the SNB defines the systemic importance of a banking institution, the bank has the possibility of developing the required plans itself. The bank can assess in this regard to what extent measures appear necessary with respect to the organisational structure and to what extent they should already be implemented on a preparatory basis or only as the need arises. FINMA reviews these plans and would intervene only if the bank does not remedy defects itself. The legislative provisions therefore define the goal, but not the concrete implementation. Every systemically important institution can choose the system suited to it. Since there are only few SIBs in Switzerland and they are also very different in nature (UBS, CS, ZKB and since June 2014 also the Raiffeisen Group), this approach does indeed make sense.

Figure 9 is a graphical representation of the different approaches in connection with the banking systems with separated functions and their different designs with regard to the affected activities and the extent to which the activities must be separated. The Swiss TBTF regime deliberately refrains from strict organisational requirements and prohibitions. The continuation of the systemically important functions must, however, be ensured by way of an emergency plan. This makes certain organisational changes necessary.

Figure 9:



Source: Credit Suisse

2.4 Measures for a crisis scenario

One of the key lessons of the financial crisis is that appropriate instruments have to be developed to either restructure or wind up financial institutions in an orderly way, particularly systemically important banks and bank groups. A credible threat of bankruptcy is the best way to ensure normal market mechanisms and mastery of the range of problems posed by TBTF.

Given that the orderly market exit of a large and heavily interconnected bank is only manageable with the tools of conventional insolvency law in exceptional situations, there have been intensive efforts at both national and international level to improve the insolvency toolkit. In the meantime, following implementation of the agreed prudential measures, the creation and implementation of international regulations to resolve insolvent financial institutions has become the key topic on the international regulatory agenda in the area of systemic risks.

2.4.1 International (BCBS / FSB)

2.4.1.1 Basis: Key Attributes

The FSB has drawn up a new international standard for resolution regimes with the objective of allowing failed financial institutions to exit the market without threatening system stability or falling back on the support of state funds, namely the "Key Attributes of Effective Resolution Regimes for Financial Institutions" (Key Attributes).[31] The G-20 have adopted the Key Attributes as an international standard.[32]

The Key Attributes determine for the first time at a global level the key characteristics of national resolution systems. Among other things, the Key Attributes contain guidelines on the general legal framework for the restructuring and resolution of G-SIBs, the powers of national resolution authorities and their cross-border cooperation, the approach to be taken with respect to settlement agreements, and treatment of the claims of creditors. The Key Attributes also contain a number of instruments aimed at ensuring the orderly resolution of systemically important financial institutions without the need to draw on taxpayers' money. Specifically listed in this respect are the bail-in instrument, the bridge bank, and the asset transfer. Four elements are specifically tailored to systemically important banks:

1. *Establishment of Crisis Management Groups (CMGs*): The idea behind CMGs is to establish a mechanism for the exchange of information, cooperation, and coordination between the relevant "home" supervisory authorities and "host" supervisory authorities. Arrangements of this kind facilitate crisis preparation and management, right up to the orderly and coordinated resolution of a financial institution.
2. *Conclusion of institute-specific cooperation agreements:* These agreements support the work of CMGs by setting up the procedures and processes for the orderly resolution of an institution between home and host supervisory authorities. They likewise define the various task areas of the authorities both in the pre-crisis stage and during the crisis itself. Of particular importance is the coordination of the relevant resolution strategies.
3. *Development of recovery and resolution plans (RRPs)*[33]*:* The recovery plan should be elaborated by the bank, setting out the measures through which the financial stability and survival of an institution would be guaranteed under difficult circumstances. The recovery and resolution plan should be drawn up by the authorities. This sets out the measures through which the systemically important functions are to be continued without systemic turbulence or losses of taxpayers' money, and how the orderly resolution of the other functions will occur if need be.
4. *Evaluation of resolvability:* The implementation of resolution strategies is reviewed. This evaluation is designed to flag up any potential gaps in the measures and enable them to be closed.

Implementation status – agreed, to apply from 2015

The FSB is calling on member states to ensure that its Key Attributes are fully implemented by 2015. Numerous countries have already taken steps to incorporate the requirements of the

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[31] The Key Attributes standard is to apply to all types of financial institutions whose default could prove systemically important, i.e. not just banks, but also insurance companies, organisations forming part of the financial market infrastructure, and investment companies (global systemically important financial institutions: G-SIFIs). The paragraphs below focus solely on the banking sector, however.

[32] Critics argue that a single global standard for insolvency law with respect to banks would be a better way forward. However, such a standard could not be achieved within a reasonable period of time, if indeed it all.

[33] Resolution measures also include measures that kick in after the "point of non-viability" is reached, e.g. including resolutions involving capital restructuring and/or the winding-up of a bank. By contrast, recovery focuses on a situation in which the survival of the institution is not yet acutely threatened, but can be secured with the assistance of stabilisation measures (capital raising, sale of business areas, etc.).

Key Attributes into national legislation. The methodology for evaluating[34] compliance with the Key Attributes is currently being finalised. It may well prove to be the case that certain minor adjustments to the Key Attributes will be made. In the medium term, the IMF and the World Bank will review implementation of the Key Attributes at national level as part of their Financial Sector Assessment Programs (FSAPs).

2.4.1.2 Recovery and resolution planning

Recovery and resolution planning is a key component of international regulatory plans. The key attributes envisage recovery and resolution plans (RRPs) being drawn up for global systemically important financial institutions at the very least.

Recovery planning

Global and national systemically important credit institutions are obliged under the Key Attributes to draw up recovery plans. The idea is that these should help institutions prepare for the event of serious financial turbulence. Every institution should consider at an early stage what measures – including from an organisational and business policy perspective – should be taken in order to enable a crisis to be overcome as rapidly and effectively as possible, and without external assistance. An institution should also describe scenario-related action alternatives to which executive management can resort in extremely adverse situations, in order to stabilise the commercial situation and thereby ensure that the credit institution is able to survive.

Responsibility for the recovery plan lies with the financial institution itself. The FSB has called for supervisory authorities to evaluate the recovery plan as part of the normal oversight process, and to review its credibility and implementability.

Resolution planning

Resolution plans represent measures on the part of the supervisory authorities to facilitate an orderly winding-up of an institution without this resulting in any systemic consequences or loss of taxpayers' money. The focus here is on the continuation of systemically important services. Resolution plans must be drawn up by home supervisory authorities with the involvement of the CMG. Resolution plans are reviewed at least once a year and adjusted where necessary.

The elaboration of a recovery and winding-up strategy should form part of resolution plans. The envisaged strategy should be described in rough terms. In the context of a bail-in, i.e. the recapitalisation and stabilisation of the bank, the FSB essentially envisages two strategies: On the one hand the so-called single point of entry (SPE) approach, which involves the home supervisory authority taking responsibility for the resolution of the bank, and on the other the so-called multiple point of entry (MPE) strategy, whereby instead of the group being restructured or wound up in its totality by the home supervisory authority, local supervisory authorities take responsibility for the specific situation of its individual entities. This latter approach requires the corresponding decentralised group structure. Under both approaches, the bail-in would create the necessary capital to allow the restructuring of the bank's business model and a continuation of the bank either as a whole or in parts.

A prerequisite for the success of an SPE strategy is for sufficient capital to be available to absorb losses at the highest possible level of the group hierarchy. This can be drawn on to cover losses in subsidiary companies and thereby guarantee the continuation of the group as a whole. In addition, the home supervisory authority must have power of disposal over the financial resources in question.

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[34] Switzerland voluntarily signed up to a pilot project in the second half of 2013. This flagged up certain gaps in Swiss legislation.

2.4.1.3 Other key initiatives

The measures to facilitate an orderly insolvency have not yet been laid down definitively. The FSB has defined other key initiatives that are likely to result in international minimum standards in the future, or will at least have to be taken into account by the home supervisory authorities of G-SIFIs.

Effectiveness of resolution instruments in the cross-border context: Cross-border cooperation and the reciprocal recognition of insolvency measures need to be improved.

Loss-absorbing capacity: on November 10, 2014, the FSB released a proposal (for public consultation) to improve the "total loss-absorbing capacity" (TLAC) of global systemically important banks in the event of a resolution case. The new requirement is designed to ensure that sufficient loss-absorbing capital is available in the event of a crisis to stabilise or resolve of the bank without recourse to public funds being needed. It therefore supplements the existing Basel III regime and the capital surcharges approved by the FSB for G-SIBs. The TLAC requirement should eventually apply to all G-SIBs, although G-SIBs from emerging markets are exempted for the time being. On the basis of the findings from the consultation and a study on the anticipated repercussions, the TLAC standard should be finalised and approved by the time of the G-20 summit at the end of 2015. The point at which the TLAC requirement will enter into force has yet to be established, but the earliest possible date is January 1, 2019.

The FSB's proposal contains both qualitative and quantitative TLAC minimum standards. With respect to *quantit*y, a TLAC minimum requirement that has to be permanently adhered to (Pillar 1) is to apply, which will be defined with respect to both risk-weighted assets (RWA) and the leverage ratio. The RWA minimum requirement will amount to between 16 and 20% of RWA, whereby the precise figure has yet to be established. The TLAC leverage ratio will amount to twice the Tier 1 leverage ratio as per Basel III, which would currently equate to a TLAC leverage ratio of 6%. In addition to the minimum requirement, institution-specific TLAC requirements (Pillar 2) are envisaged, which will be laid down in consultation with the Crisis Management Groups. The TLAC requirement must be fulfilled in parallel with the Basel III minimum requirements. Part of the TLAC requirement may be fulfilled with capital that is held to comply with the Basel III minimum requirements. However, capital held to comply with the Basel III capital buffer (or the capital surcharges that apply to G-SIBs) is not eligible as TLAC, and must be held additionally, as these capital buffers may only be temporarily undershot in the event of losses.

With respect to *quality*, capital held as TLAC – insofar as this does not already comprise equity capital – must be capable of being written off or converted into equity capital in the event of resolution, with the fewest legal risks possible and with minimal repercussions for financial stability. In short, TLAC capital must meet bail-in criteria. TLAC requirements therefore exclude many liabilities such as insured deposits and liabilities that may be called at any time, and make requirements of other liabilities eligible for consideration. These liabilities must (among other things) be unsecured, subordinate to excluded liabilities in the event of insolvency, and have a residual maturity of at least one year. An example of an instrument that is particularly suitable as TLAC capital is therefore contingent convertible bonds (CoCos). Equity capital is likewise eligible as TLAC, but at least one third of the TLAC minimum requirement must be fulfilled in the form of debt capital. Debt capital is prioritised because it is less likely to be eroded by losses prior to the point of resolution.

Improvement of resolvability through simpler group structures: Where the implementation of an effective single point of entry (SPE) or multiple point of entry (MPE) resolution plan is concerned, the FSB calls on supervisory authorities to hold dialogues with their supervised entities on the latter's corporate structures. The FSB launched a Resolvability Assessment Process (RAP) in 2014. This is designed to evaluate the resolvability of G-SIBs on the basis of predefined criteria (extent of TLAC, degree of group interconnectedness, etc.). G-SIBs had to submit a high-level plan to their supervisory authorities outlining changes to their legal, financial, and operating structure by the middle of 2014. The plan was supposed to illustrate how the selected resolution strategy can be implemented. The results are to be published in 2015.

More intensive exchange of information to prevent and manage crises: The FSB is calling on countries to remove any legislative hurdles standing in the way of an efficient cross-border exchange of information, so that crises can be prepared for and managed.

2.4.2 USA

2.4.2.1 Basis

The US has had its own regime for the resolution of banks for a number of decades now. In 2010, a new special procedure (Orderly Resolution Authority: OLA) was introduced for the resolution of systemically important financial institutions as part of the Dodd-Frank Act. This is designed to allow the bank to be resolved without a bail-out. The Federal Deposit Insurance Corporation (FDIC), which is responsible for bank resolutions, has received far-reaching powers under this procedure:

- the creation of bridge banks to take over the "shell" of a failed bank
- the transfer of the value-containing parts of the bank
- the sale of asset elements of the bank

US legislation gives the FDIC a clear mandate to conduct a resolution in such a way that shareholders, creditors, and management are held to account for the failure of the institution, while at the same time preserving systemic stability. Shareholders and creditors must shoulder the corresponding losses (see section 2.4.2.3 for more detail) without any costs arising from the US taxpayer.

2.4.2.2 Recovery and resolution planning

The Dodd-Frank Act requires major financial institutions to draw up regular reports on rapid orderly resolution in the event of a significant financial difficulties or impending insolvency. These plans are referred to colloquially in the US as "living wills". This reporting obligation for recovery and resolution plans (RRPs) applies generally to all financial groups with total balance sheet assets of more than USD 50 billion, and also applies to foreign banks if they exceed the above-mentioned threshold. The two big Swiss banks have had to submit resolution plans for their US activities since 2012 in line with the Dodd-Frank Act. The Federal Reserve Bank of New York is responsible for enforcement.

The Federal Reserve and the FDIC, which together published detailed guidelines in the autumn of 2011, are responsible for the evaluation and structuring of living wills. Resolution plans consist of a brief public section and a more detailed section which is confidential. The final implementation provisions, which set out the formal and content requirements for an RRP, were published in November 2011. The plans themselves had to be submitted by the end of 2013 at the latest. A particular feature of the US approach is that the resolution plan has to be drawn up by the bank.

Neither the Dodd-Frank Act nor the implementation provisions of the Federal Reserve and the FDIC contain explicit provisions on recovery plans, but these are drawn up as part of the annual capital planning and stress test process.

2.4.2.3 Resolution strategy for G-SIFIs

The FDIC released its preferred resolution strategy for consultation in December 2013. With respect to implementation of the requirements of the Dodd-Frank Act, the FDIC opted for the

SPE approach. According to FDIC, this approach is the most appropriate for ensuring that shareholders, creditors, and decision-makers participate in losses. Equally important is the fact that this approach guarantees financial stability by ensuring that critical functions can be continued. Given the integrated group structure of US banks, which typically exhibit a high degree of internal complexity and interconnectedness, an orderly resolution of just one part of a bank would hardly be possible without triggering systemic shock waves. The FDIC therefore sets its restructuring measures at the uppermost level of the group, making shareholders and creditors participants in the loss and replacing the management responsible.

Under the SPE approach, the FDIC transfers the assets to a transitional bank, while the liabilities for the most part remain with the insolvent holding company. Due to the massive equity overhang in the bridge bank, this entity is well capitalised and should in principle be able to generate liquidity in the market accordingly. In a second step, following a valuation of the assets and a review of the potential value of the liabilities left behind in the insolvent holding company, creditors of the insolvent holding company will be given shares in the transitional bank. In the end effect, the debt capital of the holding company is transformed into equity of the transitional bank in order to provide the new transitional bank with a strong equity capital base – using internal, private capital. Both shareholders and other creditors bear the corresponding losses. Under certain circumstances, the Dodd-Frank Act allows the FDIC to treat creditors of the same category in different ways. The bridge bank is only a transitional solution, and is to be replaced by a newly-founded and sufficiently well-capitalised company within six to nine months.

The authorities recognise that the success of this strategy is crucially dependent on the highest group company holding sufficient loss-absorbing capital to enable it to absorb the losses and capitalise the bridge bank / new company. During the restructuring phase, it will be the equity capital and debt capital of the group holding company that will have to absorb the losses.

Discussions about a minimum amount of loss-absorbing capital (equity and unsecured debt) have yet to be completed. Both the Federal Reserve and the FDIC have made it very clear that they want to introduce quantitative and qualitative minimum requirements in this area, as ultimately this will increase not only the credibility of the resolution strategy, but also its chances of success.

At the end of 2012, the FDIC made clear its preference for the SPE strategy in a joint position paper with the Bank of England.

2.4.3 European Union

On 6 June 2012 the EU unveiled a proposal for a guideline aimed at determining a framework for the recovery and resolution of credit institutions and securities companies: (Bank Recovery and Resolution Directive: BRRD). This transfers parts of the Key Attributes into European law.

Among other things, the BRRD is designed to ensure that systemically important functions can be continued in the event of a crisis. In addition, the BRRD ushers in new resolution instruments in keeping with the FSB Key Attributes. These include the sale of business areas, the use of bridging institutions, the separation of assets, the mandatory conversion of debt capital to equity capital (bail-in), and state support. Moreover, member states are obliged to set up resolution funds. Another key component of the directive is a number of provisions on how recovery and resolution plans are to be drawn up and maintained, together with guidelines on coordination of the resolution of cross-border groups.

In addition, a Single Resolution Mechanism (SRM) is being introduced for banks in the eurozone (in which other countries may participate on a voluntary basis). The SRM sets out the rules for when a decision on resolution must be made, and provides greater detail on the requirement for joint resolution funds. The SRM complements the Single Supervisory Mechanism, and is designed to meet the objective of supranational banking union. The rules of the SRM will apply from 2016 onward.

2.4.3.1 Resolution funds

Under the BRRD, every member state must create a national resolution fund to ensure that the described resolution instruments can be effectively deployed. This obligation will lapse as long as the amount available to the resolution authority has been generated through other mandatory duties. The resolution fund is to be built up directly by the banks themselves, and should amount to at least 1% of protected deposits in the relevant member state within a time horizon of eight years. For example, the resolution funds could be drawn on for guarantees, as capital for the use of bridge banks, or to compensate creditors who find themselves in a worse position as a result of the bail-in than they would in the event of insolvency.

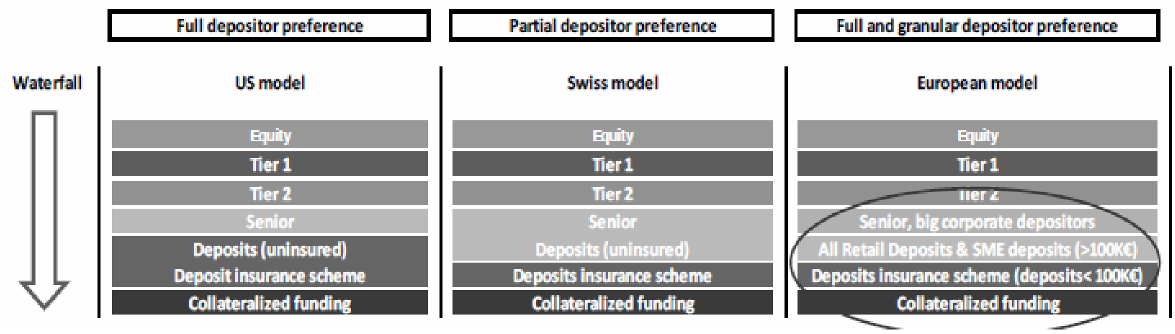
In principle, recourse should only be made to the resolution fund if certain liabilities have been excluded from the bail-in, or if – in systemic crisis scenarios – government support measures have been implemented. In these scenarios, the resolution fund may make contributions if at least 8% of all liabilities, including equity capital, has been subjected to a bail-in. In addition, contributions from the resolution fund may not exceed 5% of the total liabilities of a bank. At the current time, it remains unclear what financing sources would be resorted to if the resources of the resolution fund prove insufficient or have yet to be built up to the requisite level. As things stand, it looks likely that the European Stability Mechanism (ESM) would kick in.

The national funds will be bundled together over a period of eight years. The target size of the eurozone resolution fund amounts to EUR 55 billion.

2.4.3.2 Bail-in

One of the key elements of the BRRD is the bail-in instrument. This is designed to apportion losses first of all to shareholders, and then to creditors. Essentially, all the liabilities of a credit institution are subject to the scope of the bail-in unless they are explicitly excluded, e.g. protected deposits. Protected deposits comprise mainly client deposits with banks, which are protected up to a value of EUR 100,000 by a deposit guarantee scheme.

Figure 10: The European "liability waterfall" compared to the US and Switzerland



Source: NATIXIS (2013): Bail-in and new regulatory developments: A paradigm shift for the banking sector, slide presentation, September 2013 (quoted in: http://www.jku.at/ibfw/content/e53860/e53867/e53871/e226613/DiplomarbeitAlbertFercher.pdf)

Essentially, it is the owners and creditors of a financial institution that should bear the costs of any insolvency. The bail-in instrument must be used until the minimum CET1 requirement of the insolvent enterprise (or the bridge institution) is restored. Other financing sources (resolution fund, state support) may only be resorted to after at least 8% of the balance sheet total has been subjected to the bail-in.

Accordingly, the BRRD contains guidelines for liabilities capable of being written down, so-called "minimum requirements for own funds and eligible liabilities" (MREL), which must be maintained at all times. The guidelines so far are solely qualitative by nature (minimum residual duration, fully paid up, not owned by the institution), with no explicit figure specified for the level of MREL to be held (although given the mechanism of the resolution fund it may be inferred that this should amount to a minimum of 8%). Member states may decide for themselves whether or not to have a minimum level of capital capable of being bailed in. Here a differentiated approach could apply, depending on the size, business model, and risk profile of the institution, as well as on the repercussions of a failure of the institution for the stability of the financial system.

MREL must at the very least exist in sufficient quantity to facilitate orderly resolution (incl. bail-in), while after the bail-in it must be possible for the minimum CET1 requirement (as per licensing requirements) to be complied with. The European Banking Authority (EBA) will draw up a report on national implementation of the MREL requirement by October 2016, which will also look at the interaction of this instrument with the Capital Requirements Regulation (CRR). If the European Commission comes to the conclusion that harmonisation in this area is required, it will issue a legislative proposal for the EU Council and Parliament by the end of 2016.

The European Council and the Council of Ministers agreed on a joint directive draft in December 2013. Formal adoption of this draft is still pending. The guidelines should enter into force and be implemented in national law in 2015. Where the bail-in provisions are concerned, a transitional period for implementation applies until 1 January 2018.

2.4.4 United Kingdom

2.4.4.1 Special Resolution Regime

Until recently, the UK did not have specific insolvency legislation for banks, and the general provisions of bankruptcy law applied. It was not until 2008/09 that a so-called Special Resolution Regime (SRR) was created, which was designed to give the authorities the instruments they needed to deal with banks in jeopardy, namely:

- transfer of all or parts of a bank to a private sector purchaser
- transfer of all or parts of a bank to a bridge bank as a subsidiary of the Bank of England
- temporary nationalisation
- opening of a Bank Insolvency Procedure (BIP), which is designed to allow for rapid payments to insured depositors
- opening of a Bank Administration Procedure (BAP) to deal with the parts of a bank that are not transferred.

The SSR entered into force in February 2009. In its overall effect, the Special Resolution Regime is compatible to the OLA in the US.

2.4.4.2 Bail-in tool

The resolution instruments of the SRR are completed by the bail-in powers proposed by the Vickers Commission. In 2013, the government amended the Banking Reform Act in line with this proposal. The UK government had been intending to implement the corresponding provisions for a considerable while, but wanted to wait on developments within the EU to avoid having to amend the same legislation twice within a short space of time.[35]

The bail-in tool is reserved for the use of the Bank of England (BoE), and may be deployed under three conditions: i) the bank has failed or its insolvency is imminent, ii) no other measure promises similar chances of success and iii) such a step must be in the public interest. As in the EU, Switzerland, and the US, protected deposits may not be drawn on to make good

[35] Cf. for example the joint paper co-authored by the Federal Deposit Insurance Corporation and the Bank of England.

losses. Under certain circumstances, the BoE may deviate from adherence to the normal creditor hierarchy and the principle of equal treatment of creditors within any given creditor class. If the BoE decides to make use of this tool, it must set out its reasons to the Chancellor of the Exchequer and Parliament.

As explained below (see section 2.2.1.4.1), the UK has also established quantitative rules for total loss-absorbing capacity. These include liabilities that may be drawn on to cover losses.

2.4.5 Switzerland

With the so-called "deposit protection scheme bill" in the autumn of 2011 and the TBTF bill in the spring of 2012, the procedure for restructuring banks was compressed into a tighter timeframe, and key guidelines of the FSB that were still lacking were implemented. Specifically, it was now envisaged that not only shareholders but also creditors (particularly bondholders) could be forced to contribute to the resolution process. With the total revision of the FINMA Bank Insolvency Ordinance (formerly Bank Bankruptcy Ordinance) at the end of 2012, FINMA issued detailed provisions on the restructuring procedure and closed various existing legislative gaps. Switzerland's toolkit for the restructuring and orderly resolution of banks was thereby strengthened.

As the insolvency authority, FINMA bears responsibility for the restructuring and resolution of banks and securities dealers. It may also enter into cooperation agreements with other supervisory and insolvency authorities. In the event of an impending insolvency, FINMA is authorised to take immediate measures, including the imposition of so-called protection measures.

2.4.5.1 Resolvability

The planning activities of the bank and the supervisory authorities must go beyond the emergency plan for Switzerland and encompass the recovery and resolution of the bank as a whole. Two specific plans are required in this context: a private/autonomous recovery plan drawn up by the systemically important bank in question, and an official resolution plan drawn up by FINMA with the assistance of the systemically important bank. Irrespective of the planning requirements that are designed as a minimum requirement, the systemically bank is also required to describe what measures it is preparing (or has already implemented) in Switzerland and abroad to improve its "resolvability" (Art. 22b BankA). The measures to improve the bank's ability to be resolved may encompass in particular:

a) structural improvements and unbundling;

b) financial unbundling to contain risks of contagion; and

c) operational unbundling to safeguard data and the continuation of important operational services.

Making available sufficient and debt capital that can be converted into equity in the event of resolution or written off (i.e. a bail-in) is also seen as a measure to improve resolvability.

As part of the improvement in resolvability and the associated discussion of discounts with respect to the progressive component, a number of discussions took place between FINMA and UBS and CSG with a view to establishing the advantages and drawbacks of certain structures. Both financial groups have now announced that they will be hiving off the functions described as systemically important into a standalone legal unit. It may be assumed that both UBS and CSG will make additional adjustments to their legal structures with a view to improving their resolvability further. Once a bank has exceeded the minimum organisational requirements set for it, FINMA can grant discounts on the progressive capital component.

2.4.5.2 Bail-in

Capital measures are a core component of any resolution. Within the legal framework, FINMA can reduce claims against the company or convert them into equity capital ("bail-in") or decree the transfer of assets and liabilities between legal entities in order to ensure the continuation of critical banking services. The activation of a bail-in involves a mandatory requirement for debt capital to be converted into equity capital. This has the effect of transforming creditors into shareholders. However, there is also the possibility of obliging creditors to participate in the losses suffered through the reduction of claims, with creditors therefore being either partially or wholly forced to relinquish their claims ("haircuts"). Bail-in measures of this kind supplement the Swiss system of contractual convertible capital (contingent convertible capital, CoCos), which systemically important banks in Switzerland are required to hold.

The aim of the centrally managed bail-in, which is FINMA's preferred resolution measure[36], is to secure the continued operations of the banking group as a whole with a restructured capital base (so-called "single point of entry" strategy). The group structure remains intact, the operating business can be continued without interruption, and the functions critical to the wider economy can be maintained. If the recapitalisation of a financial institution succeeds thanks to a bail-in, breathing space is secured so that carefully considered adjustments can be made to the business model as required. However, if it should emerge – when the resolution procedure is embarked upon – that a bail-in is not working, is not proving sufficient, or that the probability of it succeeding is unlikely, the breakup of the entire group will be necessary. This scenario is clearly less desirable and involves greater risks, but FINMA's resolution plan encompasses this alternative scenario too.

A key requirement for the single point of entry bail-in is the availability of sufficient capital backing. Ideally, the uppermost holding or parent company should issue these liabilities to third parties via the market. The liabilities underlying the bail-in, which are either to be converted into equity capital or downgraded, must lie within the resolution powers of FINMA and be resistant to external challenges. Under Swiss tax legislation, this only applies to a very restricted extent at the moment. These liabilities must suffice to cover the anticipated recapitalisation requirement of the consolidated group and all group companies.

According to the Swiss bank insolvency regime, all liabilities can essentially either be converted from debt capital to equity capital or be "written down". However, any "privileged" claims (e.g. the claims of employees) are excluded, as are client deposits up to the protected ceiling of CHF 100,000 per deposit. Secured and offsettable claims may likewise not be converted or written down. Unlike other countries, Switzerland has so far not envisaged any minimum requirements of bail-in liabilities beyond the already established requirements of CoCos.

2.4.6 Summary of measures for a crisis scenario

The first steps in the area of crisis preparation and crisis management have now been taken at both national and international level. A common feature to all jurisdictions and international standard-setters is the desire to facilitate an orderly market exit of a systemically important institution. In addition to what has already been achieved, a number of key characteristics, including the loss-absorbing capacity requirement and the development of viable international cooperation, are still very much in flux.

Nonetheless, in summary it may be stated that all jurisdictions are seeking to implement the guidelines of the Key Attributes. All jurisdictions have improved their legal toolkits for bank insolvencies in recent years (or in the case of the UK, created one for the first time). All jurisdictions have responded to the requirement for recovery and resolution plans, and are now using this as a supervisory instrument. Furthermore, there has also been an intensification of international cooperation in the context of CMGs, which exist for all G-SIBs.

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36 Cf. FINMA's position paper on the resolution of systemically important banks of August 2013.

Common to all proposals is the conviction that creditors have to be involved in bearing the losses of a financial institution in crisis. Another feature to have clearly emerged is the international trend in favour of an SPE approach involving creditors (bail-in). The survival of the bank is to be ensured through mandatory capital restructuring at the highest group level. In this context, there is also evidence of attempts to issue minimum requirements for loss-absorbing capital. The UK is playing a pioneering role in this respect and has already unveiled a legislative draft, but the US and the EU have also stated their clear intent to issue regulations in this area. The FSB is currently driving forward developments at a fast tempo. Switzerland has amended its Banking Act and its Banking Insolvency Ordinance, so that essentially all liabilities that are not specially protected, offsettable, or secured must be included in the scope of a bail-in. However, deposits will only enter into consideration for a bail-in if all other liabilities available for the bail-in prove insufficient.

Certain differences are also evident when it comes to preservation of the creditor hierarchy, with both the US and the UK envisaging certain deviations, unlike Switzerland. The same is true for the principle of equal treatment of creditor classes.

2.5 Summary

2.5.1 Measures

A comparison of the various TBTF measures reveals a degree of convergence on the part of individual countries. The international guidelines of the BCBS and FSB are considered the benchmark. Depending on national parameters, these may be supplemented by other measures or by additional requirements that go beyond the international minimum.

All the jurisdictions analysed are trying to deploy fairly nuanced instruments. More radical measures of the kind discussed at the peak of the crisis in 2008/09, such as direct restrictions on institutional size, incentive taxes, or fully segregated banking systems, are no longer envisaged.

Instead the focus lies on increasing the resilience of financial institutions in the face of crises and on preparations for a new crisis scenario. The similarity of measures is without question partly attributable to competitive considerations, but it is also partly due to international pressure to adopt global minimum standards.

There are major differences in the weighting of the various measures applied, as the following table shows. The fear that certain jurisdictions are lagging behind international guidelines, and that these guidelines will prove less onerous than national measures already implemented, is increasingly proving to be unfounded.

Switzerland lays relatively strong emphasis on prudential measures. For example, it requires systemically important banks to meet the highest risk-weighted capital requirements. However, the Scandinavian countries are not far behind. The US too is likely to close some of the gap that exist between itself and Switzerland, even though the precise level of requirement is not yet known here. If the comparison is restricted to just CET1, however, Sweden actually goes further than Switzerland, while the UK is very much on a par. In addition, the US sets proportionately greater store by the unweighted leverage ratio, an area in which it goes beyond other countries. The UK too has recently set a leverage ratio that goes beyond international standards. Although the European Union does not go beyond the international minimum for either criterion, a number of member states have expressed their dissatisfaction with this situation, and are exploiting the freedom of manoeuvre granted to them in this area.

Greater differences are evident where organisational measures are concerned. A feature common to all jurisdictions is that they view organisational measures as a necessary component in one form or other. However, it is not possible to distinguish any elements that are standard to all jurisdictions, be with respect to the type of segregation, the definition of high-risk activities, or the area of deployment. Switzerland is something of an exception here, in that it sets relatively great store by the principle of subsidiarity, and clearly focuses on the improvement of resolvability where organisational measures are concerned. All other countries have geared their efforts towards drawing up detailed regulations on bank structures. This involves either classification of services worthy of protection or – at the other end of the spectrum – a definition of high-risk activities that are either prohibited altogether (as in the case of the US and the EU) or have to be hived off into separate group units. The length of the corresponding legislative texts and the duration of their drafting illustrate clearly that complex definitions of this kind pose their difficulties. The introduction of complete segregation between retail deposits and trading activities has not found sufficient support in any jurisdiction.

For some time now, the main focus at international level has been on measures for a crisis scenario. The objective is to ensure an orderly market exit and the continuation of systemically important services. The bail-in approach, whereby creditors are forced to participate in the bank's losses through capital restructurings, is becoming increasingly commonplace at international level. In order to increase the prospect of success of this instrument, there is an increasing international tendency to envisage minimum requirements of both a quantitative and qualitative nature for loss-absorbing capital.

Figure 11:

Internationale TBTF-Regulierungen

		Schweiz	EU	GB	USA
Kapital	**Leverage Ratio** (für Grossbanken)[1]	▪ 4,56%[2] Gesamtkapital (resp. 24% der RWA Anforderungen) ▪ *Beschlossen*	▪ 3,0% Tier 1 ▪ Beobachtungsphase bis 2017 – *Umsetzung noch nicht beschlossen*	▪ 3.35%-4.95% (0.75% Tier 1, der Rest CET1) ▪ *Beschlossen*	▪ 5% (Holding) resp. 6% Tier 1 ▪ (Einzelinstitut mit Einlagen) für G-SIBs ▪ *Beschlossen*
Kapital	**Risikogewichtete Kapitalanforderungen**	▪ Gesamtanforderung 19%[2] (wobei bis zu 6% Bail-in Instrumente) ▪ CET1 – 10,0% ▪ *Beschlossen*	▪ Gesamtanforderung 11.5%-15.5% ▪ CET1: 8%-12% ▪ *Beschlossen*	▪ Gesamtanforderung 19% (inkl. Bail- in Instrumente) ▪ CET1: 11% (Ring-Fence Einheit) ▪ *Beschlossen*	▪ Gesamtanforderung: Mind. 10.5%[3] (ohne FSB Zuschlag 1-2.5%) ▪ CET1: 7% (ohne FSB Zuschlag 1-2.5%)) ▪ *Beschlossen (FSB Zuschlag noch ausstehend[4])*
Liquidität	**Mindestliquiditäts-quote (LCR)**	▪ Basel III LCR ▪ *Beschlossen* (100% ab 2015)	▪ Basel III LCR ▪ *Beschlossen* (100% ab 2015-2018)	▪ Basel III LCR ▪ *Beschlossen* (100% ab 2018)	▪ Basel III LCR ▪ *Beschlossen* (100% ab 2017)
Risikoverteilung		▪ Gegenpartei max. 25% der Eigen-mittel (CET1+I High trigger CoCos) ▪ *Beschlossen*	← ▪ Engagement ggü. anderem Finanzinstitut maximal 25% des Gesamtkapitals („Gesamtengagement" gegenüber Finanzinstituten 200%) ▪ *Vorschlag (formelle Annahme der Richtlinie ausstehend)* →		▪ Engagement ggü. Gegenpartei max. 10% Gesamtkapital (Aktiven > 500 Mrd. USD ▪ *Beschlossen*
Organisatorische Massnahmen		▪ Keine direkten organisatorischen Vorgaben (subsidiär Anordnungen FINMA) ▪ Nachweis zur unabhängigen Weiterführung systemrelevanter Funktionen über Notfallplan (Trennbarkeit) ▪ *Beschlossen*	← ▪ Vorschlag EU-Kommission: Eigentumsrechtliche Trennung von Eigenhandel und Auslagerung in separate Handelsunternehmen von risikoreichen Geschäften (Anordnung durch Aufsichtsbehörden) ▪ *Vorschlag* → ▪ Deutschland und Frankreich:Funktionale Trennung Handels- und Kundengeschäft ▪ *Beschlossen*	▪ Ring-Fence (funktionale Trennung) volkswirtschaftlich wichtiger Dienstleistungen. Verbot Eigenhandel für Ring-Fence Einheit ▪ *Beschlossen*	▪ Volcker Rule: Eigentumsrechtliche Trennung von Eigenhandel und Exposure ggü. Venture Capital/PE und Hedge Funds ▪ Erfordernis Zwischenholding für ausländische Grossbanken ▪ *Beschlossen*
Massnahmen für den Krisenfall	**Sanierungs- und Abwicklungs-planung**	← Entwicklung von Sanierungs- und Abwicklungsplänen bereits beschlossen → ▪ Privatrechtliche Sanierungs- und hoheitliche Abwicklungspläne ▪ Nur systemrelevante Banken ▪ Eigenmittelrabatte bei Verbesserung globalen Sanier-und Abwickelbarkeit ▪ SPE-Strategie	← ▪ Sanierungs- und Abwicklungspläne entlang Bank Recovery and Resolution Directive (BRRD) ▪ Betrifft Banken mit Aktiven > 50 Mrd. EUR ▪ Abwicklungsfonds →	▪ SPE-Strategie	▪ Abwicklungspläne für Banken mit Aktiven > 50 Mrd. USD ▪ Sanierungspläne im Rahmen der jährlichen Kapitalplanung und Stresstest ▪ SPE-Strategie
Massnahmen für den Krisenfall	**Bail-in Instrumente**[5]	▪ Low Trigger CoCos: 1-6% RWA[2] ▪ *Erarbeitung TLAC/GLAC Konzept, noch keine Vorschlag*	← ▪ MREL: Qualitative Vorgaben, Quantität mind. 8% Total Liabilities *Einigung Richtlinienentwurf, Formeller Beschluss noch ausstehend* →	▪ PLAC ▪ *Beschlossen*	▪ Öffentliche Ankündigung über Mindestanforderung ▪ *Umsetzung noch offen*
OTC Marktregulierung		▪ Regulierungsbestrebungen im Rahmen FinfraG ▪ *In Planung*	← ▪ EMIR ▪ *Beschlossen* →		▪ Dodd Frank ▪ *Beschlossen*

1 Der Basler Ausschuss hat im Februar 2014 eine revidierte Fassung der Basel 3 Leverage Ratio vorgelegt. Anpassungen an diese Version sind in allen Jurisdiktionen noch ausstehend.
2 Gegenwärtig wird von einer progressiven Komponente von ca. 4.5 % RWA und damit Gesamtkapitalanforderungen von 17.5% RWA und ca. 4% Leverage Ratio für die beiden Schweizer Grossbanken ausgegangen.
3 Collins Amendment: Parallele Berechnung Risikogewichte nach internen Modellen und Standardansatz; tiefere der beiden Quoten ist ausschlaggebend. Dürfte tendenziell zu höheren Eigenmittelanforderungen führen.
4 Die USA werden beim Systemrelevanzzuschlag für G-SIBs über die internationalen Mindeststandards gehen. Die genaue Kalibrierung erfolgt in den nächsten Monaten (siehe Governor Tarullo, 9. September 2014).
5 Unter Federführung des FSB wird eine internationaler Standard für Total Loss Absorbing Capacity (TLAC) erarbeitet. TLAC beinhaltet neben regulatorischem Kapital auch Bail-in Instrumente, welche im Sanierungsfall Haftungssubstrat bereitstellen. Die Stossrichtung wird im November 2014 öffentlich bekannt werden.

Source: FINMA

2.5.2 Status of implementation

As is the case with the design of the different measures, there are also certain differences where the status of implementation is concerned. Here the reference point for all jurisdictions is the phased introduction envisaged for the Basel III requirements. Switzerland has implemented virtually all these measures, for the most part more rapidly than other countries, as is clear from a comparison drawn up by the BCBS.[37] With respect to the toolkit for overcoming a crisis, however, there is still a certain need for adjustment in comparison to the Key Attributes, while both in Switzerland and internationally a standardised minimum requirement for loss-absorbing capital is lacking.

In particular, the United Kingdom is also proposing a more rapid tempo than the established international timeline for a number of prudential measures. Moreover, a legislative draft with requirements for loss-absorbing capital has already been drawn up by the UK. However, the speed of implementation for certain measures will depend on the speed of the EU regulatory process.

It is also apparent that the EU is rather lagging behind in the implementation of TBTF measures. The US has likewise yet to definitively approve all measures in this area, although the progress of this work and the recent public utterances of decision-makers suggest that the remaining work will be completed before the end of 2014. These include the supplement for systemic importance ("leverage surcharge"), the minimum requirement for loss-absorbing capital, and measures to reduce exposure in short-term financing.

The requirements at international level will converge as the Basel III guidelines are implemented in stages.

3 Evaluation of the Swiss TBTF regime

This section evaluates the Swiss TBTF regime on the basis of the criteria defined in Section 1 and in light of international developments, whereby the latter includes the work of international standard-setters and that of other countries that are home to G-SIBs. The evaluation is restricted to those elements that have been regulated within the context of the Swiss TBTF regulation to date. The first sub-section is dedicated to an analysis of the Swiss TBTF measures on the basis of qualitative criteria. This rather theoretical view is then contrasted with a practical examination in the form of an investigation of the actual impact of this regulatory package. The second sub-section involves a summary comparison of the Swiss TBTF regime with developments in the US, the UK, and the European Union. Section 2 provides a more detailed comparison. The third sub-section then contains a synthesis and an evaluation of the Swiss TBTF regime. This also includes the recommendations of the International Monetary Fund (IMF).

3.1 Evaluation of the Swiss TBTF regime on the basis of selected criteria

3.1.1 Prudential measures

3.1.1.1 Effectiveness / risk containment

Measures in the areas of capital, liquidity, and risk diversification increase the ability of systemically important Swiss institutions to withstand crises. High prudential requirements lower the probability of a systemically important bank ending up in huge financial difficulties and thereby becoming a threat to both system stability and the taxpayer. The equity capital is designed to cover any losses. The higher the proportion of capital with loss-absorbing capacity, the lower the probability of an institution's insolvency. This is particularly true of capital of the highest quality (CET1). Plentiful liquidity ensures that sufficient funds are available to cover

[37] www.bis.org/publ/bcbs260.pdf.

any liabilities in tense market situations. Finally, the limitation of cluster risks ultimately leads to a lower degree of interconnectedness between institutions, which may be compared to inserting an immovable barrier in a row of dominoes.

Prudential measures make a key contribution to reducing risks in the financial system. Furthermore, high prudential requirements boost the confidence of clients and the market in the financial stability of an institution. They also provide negative incentives for companies to become systemically important. It is therefore not surprising that international standard-setters embarked on their first post-crisis reforms in the area – with Switzerland playing a pioneering role as a result of its own painful experiences.

The prudential measures of Switzerland's TBTF legislation and the new Basel III regulation therefore reduce the risk of the taxpayer having to step in once again to bail out systemically important banks, as the ability of institutions to absorb losses is increased. Greater account is taken of the "originator pays" principle when the costs of the additional prudential requirements resulting from systemic importance are borne by the corresponding institutions themselves, whereby these costs are partly passed on to clients. The problem of moral hazard is likely to be partly reduced by making the liability base of the capital provider that much greater, which can have a disciplining effect with respect to the company's risk appetite. Prudential measures can also lead to a reduction in complexity by making risky and complex activities financially unappealing. They can also reduce market concentration. On the one hand, the progressive component of the Swiss regulations regarding equity capital sets direct incentives for institutions to have a lower market share in systemically important services. On the other, the strengthening of the "originator pays" principle means that there is a reduction of indirect subsidies to systemically important institutions.

3.1.1.2 Efficiency / repercussions for financial intermediation

Prudential measures are compatible with a regulatory system that is as simple and principle-based as possible. Greater prudential measures lead to an internalisation of costs. The financing costs of the TBTF institutions are subsidised by the implicit state guarantee, and are accordingly too low. Higher prudential requirements have already reduced this subsidy in part, and will have an even greater effect in the future. In addition, the market has made the additionally required equity capital and convertible capital available to the banks on appropriate terms, without any problems. This was facilitated by the scaling-down of the banks' balance sheets and risk-related assets, as well as by the development of new markets for convertible bonds.

During the debates on the definitive design of prudential measures, fears were expressed that excessively high prudential requirements could have a negative impact on credit supply and the spectrum of financial services offered. As expected, these fears have proved unfounded.[38] Empirical investigation reveals no negative impact on the overall economy[39], with the banks still able to fulfil their key economic tasks of credit supply and maturity transformation. This is partly explained by the phased introduction of the new guidelines.

3.1.1.3 International best practice

An increase in prudential requirements for (not only) systemically important financial institutions was given the highest priority in international reform initiatives (see comments on Basel III and the FSB's surcharge for systemic importance in Section 2.2.1.1). As explained elsewhere, all key jurisdictions are implementing the international minimum requirements, and indeed going further in some areas.

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[38] Cf. in this context also the Regulatory Impact Assessment of the TBTF legislation in 2011 (http://www.efd.admin.ch/dokumentation/zahlen/00578/02267/?lang=de). [DE/FR only]

[39] Basel Committee on Banking Supervision (2010): "An assessment of the long-term economic impact of stronger capital and liquidity requirements".

Switzerland played a pioneering role in the elaboration of prudential measures, not just in its capacity as an "early mover", but also with respect to the level of its prudential requirements. However, the differences between jurisdictions have now become less stark, with the requirements set by other jurisdictions having converged with those of Switzerland. Accordingly, there is no significant competitive disadvantage for Swiss institutions. In addition, it should be borne in mind that Swiss G-SIBs may actually end up with a competitive advantage over their international rivals in the area of organisational measures, insofar as the former are based in a jurisdiction that has prescribed strict measures in this area. However, the foreign units of the Swiss banks are also affected by national regulations (e.g. in the US).

Higher requirements for systemically important institutions compared to less important institutions are clearly justified on the grounds of systemic protection.

3.1.1.4 Impact in practice

Switzerland has developed an innovative concept with respect to capital requirements that gives the affected banks an incentive to scale down their balance sheets and market share in systemically important services, and to improve their global resolvability. The measures have already borne fruit insofar as the banks have made adjustments to their business models and downsized their balance sheets.

However, it should be pointed out that the capital bases of the banks (and therefore their ability to withstand crises) are not yet as high as might be expected on the basis of the work carried out by the TBTF Commission of Experts. The following three reasons explain to a large extent why this deviation exists:

Firstly, this is attributable to the fact that the capital ratio that the banks actually have to fulfill will not be 19% (as assumed during the discussions of the Commission of Experts), but will instead be closer to 17.5%.[40] This is a consequence of the scaling-down of the banks' balance sheets and a corresponding reduction in the progressive component. At the moment, the risk-weighted overall capital requirement for Credit Suisse (prior to the granting of any discount) amounts to 16.7%, while UBS expects its own requirement to work out at 17.5% in 2019.[41] On top of this must be factored in a discount on the progressive component that FINMA may grant in the event of a global resolvability exceeding the statutory minimum. As a result, less capital will be available for the resolution process in the event of an emergency.

The banks' ability to withstand crises is therefore much lower when expressed in absolute figures than was originally thought when the Commission of Experts undertook their calibration. For example, the committee based its assumptions on RWA of CHF 400 billion per bank, which would have been equivalent to a capital base of CHF 76 billion with the 19% requirement. With the targeted RWA of CHF 250 to 250 billion per bank and a 17% requirement, the target capital would work out at between CHF 34 and 43 billion – or even less in the event of any discounts being granted. When drawing up the TBTF legislation, the basic assumption was that around CHF 75 billion of total capital would be required by each big bank. However, this development also reflects the lower risks posed to Switzerland by the systemically important banks following the scaling-down of their balance sheets and risk-weighted assets. On the other hand, the question arises as to whether such a significant deviation with respect to the absolute capital base is justified given the present size and risk profiles of the big banks.

Secondly, the improved capital ratios are largely attributable to the reduction of risk positions and scaling-down of balance sheets. Capital quality was improved through the buildup of hard core capital, and the Basel II supplementary capital was converted into convertible bonds and bonds with a waiver of claims in order to comply at an early stage with the TBTF guidelines

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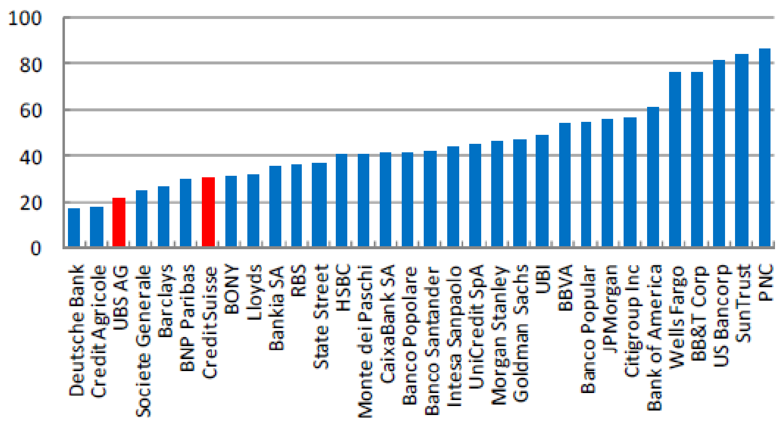
[40] Cf. FINMA media release of 7 May 2014 http://www.finma.ch/e/aktuell/Pages/mm-finma-informiert-ueber-tbtf-verfuegungen-20140507.aspx.

[41] For large, non-systemically-important Swiss banks (Group 2), the prescribed risk-weighted total capital ratio is 13.6-14.4%.

that will apply fully from 2019. The two big banks currently have total capital of CHF 42 to 43 billion each. They have issued both high-trigger and low-trigger CoCos (or write-down bonds) in significant volumes. Although the redemption, buyback, and amortisation of capital instruments with expiring eligibility partly neutralise this capital buildup, they ultimately lead to an improvement in capital quality. In comparison with the capital situation prior to the financial crisis, therefore, a clear improvement in capital quality is evident. Thanks to their lower RWA, the banks are no longer forced to build up their capital.

However, the size of the banks' balance sheets has not been scaled down as much as the corresponding risk-weighted positions. The big banks' ability to withstand crises will therefore be assessed differently depending on whether the risk-weighted ratio or the leverage ratio is applied. For example, both big banks have a Tier 1 leverage ratio of 3-4%, which meets the international minimum standard but falls significantly short of that of other Swiss banks[42]. According to the IMF, the two Swiss G-SIBs have among the lowest ratios of RWA / total assets.

Figure 12: Switzerland: Risk-weighted assets / total assets (as of Sep. 2013)



Source: Bloomberg.

There are therefore considerable doubts about the actual evaluation of the big banks' ability to withstand crises on the basis of risk-weighted-based capital requirements. In this context, FINMA is currently investigating (with the support of the SNB) whether (and to what extent) the RWA based on the bank-internal model approaches differ from those of the standard approach (which is not model-dependent).

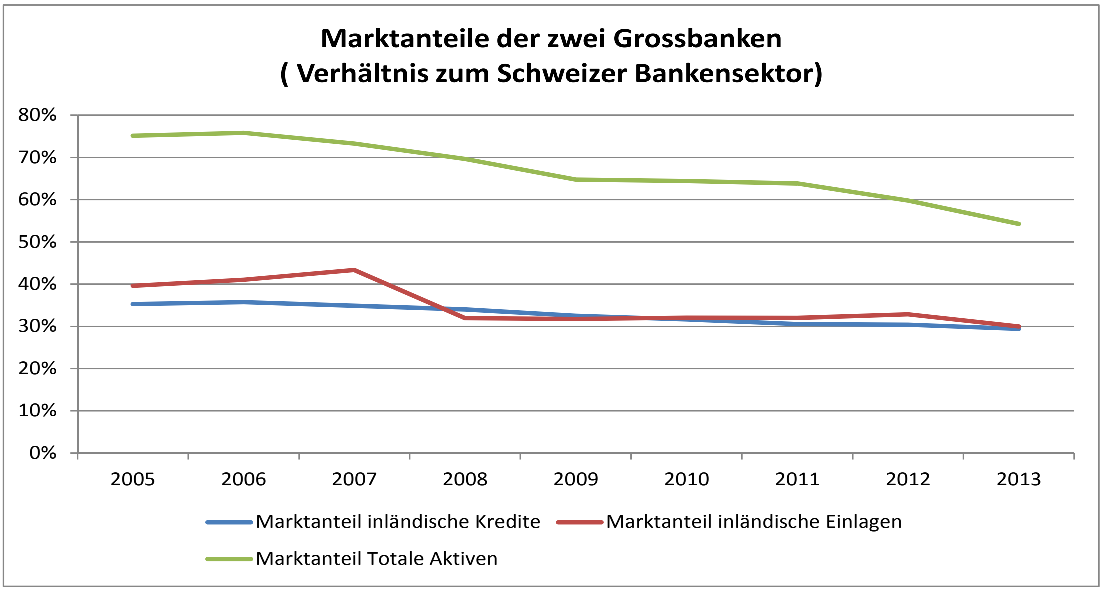
Thirdly, the Swiss TBTF legislation envisages the banks being granted rebates at individual institution level, in the event of the requirements at individual institution level leading to an overfulfilment of requirements at a consolidated level (Article 125 CAO). The aim here is to compensate for duplicate burdens arising through the application of prudential requirements at individual institution level. Intragroup transactions are also subject to regulatory requirements and have to be backed by capital accordingly. As a result of this provision, the lowest possible ratio 14% of RWA is demanded at individual institution level. Even this minimum ratio is only achieved as a result of additional regulatory rebates: Without these rebates, the ratio would actually end up below 14%. Bearing in mind (for example) that the Swiss individual institution encompasses systemically important functions such as the domestic deposit and credit business, this capital base appears low. As an additionally complicating factor, Swiss G-SIBs continue to assume considerable risks through foreign branches or subsidiaries at individual institution level, for which capital has to be held "locally" abroad. Local guidelines in this area have been tightened recently, so that an even greater dynamic is playing out here: Any tightening of foreign local guidelines leads automatically to a situation in which the Swiss individual institution has less capital. On the other hand, account

[42] By contrast, the weighted average Tier 1 leverage ratio of domestically-oriented Swiss banks amounts to approx. 7%.

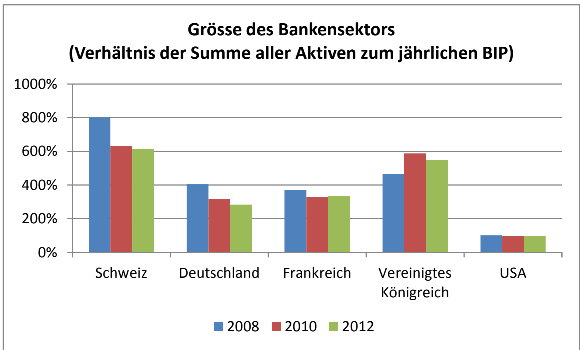
is taken of the effects described in connection with Article 125 CAO insofar as both big banks are transferring their systemically important functions to separate entities, which will not benefit from any rebates as per Article 125 CAO.

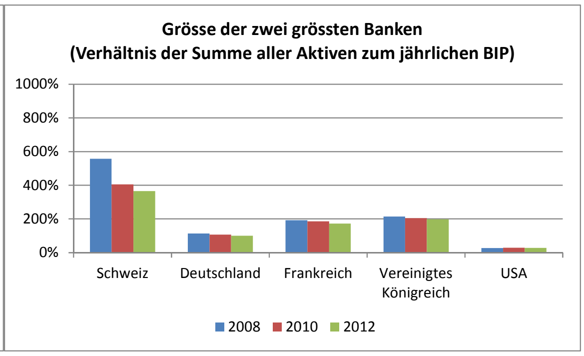
By contrast, an aspect of the Swiss approach that should be assessed as positive is the fact the banks have scaled down their balance sheet totals due to the incentive effect of the progressive component. Other possible drivers of this development include changes to general incentives through the new TBTF and Basel III regulations, as well as the more difficult economic environment faced by the investment banking business. In particular, the assets of the big banks have shrunk dramatically since the financial crisis, and have been scaled down further since 2010 (albeit to a lesser extent). Their market shares in the domestic deposit business and the domestic credit business have not changed so dramatically, undergoing only a slight decline. Both the size of the Swiss banking sector as a proportion to GDP and the level of market concentration remain high in an international comparison.

Figures 13, 14 and 15:



Source: SNB





Source: Datastream, ECB, SNL

3.1.1.5 Prudential measures: summary

Prudential measures increase the ability of systemically important banks to withstand crises, and therefore make a crucial contribution to reducing risks in the financial system. They act as a kind of preventative firewall against instabilities in the financial sector, and constitute an important pillar of the Swiss TBTF regime. A core element of these prudential measures is an incentive mechanism to reduce the risk to the wider economy.

However, clear deviations from the original expectations have become apparent. First of all, it is now becoming clear that the progressive component of the big banks will turn out to be lower than the original 6%. Accordingly, the total capital ratio will also turn out to be lower. Moreover, a liability substrate in the event of a crisis is lacking. In addition, the original calibration of requirements was based on the assumption of a larger bank, which ultimately (in absolute terms) will result in a capital base that is lower than that predicted by the Commission of Experts by almost a half.

Secondly, the size of the banks' balance sheets has been scaled down less strongly than the corresponding risk-weighted positions. In an international comparison, the two Swiss G-SIBs have a low RWA / total assets ratio. There are therefore certain question marks over the ability of the two big banks to withstand crises on the basis of equity capital requirements being geared around RWA.

Finally, the Swiss system envisages rebates with respect to the equity capital requirements of the individual institution, in order to prevent overcapitalisation at group level. If one takes into account (for example), that the Swiss individual institution encompasses systemically important functions such as the domestic deposit and credit business, this capital base appears low for the individual institution. This problem will be lessened after implementation of the announced transfers of the systemically important functions to separate entities, as the new Swiss legal entities will not benefit from rebates as per Article 125 CAO. The capitalisation of these entities will therefore turn out to be above the minimum requirement of 14%. Unlike in the former structure, therefore, the systemically important functions will no longer be operated in those comparatively less well capitalised banks in the medium term.

The difference ultimately lies in the calibration of prudential requirements, particularly so when one bears in mind how low the initial basis was for the latest tightening in the area of prudential measures. The external indebtedness of the banks has increased persistently over the last few decades, resulting in the kind of undesirable consequences witnessed back in 2008/09.

3.1.2 Organisational measures

3.1.2.1 Effectiveness / risk containment

The organisational measures in the Swiss TBTF regime are designed to ensure the continuation of systemically important functions in the event of an impending insolvency on the one hand, and to improve global resolvability on the other. The focus is therefore on limiting the negative consequences of such a scenario. Systemic risks are not reduced directly through a lower probability of insolvency, as is the case of the prudential measures. Rather, the organisational measures are geared around damage limitation: They are designed to ensure that systemically important functions can be continued in the event of an emergency, and that the remainder of the bank can be resolved in an orderly way. This reduces the risk of the state having to bail out an insolvent institution.

There are three cornerstones of the organisational measures:

Emergency plan: The banks must provide proof that they are able to continue their systemically important functions independently in the event of bankruptcy. This proof takes the form of an emergency plan that is subject to review by FINMA. If the bank is unable to eliminate any shortcomings that FINMA has identified in the emergency plan within a reasonable period of time, FINMA may then decree subsidiary organisational measures.

RRP: Systemically important banks must also draw up a recovery plan. For its part, FINMA draws up a resolution plan in which it sets out how any winding-up or liquidation of the systemically important bank it decrees can be implemented (while preserving the systemically important functions).

Improvement of global resolvability: If a systemically important bank improves its resolvability – both domestically and abroad – beyond the statutory minimum set out in the emergency plan, FINMA may grant a capital discount. This involves taking into account the extent to which the required measures have been implemented. FINMA is therefore able to set incentives. In particular, measures to improve the resolvability of the bank may comprise structural, financial, or operational reductions in interconnectedness.[43]

In addition, the organisational measures are supposed to reduce the complexity of institutions and interdependencies within the financial system. As a result of the organisational measures, an (orderly) bankruptcy of a systemically important institution should again become a credible scenario, thereby reducing the problem of moral hazard inherent in a TBTF situation. The organisational measures have no direct impact on the criterion of market concentration.

The Swiss approach does not envisage direct organisational measures, with the exception of the emergency plan, which is to be activated in a worst-case scenario. For this reason, particular importance is ascribed to the implementability of the emergency plan. The two Swiss big banks have now submitted their emergency plans to FINMA. However, these plans have yet to reach the state at which they can be implemented. These are still *ex-post* plans that cannot be implemented, and therefore cannot guarantee the continuation of systemically important functions in the event of a crisis. A conclusive evaluation of their effectiveness is not possible. Work on global recovery and resolution plans has likewise progressed. Overall, the regulations have acted as a catalyst for the first organisational steps to be taken that will have a positive impact on resolvability.

3.1.2.2 Efficiency/repercussions for financial intermediation

The organisational measures of the Swiss TBTF regime are compatible with a regulatory system that is as simple as possible. Switzerland is remaining true to its principle-based philosophy in its financial market regulation, and has eschewed comprehensive and detailed guidelines.

In contrast to international trends, the measures established in Switzerland do not envisage any interference with economic freedom. The subsidiarity principle is emphasised in Switzerland to a particularly strong degree. It is primarily left to the banks to decide on the organisational measures they want to take to meet the objective of protecting systemically important functions. This special feature allows for account to be taken of the different business models of the systemically important banks.

The organisational measures have no impact on the economic contribution of the banks or financial innovation, as Switzerland has steered clear of restricting or banning certain activities. The management of high-risk business continues to be left to the banks themselves. However, in the event of these risks manifesting themselves and jeopardising the financial stability of the institution, the systemically important functions must remain protected.

3.1.2.3 International best practice

There is no single international standard in the area of organisational measures. Quite the contrary – there are huge differences in the way these regulations have been designed from country to country. Accordingly, there is no benchmark against which the compatibility of any particular measures can be evaluated. What is clear is that Switzerland has a liberal and subsidiary system is an international comparison. Other countries are much more prescriptive, and interfere directly with the structure and business models of the banks.

In collaboration with FINMA, the two global systemically important Swiss banks have drawn up global recovery and resolution plans, as envisaged in the Banking Ordinance. These are in line with the requirements of the Financial Stability Board. They are also regularly discussed with foreign supervisory authorities as part of the Crisis Management College convened by FINMA.

Swiss institutions are not exposed to any international competitive disadvantages as a result of the organisational measures of the TBTF legislation, as this legislation does not directly interfere with their business models. Indeed, Swiss institutions may actually end up holding

[43] Article 22b BankA.

competitive advantages over certain competitors, insofar as the latter are domiciled in a jurisdiction that prescribes strict organisational measures. Whether or not measures taken in other countries are having undesirable consequences for global financial markets is something currently being investigated by the FSB. Where the analysis of the Swiss TBTF regime is concerned this is not a crucial point, as long as the protection of systemically important functions is guaranteed.

3.1.2.4 Impact in practice

Existing concepts for the continuation of systemically important functions are based on an *ex post* solution. In the event of emergency, the corresponding plans would therefore have to be implemented under great time pressure, and without having been tested. A lasting improvement would be achieved through an *ex ante* separation of the Swiss business. Although such a step has already been initiated by the two big banks, it will not be completed until 2015 and 2016 respectively. Beyond these announcements, the emergency plans still have not contributed sufficiently to improved resolvability.

3.1.2.5 Organisational measures: summary

The organisational measures in the Swiss TBTF regime are designed to ensure protection of systemically important functions and the orderly resolution of the remainder of the bank. They deliver the desired reduction in complexity and interconnectedness of institutions. They do not reduce the probability of crisis occurring but are expected to reduce the repercussions of such an event. This has the effect of reducing the risks faced by the taxpayer.

The Swiss approach is superior to that of other jurisdictions with respect to subsidiarity and simplicity. Switzerland has eschewed bulky legislative texts[44] that actually add to the complexity of the situation, and has avoided the temptation of trying to segregate high-risk activities from low-risk activities. Apart from anything else, the prohibition of certain activities is only likely to lead to the outsourcing of such activities to less regulated and less well-supervised areas.

Where emergency planning in Switzerland is concerned, FINMA is able to decree subsidiary measures. An incentive system to improve global resolvability is in place in the form of capital discounts that can be granted after measures have been implemented.

3.1.3 Measures for a crisis scenario

3.1.3.1 Effectiveness/risk containment

The measures drawn up for a crisis scenario are designed to limit the damage caused by an impending insolvency on the part of the systemically important institution. These measures are based on global recovery and resolution plans. In the international debate, the resolution concept of a "bail-in" has come to the fore. This involves creditors (with the exception of protected depositors) being forced to participate in any losses incurred by the bank. The aim of the centrally managed bail-in is to enable the banking group to continue either temporarily or permanently (on the basis of certain restructuring measures) with a restructured capital base. The group structure remains intact, which then enables the supervisory authority to implement a restructuring and/or an orderly resolution. The operating business can then be continued without interruption, and the functions critical to the wider economy can be maintained. As a last resort, an orderly market exit must be possible without systemic consequences.

The SPE strategy is an effective approach due to the group structures of the two Swiss big banks (as the parent company manages financing for the group as a whole). The actual impact of the measures is still subject to uncertainty at the moment. On the one hand international cooperation is not yet firmly established – Switzerland is not a solitary case – while on the

[44] The Volcker Rule's implementation provisions alone run to more than 1,000 pages.

other a bail-in also harbours a number of legal and implementation risks as a result of the current liability structure of the two big banks.

Legal security and rigour of implementation are the crucial factors if a crisis is to be successfully overcome. Only then can it be guaranteed that resolution plans will work in practice and their envisaged function can be fulfilled. With regard to the legal toolkit in the area of crisis measures, recent international studies[45] have identified certain weak spots in Switzerland's protective shield. For example, a reduction in claims is not expressly mentioned in Swiss legislation, even though this aspect is an inherent part of the restructuring process. In addition, according to the wording of the Banking Act, a bail-in would only be possible as a last resort. There is something of a conflict between this wording and the preferred resolution strategy of FINMA and international developments.

The measures for a crisis scenario are above all designed to protect the general public from financial risks. These likewise reflect the "originator pays" principle, by making creditors of the financial institution liable for its losses rather than the taxpayer (as in the recent financial crisis). The measures help to reduce the subsidy aspect of the implicit state guarantee and restore market order.

Moreover, the resolution planning process provides transparency with respect to internal operational dependencies and allows their expediency to be analysed. This could have the effect of reducing organisational complexity.

The measures therefore also help to reduce risk in an indirect way. Given that creditors– particularly shareholders and holders of CoCos, as well as (in the event of a bail-in) the holders of bail-in bonds – become liable in the event of an insolvency, they are likely to be in favour of a low-risk strategy. The anticipation of having to participate in losses is therefore likely to have a preventative effect. A credible threat of bankruptcy also makes a key contribution to reducing the problem of moral hazard. These measures have no direct impact on market concentration.

3.1.3.2 Efficiency / repercussions for financial intermediation

The measures drawn up for a crisis scenario do not have any impact on credit supply or financial intermediation. They could lead to higher debt capital costs for institutions through the internalisation of bankruptcy costs, as creditors would demand a higher return for their risk of loss. This is a wholly desirable outcome with respect to an originator-based distribution of costs, the protection of financial stability, and the protection of the taxpayer.

The measures drawn up for a crisis scenario respect the subsidiarity principle. Priority is given to the stabilisation of the bank, with state intervention on the part of the authorities only taking place as a subsidiary development.

3.1.3.3 International best practice

With the measures it has taken in this area, Switzerland is very much in step with international developments. A strengthening of the insolvency regime for banks and the associated assignment of powers to supervisory authorities have been implemented in all jurisdictions. The enforced participation of creditors in a bank's losses has also become established international practice. Accordingly, no competitive distortions exist in this area. Swiss measures are internationally compatible.

Key international bodies are working on a further piece of the jigsaw: On the occasion of the G-20 summit in Brisbane on 15-16 November 2014, the FSB unveiled a proposal on TLAC, whereby this can be drawn on in the event of an insolvency through a bail-in for the recapitalisation of the bank[46]. The implementation of the resolution strategy should therefore be facilitated by virtue of the fact that there is a sufficient liability substrate available – in the right place, and in the right form. Here FINMA has a preference for the so-called single point

[45] Key Attributes pilot assessment and IMF FSAP.
[46] Cf. also the press communiqué of the FSB.

of entry (SPE) resolution strategy. Switzerland already has instruments in place that can serve as such a liability substrate in the form of low-trigger CoCos of the progressive component. However, the specificity of the progressive component must be taken into account. The need to act from both a quantitative and a qualitative respect where the Swiss approach is concerned needs to be reviewed against the background of the FSB's proposal regarding TLAC, which has only just been unveiled. The final international standard, which is expected to be approved by the FSB before the end of 2015, must be appropriately taken into consideration here.

3.1.3.4 Impact in practice

Both big banks have drawn up recovery plans that have been approved by FINMA. In the area of resolution plans, intensive discussions are taking place between the banks and the supervisory authority. FINMA has set out its preferred resolution strategy (SPE bail-in) in a position paper. With the SPE bail-in, holders of capital market bonds issued by the group's parent company are to participate in the restructuring of the bank through the enforced waiver of creditor rights or conversion of the bonds into equity. Switzerland's withholding tax is currently acting as an obstacle to the issuance of capital market bonds from Switzerland, as well as hindering their international placement. Instead, the issuer is typically a foreign entity, and the funds raised also have to be used abroad. FINMA has no powers to decree a bail-in in the case of foreign entities. The implementation of a bail-in decreed by FINMA in keeping with the restructuring provisions of the Banking Act could be ensured if bonds were issued by a Swiss entity.

In the debt capital market, bonds are typically issued under Anglo-Saxon law with New York or London as the place of jurisdiction; in some markets, e.g. for CoCos, issues have taken place under Swiss law with Switzerland as the place of jurisdiction. Internationally, efforts are made to ensure contractual bail-in clauses with respect to issues under foreign law/jurisdiction, whereby the investor in bonds issued by Swiss banks or group parent companies acknowledges the validity of the restructuring provisions of the Swiss Banking Act. This is designed to avoid legal uncertainty when it comes to foreign judges ruling on the applicability of Swiss restructuring provisions or on the recognition of restructuring provisions. Consideration of the creditor hierarchy, the need for creditors within the same creditor class to be treated equally, and the importance of creditors not being placed in a worse situation than they would in a liquidation process are key principles for legal security when implementing a bail-in. Risks also arise due to the difficulty of ensuring cross-border resolutions of big banks. This problem is not limited to Switzerland alone: International efforts are required in this area. However, this is very likely to be relevant for practical implementation, as the TBTF problem can only be resolved fully once an orderly market exit of a large financial institution is possible. Until this proves to be the case, preventative measures in particular should be viewed as extremely important.

3.1.3.5 Measures for a crisis scenario: summary

The measures for a crisis scenario provide an effective means of limiting damage and also have a risk-reducing effect. Careful and ongoing crisis preparation involving recovery and resolution plans can lay the basis for dealing with a serious incident, and helps to identify the potential collateral damage of a crisis at an early stage. The participation of creditors in losses is to be endorsed from a regulatory policy standpoint. Moreover, a credible threat of bankruptcy is an effective way of eliminating the implicit state guarantee.

There are still a number of gaps that need to be closed before the threat of bankruptcy becomes credible once again for systemically important banks too. For example, the FSB used the G-20 Summit in Brisbane on 15-16 November 2014 as an opportunity to unveil a proposal on TLAC, with the final international standard due to be approved by the FSB by the end of 2015. In view of these new international standards, there are still a number of weak points in the Swiss legal toolkit.

3.1.4 Summary

On the basis of these analyses, the Swiss system appears in theory to achieve the target of reducing the TBTF problem and containing the risks for the financial system and the taxpayer. To a certain extent, the measures supplement and strengthen one another, and strike a good balance between interfering in economic freedom on the one hand and guaranteeing the stability of the financial system on the other. The Swiss approach involves a consistent and coherent package of measures, and the individual measures are aligned with one another. For example, this is evident in the interchangeability and interaction of the organisational measures and the capital requirements.

The approach underlying the current Swiss TBTF regime fulfils all the predefined criteria from a quantitative perspective. Even the IMF recently delivered a positive summary of the Swiss TBTF regime as part of the FSAP, praising in particular Switzerland's pioneering role in the area of prudential measures.

However, with the benefit of a certain amount of hindsight, this theoretical viewpoint needs a considerable amount of qualification. For example, the resulting capital bases of the two big banks have turned out to be lower than originally forecast by the Commission of Experts. The implementation of the emergency plans is shrouded in great uncertainty. Up until now, the plans have been based on *ex post* solutions, which involve a correspondingly high degree of implementation risk. There also appears to be a fair amount of optimisation potential where the toolkit for dealing with a crisis scenario is concerned.

An important role in the Swiss approach is assumed by the progressive component, which has an important part to play in all three measure-related dimensions (prudential, organisational, crisis scenario). Firstly, the progressive component has the effect of incentivising the banks to reduce both their size and market share of systemically important services. Secondly, it should provide an incentive for the banks to improve their global resolvability above and beyond the emergency planning process. Finally, the progressive component is also designed to ensure the orderly resolvability of the banks in the event of a crisis. The progressive component therefore pursues three objectives at the same time, and is an innovative concept in itself. However, it is argued persuasively in economic theory that an additional policy instrument should be made available for every additional policy target ("Tinbergen rule"). There is a danger that the different objectives will conflict with one another and that not all objectives can be simultaneously achieved with a single instrument. Even if no conflicts were to arise between the individual objectives, the quantitative design of the progressive opponent appears to be too low to meet all requirements.

In summary, therefore, it may be said that while Switzerland has taken steps to contribute to the containment of the TBTF problem, it is still some way removed from a complete solution to the problem. Implementation and operationalisation require further steps to be taken. For example, ratings agencies continue to assume a state guarantee exists in their evaluations of the liabilities of Swiss G-SIBs, which leads to better creditworthiness and therefore lower refinancing costs. S&P, for example, rates the creditworthiness of the two Swiss G-SIBs two notches higher than would be the case without their TBTF status and the associated prospect of government support. In its analysis, S&P concludes that the likelihood of the state intervening to bail out one of these banks in the event of a crisis continues to exist, at least until the banks strengthen their capital buffers and adjust their business models.[47] S&P recently confirmed this rating "bonus" while at the same time stressing the improved capital situation. It anticipates persisting with this approach until at least the end of 2015. At the same time, however, S&P has praised the progress made in improving the resolvability toolkit, particularly the bail-in[48].

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[47] Standard and Poors: "How the Swiss Bank Resolution Regime Affects Government Support for Its Banks", November 2012.

[48] Standard and Poors: "The Rating Impact of Resolution Regimes for European Banks", April 2014.

A study recently published by the IMF also concludes that the state guarantee and the associated subsidies continue to exist, i.e. that the measures taken by Switzerland have not yet fully resolved the problem. However, there are great discrepancies with respect to the value put on this state guarantee. In its recently published study, the IMF concludes that – depending on the estimation method applied – the value of the state guarantee for G-SIBs in Switzerland amounts to between CHF 5 billion and CHF 18 billion a year (rating-based approach) or as much of CHF 45 billion a year (contingent claims analysis approach).[49] The value of the TBTF subsidy varies over time, and is at its peak in times of great uncertainty, as it is then that state support becomes most likely. A study by the Swiss Finance Institute, which applies an option pricing model, comes to the conclusion that the value of the Confederation's guarantee in the crisis year amounted to a total of CHF 34 billion for the two big banks.[50] A recent OECD study estimates that the value of the implicit state guarantee for the Swiss big banks has amounted to a total of between CHF 3.5 to CHF 7 billion annually for the last few years[51].

There are also studies that arrive at lower values, however. For example, in a paper drawn up for Switzerland's Social Democratic Party in 2010, Prof. Urs Birchler arrived at a figure of CHF 4-5 billion overall. According to a study by Boston Consulting Group (BCG), the survival guarantee given to UBS by the state during the financial crisis had a value of CHF 1.6 - 2.1 billion a year; the equivalent figure for Credit Suisse amounted to CHF 0.7-1.3 billion.

3.2 Comparison of the Swiss TBTF regime with other jurisdictions / international standards

The Swiss TBTF regime can now be easily compared with the TBTF measures taken by other countries. Action has followed words in many jurisdictions, and in many areas specific resolutions have been passed as in Switzerland, or at least the outline of measures has become clear. As described in Section 2, the different regulatory measures taken to contain the TBTF problem have strong resemblances. A brief overview of the key differences / similarities of the Swiss TBTF regime with international trends is provided below. Section 2 provides a more detailed illustration.

3.2.1 Measures

3.2.1.1 Prudential measures

In theoretical terms, Switzerland has set comparatively high prudential requirements. For example, the provisions for systemically important banks call for a high risk-weighted equity ratio. Switzerland's advantage in this area is being eroded, however. Other countries have now reached a level that compares to that of Switzerland. Where the scope of CET1 is concerned, the requirements in the UK, for example, are equally high, while in Sweden and Norway these actually go beyond Swiss requirements. The difference in the overall capital base required by Switzerland and that required by other countries stems from the progressive component.

The progressive component is subject to both upward and downward fluctuations, depending on the systemic importance of an institution. It is designed to set incentives for banks to reduce their size and market shares, similar to the graded approach of the FSB with its five categories. In addition, the progressive component is supposed to help with the resolution of systemically important banks. Furthermore, when designing the progressive component, Switzerland broke new regulatory ground with its decision to weight contingent convertible capital (CoCos) quite strongly. Other countries have not envisaged as prominent a role for convertible capital. As discussed below, the FSB is currently drawing up a proposal on bail-in debt.

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49 IMF, "How big is the implicit subsidy for banks considered too important to fail?", *Global Financial Stability Report*, April 2014.

50 Haefeli, Mario and Jüttner, Matthias P., "The Value of the Liability Insurance for CS and UBS", Working Paper No. 609, FINRISK, 2010.

51 Schich, Sebastian; Michiel Bijlsma and Remco Mocking, "Improving the Monitoring of the Value of Implicit Guarantees for Bank Debt" OECD Journal Financial Market Trends, March 2014.

Switzerland was one of the first countries in Europe to introduce a leverage ratio. This is designed to act as a safety net, and is directly coupled to risk-weighted requirements[52]. Switzerland published its rules on the leverage ratio at a time when the discussions of the Basel Committee were not yet complete. In particular, the Basel Committee decided to permit only Tier 1 capital instruments in the calculation of this ratio. This is in contrast to the Swiss approach, which also permits Tier 2 CoCos. Although Swiss CoCos can be designed by the banks in such a way that they correspond to Tier 1 capital under Basel III guidelines, according to calculations by the IMF, the Swiss leverage ratio may actually be some way behind the Basel leverage ratio given certain assumptions (not all CoCos count as Tier 1).

For American G-SIBs, the US envisages a leverage ratio of 5% at group level and as much as 6% at individual institution level if the latter holds protected deposits. Here the US will for the most part align itself with the latest guidelines of the Basel Committee, with Tier 1 capital in particular being applied in the ratio as per the Basel III definition. The UK envisages a leverage ratio of 3.35-4.95% for British G-SIBs.

Given the fluctuations in the progressive component – as a consequence of changes in the volume of balance sheet and off-balance-sheet positions, as well as changes in the domestic market share on the one hand and any discount on the other – a generally applicable comparison with other countries is difficult to make with respect to equity capital requirements for total capital (including "gone concern" capital). By contrast, comparisons of requirements for "going concern" capital can be made. Here it is clear that the Swiss advantage with respect to risk-weighted requirements is small, and in the area of leverage ratio Switzerland actually lags behind the US and the UK. Overall, however, Switzerland ranks among the countries that set great store by generally rigorous capital requirements.

Where the liquidity provisions are concerned, it is above all Switzerland's rapidity of implementation that stands out. Another characteristic is the continued existence of a parallel regime for the big banks for at least another two years. Both conceptually and qualitatively, however, Switzerland's liquidity requirements are very similar to those of other countries. The benchmark is the international Basel standard, and implementation of this international standard has been formally adopted almost everywhere.

While there are international similarities with respect to risk distribution guidelines, there are differences in the calculation method and in the definition of eligible equity capital. When it comes to the definition of eligible capital (CET1), Switzerland may be judged to be more rigorous than other jurisdictions, which typically base their approaches on total capital. The US, for example, envisages particular restrictions applying in cases of mutual interconnections between G-SIBs. In addition, there are even tighter risk distribution guidelines in Switzerland with regard to non-TBTF banks as compared to institutions described as systemically important, either nationally or internationally. An international minimum standard was published on 15 April 2014[53].

3.2.1.2 Organisational measures

In the case of organisational measures, a distinction should be made between the guidelines for a Swiss emergency plan and the improvement to global resolvability.

In contrast to the prudential measures, the Swiss regulations in the area of organisational measures differ greatly from those of other jurisdictions. Due to the lack of international standards in this area, all jurisdictions exhibit certain differences from one another. Three differences in particular stand out where Switzerland is concerned: Firstly, Switzerland has eschewed any direct interference with the business models of the systemically important banks. Secondly, Swiss regulations in this area are clearly focused on improving institutional

[52] The leverage ratio amounts to 24% of the risk-weighted requirements. This 24% also applies to each individual component (minimum, buffer, and progressive component) of the risk-weighted requirements.

[53] See http://www.bis.org/publ/bcbs283.htm

resolvability. Although this is a welcome side-effect in some foreign regulations, nowhere other than in Switzerland does this aspect constitute the focus of regulatory development. Thirdly, Swiss attempts to improve global resolvability involve incentives that take the form of discounts on the progressive component.

Elsewhere, organisational measures are more directly focused on limiting potential risks from certain activities, such as proprietary trading, for example. However, no country is envisaging a return to a segregated banking system that allows no form of financial interconnection between different entities.

In an international comparison, the Swiss regime emphasises the aspect of subsidiarity strongly. It is essentially at the discretion of the bank to decide on the scope of measures required with respect to its organisational structure, and the extent to which these measures must be implemented in a preparatory way as part of the emergency plan, or only in the event of the need arising. FINMA is reviewing these plans, and would only intervene in the event of deficiencies not being eliminated by the banks themselves. The statutory guidelines therefore set out the end objective, but do not lay down the specifics of implementation. Ultimately, it is for the banks to decide on their own corporate structure. However, each bank must demonstrate that it can continue its systemically important functions independently from the other parts of the bank in the event of a threatened insolvency.

If a bank succeeds in improving its global resolvability, this is rewarded in the form of rebates on the capital requirements that apply. The granting of these discounts is subject to strict requirements, however, which has the effect of ensuring an appropriate level of capital. This approach selected by Switzerland has no parallel elsewhere.

3.2.1.3 Measures for a crisis scenario

In this area, Switzerland's approach has largely been in harmony with international developments. For a number of years now, Switzerland has had its own special legislation covering the insolvency of banks, with the aim of ensuring their rapid and orderly resolution, while taking into account the need to protect the financial system, creditors, and depositors.

Like other countries, Switzerland has also refined its toolkit in this area recently, partially implementing the guidelines of the FSB. Specifically, provisions on the bail-in have been adopted and the option has been created for assets, liabilities, and contracts to be transferred to other legal entities such as bridge banks. There are still a number of gaps in the Swiss legal framework when compared to international standards, however. For example, a reduction in claims is not expressly mentioned in Swiss legislation, even though this aspect is an inherent part of the restructuring process. In addition, according to the wording of the Banking Act, a bail-in would only be possible as a last resort. There is a conflict between this wording and the preferred resolution strategy of FINMA and international developments.

In addition, FINMA has published a public position paper in which it sets out its own strategy for tackling a situation in which a systemically important financial institution finds itself in a crisis. In harmony with international developments, FINMA envisages the enforced participation of creditors at the highest consolidated level (single point of entry bail-in) for the resolution of an institution that finds itself in dire straits.

On the occasion of the G-20 Summit in Brisbane on 15-16 November 2014, the FSB unveiled a proposal for international standards of total loss-absorbing capacity (TLAC), and will finalise and approve these guidelines by the end of 2015. The work undertaken in this area is a logical consequence of resolution strategies involving the bail-in, which have now become internationally commonplace. TLAC is designed to promote and secure market confidence that an institution will at least be able to adhere to the capital requirements that apply after a restructuring, given a normal course of business.

The UK has already unveiled a concept with general loss-covering potential that includes bail-in liabilities in the form of the "Primary Loss Absorbing Capacity" (PLAC) concept. In the EU, at least 8% of an institution's balance sheet total will be subject to a bail-in in the future before state bailout funds can provide any financial assistance. With its progressive component, Switzerland too has a form of cover for a crisis scenario, although this is subject to fluctuations, which poses a question mark with respect to credibility and implementation certainty. In addition, the scope of the progressive component tends to be below international notions of what is required, even before any discounts are granted. The US meanwhile has declared its intention to draw up regulations with respect to bail-in liabilities. Switzerland will have to acknowledge these international developments and likewise define additional loss-absorbing capacity for a resolution event, in addition to the progressive component (whereby this component will be factored into calculations).

3.2.2 Status of implementation

Switzerland was the first country of the comparison group to act when it implemented a wide range of measures. It therefore partially shaped the development of international guidelines. Even as recently as a year ago, Switzerland was the only country to have binding rules in many areas. Now however, there is clarity with respect to regulatory parameters in almost all areas. Only the EU continues to lag somewhat behind, which is probably partly attributable to its special legislative and institutional setup. In addition, the international rules of the FSB and BCBS also appear to be stable now, although work is still being done in certain areas, such as the TLAC standard.

3.2.3 Summary

Switzerland attaches strong weighting to prudential measures in international comparison. By contrast, it eschews interference with corporate business models. However, the banks must be organised in such a way that the continuation of systemically important functions is guaranteed in the event of a crisis. Another feature unique to Switzerland is the coupling of the two measures, whereby an improvement in global resolvability of an institution can lead to rebates where the capital requirements are concerned. This approach is interesting insofar as it facilitates a certain degree of interchangeability between organisation adjustments on the part of the bank and the special equity capital requirements. The underlying logic of this approach lies in the fact that the residual risk for the state can be reduced by both measures. Additional equity capital reduces the likelihood of an insolvency, whereas organisational measures reduce the repercussions of any damage. If the appropriate organisational measures are taken, therefore, the justification of the capital surcharge therefore weakens to a certain extent. The progressive component also sets incentives for the banks to reduce their size and domestic market share. Together with possible capital discounts, however, this could lead to a situation in which there is insufficient cover to ensure an orderly resolution. International guidelines on TLAC will enable the Swiss approach to be improved in this area.

In summary, it may be concluded that Switzerland played a comparatively pioneering role, but was not alone. The international minimum standards of the FSB and BCBS are now being adopted everywhere. Fears that Switzerland might end up completely isolated with its TBTF regime – which was conceived and bindingly implemented within a very short space of time – have proved unfounded. Other countries have taken steps to close the gap between themselves and Switzerland.

3.3 Overall evaluation of the Swiss TBTF regime

On the basis of the considerations set out above, an overall valuation is undertaken in accordance with four specific questions. The first question is whether the overall concept – rather than its implementation status – is sufficient in an international comparison. The second question concerns the extent to which the envisaged results of the TBTF legislation have been achieved. The third question is whether the Swiss approach resolves the TBTF problem, or whether adjustments are necessary within the overall concept. Based thereon, the fourth question concerns how the TBTF regime can potentially be improved within the framework of the existing concept.

1. Should the Swiss approach be judged positively in an international comparison?

From an overall standpoint, the Swiss approach can essentially be judged to be positive in an international comparison. No realignment of the regulatory model is therefore necessary (e.g. in the direction of more rigorous rules such as segregated banking systems, bans on certain transactions, size restrictions).

When arriving at this view, it should be borne in mind that both the size of the Swiss banking sector as a proportion of GDP and its market concentration are high by international standards. The TBTF problem is therefore a particularly significant challenge from the Swiss perspective, justifying measures that go beyond the international average. Against this backdrop, the Swiss approach with respect to prudential measures (relating to capital, liquidity, risk distribution) was very much a pioneering one, both from an "early mover" perspective and with regard to the magnitude of the project. At the time of writing, comparative – and in some cases higher – requirements had come into force in other G-SIB jurisdictions.

Compared to other jurisdictions, the organisational measures chosen by Switzerland are liberal and subsidiary by nature, with rigorous organisational rules having been eschewed. The measures required for a crisis scenario are in accordance with international trends (recovery and resolution plans; bail-in strategy).

Conclusion: The Swiss approach should be evaluated positively in an international comparison, and no fundamental restructuring of the regulatory model is required.

2. Are the regulations laid down by the legislator being implemented by the big banks?

Both with regard to the risk-weighted capital requirements and with regard to the leverage ratio, implementation has so far has been rapid, to the extent that both Swiss big banks are ahead of the legally prescribed guidelines at the current point in time.[54] In terms of the requirements that will apply at the end of the transitional period (2019), the banks are still some way from achieving their quantitative targets (leverage ratio and RWA ratio).

Comprehensive progress has been made in the area of emergency planning. However, the status of implementation is not yet sufficiently advanced for Switzerland to be able to guarantee continuation of systemically important functions in the event of a crisis. Further progress is needed if this to be achieved. Both big banks have announced (and initiated) the necessary organisational measures in this respect, and are in the process of implementing the required Swiss emergency plan via an *ex ante* separation. According to the plans of the big banks, the implementation of this *ex ante* separation will last until at least 2015 and mid-2016 respectively. Even after this *ex ante* separation, it is clear from the banks' plans that further dependencies on the residual bank – e.g. financial interconnections such as initial guarantees to avoid termination rights being exercised by existing creditors – will impair the effectiveness of the emergency plans (in the sense intended by the legislator) for a transitional period of several years.

The same finding applies to measures to promote the resolvability of the entire systemically important bank, which go beyond the continuation of systemically important functions alone. As things stand today, an orderly resolution of the Swiss big banks would not be possible, which is why further progress by the banks in this area is crucial. Measures that promote the resolvability of the entire systemically important bank are a component part of the big banks' restructuring projects. Implementation of these measures is being coordinated with FINMA, but will take several more years according to the banks' own plans.

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[54] The legislation envisages staggered introduction of the requirements over a period of several years. This is designed to ensure that there are no negative repercussions for domestic credit supply.

Conclusion: In the area of prudential measures, implementation is basically on track. The target values for the capital ratios are likely to be achieved prior to the statutory deadline (beginning of 2019). However, the emergency plans as envisaged by legislation and the Banking Ordinance, as well a general improvement in resolvability, have yet to be implemented. The big banks have initiated steps for the necessary restructuring. If all the measures planned by the big banks with respect to the Swiss emergency plans and resolvability were to be implemented fully, the currently applicable minimum statutory requirements would probably be met.

3. Does the Swiss approach (as per the legislator) resolve the TBTF problem?

Both the estimates of the IMF and the rating bonus applied by S&P[55] suggest that the implicit state guarantee for the Swiss banks still exists, even if it is now of a lower magnitude than back in 2009. In addition, various developments and findings since the introduction of the TBTF legislation have made it clear that even complete implementation of the overall package of measures will not resolve the TBTF problem. Supplementary measures are therefore necessary.

Prudential measures

As the size of the banks' balance sheets has declined less strongly than the corresponding risk-weighted positions, and the two Swiss big banks have low RWA / total assets ratios in an international comparison, the question arises as to whether bank-internal models are adequately assessing the risks assumed. If the banks are underestimating these risks, their ability to withstand crises would be too low. In view of the great importance of the RWA capital ratios under the Swiss approach, appropriate calculation of RWA is a prerequisite if the TBF regulations are to have their envisaged effect.

The rebates on equity capital – which the banks will have to be granted in order to avoid consolidation effects resulting in increased requirements at group level (Article 125 CAO) – have led to the lowest statutory permissible risk-weighted capital requirements at individual institution level of 14% (plus countercyclical buffer), and to the preferential treatment of participations. As other jurisdictions have now ushered in higher capital requirements for subsidiary companies, these rebates in Switzerland have brought about a situation in which the capital bases of the parent companies of the big banks, which are of particular importance from the Swiss perspective, now look rather meagre. As things stand today, the parent companies with their systemically important functions remain the core of both banking groups.

Organisational measures

The greatest challenge from today's standpoint is the implementation of the Swiss emergency plans. As the Swiss approach does not prescribe direct organisational measures, the implementability of the emergency plans is of particular importance, as only with an implementable emergency plan that guarantees the continuation of systemically important functions can the *de facto* obligation of the state to bail out a bank be reduced in the event of a crisis. In Swiss legislation, it is left up to the banks to decide whether to base their emergency plans on an *ex post* or an *ex ante* separation of their systemically important parts. However, the *ex post* separation of systemically important parts has turned out to be problematic in Switzerland. Both the Swiss big banks have clearly stated their desire to achieve the prompt practicability envisaged by the legislation through an *ex ante* hiving-off of their systemically important functions into a separate legal entity. Should an SPE bail-in not function or prove insufficient, the prerequisites for the continuation of the systemically important functions include the complete implementation of the *ex ante* separation, operational and therefore

[55] At the current time, both UBS and CS enjoy an uplift of two notches. S&P has recently put CS on its negative watch list, but the rating bonus remains in place for now. Over the next few years, S&P will review whether the TBTF measures will result in a deterioration of the Swiss big banks' credit ratings (thereby confirming the effectiveness of the measures).

financial decoupling from the rest of the banking group, and an appropriate capital and liquidity base for this entity in every phase of the process.
International experiences and regulatory discussions show that a single point of entry resolution strategy presupposes the subordination of loss-absorbing capital – structurally, legally, or contractually – as well as requiring at least a minimal decoupling of organisational entities in order for a restructuring to be possible (should the need arise). In the US, for example, the big banks are set up as bank holding companies.

Measures for a crisis scenario

Furthermore, it is unclear whether there is a sufficient liability substrate to enable an orderly resolution of the remainder of the bank in the event of a crisis. Under Swiss TBTF regulations, the progressive component also has a role to play in providing such a liability substrate. The level of the progressive component is unlikely to be high enough for this function to be fulfilled, however. Among other things, this is explained by the different objectives that the progressive component is designed to meet (incentive mechanism for reducing the size of the balance sheet and market share, as well as to improve global resolvability; ensuring sufficient funding is available for resolution). In this context, work is in progress on the bail-in as a means for obtaining capital for resolution, with the forced participation of certain bondholders being envisaged. The crucial requirement is for there to be sufficient liabilities available at the point of threatened insolvency to facilitate a restructuring. Legal certainty and enforceability are of paramount importance. Where the legal toolkit in the area of crisis measures is concerned, recent international studies[56] have confirmed that there are weaknesses in Switzerland's armoury.

Conclusion: From today's standpoint, even complete implementation of the TBTF legislation does not fully resolve the problem. Additional measures to strengthen the overall Swiss package are required to increase the resilience of the big banks, and to facilitate a restructuring or orderly resolution without this requiring taxpayers' money.

4. How can the implicit state guarantee be eliminated (or dramatically reduced)?

In the light of international developments, a number of more rigorous requirements within the framework of the existing regulatory model are called for. Conceivable approaches in this respect include:

⇒ Significant TLAC requirements (e.g. bail-in bonds) to ensure that sufficient resources in the form of bail-in bonds are available to facilitate a restructuring or orderly resolution.

⇒ High capital requirements: An increase in requirements for the leverage ratio and/or higher risk-weighted capital requirements; introduction of an RWA floor or multipliers[57] and/or higher transparency requirements regarding the calculation of RWA.

⇒ Additional requirements with respect to the Swiss emergency plan and global resolvability, e.g. for the *ex ante* separation of systemically important functions in order to ensure their uninterruped continuation in the event of a crisis, or regulations to limit financial and operational interconnectedness.

Such measures have complementary and/or mutually substitutable characteristics, and may be combined with one another to a certain extent. As they pursue different objectives, however,

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[56] Key Attributes pilot assessment and IMF FSAP. For example, the reduction in claims should be expressly mentioned in legislation and the bail-in explicitly regulated.

[57] An RWA floor involves the setting of a minimum level of certain model-based RWA based on the model-independent standard approach, for example. This can prevent the problem of banks that rely on internal models being able to hold significantly less equity capital than other banks. In the US, for example, systemically important banks calculate not only model-based RWA but also RWA under the standard approach (the so-called "Collins Amendment" to the Dodd-Frank Act). The higher of the two figures is used for purposes of determining regulatory capital ratios. Another possibility would be the application of multipliers to model-based risk weightings for specific positions, just like FINMA has decreed with respect to a certain proportion of a Swiss mortgage, for example.

the degree of substitutability is limited. The prudential measures (CET1 and high-trigger CoCos) reduce the likelihood of a crisis, while organisational measures / measures for a crisis scenario (e.g. TLAC requirements) reduce the bank's costs in a crisis. In order to eliminate the state guarantee, an orderly resolution of an institution – including the continuation of systemically important functions – must be possible. This cannot be achieved through higher capital requirements alone. The combination and design of these measures should be determined against the backdrop of further international developments in the area of TLAC.

4 Recommendations

Comparative international analysis has confirmed that the Swiss regulatory model is fundamentally well-suited to reducing the TBTF problem. However, it has also become apparent that certain adjustments within this model are necessary in order for the implicit state guarantee – which lies at the heart of the TBTF problem – to be eliminated permanently. The group of experts proposes already making changes in the three sub-areas (prudential measures, organisational measures, measures for a crisis scenario), and conducting further regular reviews of the effectiveness of the overall packages in the future.

Prudential measures

1. *Review of RWA calculation method and possible introduction of improvement measures*

FINMA is currently investigating (with the support of the SNB) whether (and to what extent) the RWA based on bank-internal model approaches differ from RWA calculated according to the standard approach (which is not model-dependent). As long as this investigation does not reveal any material and inexplicable differences, the market's confidence in the model-based approach is likely to be strengthened. By contrast, if inexplicable material differences do emerge, corrective measures should be reviewed and implemented. Conceivable approaches here include the introduction of an RWA floor or multipliers, for example. Higher transparency requirements may also make sense.

2. *Recalibration of capital requirements*

Without including the progressive component – which represents the liability substrate for a crisis scenario under the Swiss approach – the requirement for the "going concern leverage ratio" for the big banks amounts to 3.12%.[58]

This is scarcely any higher than the international minimum standard of 3% that applies to all banks (including non-systemically-important banks), and is significantly below the corresponding requirements that will apply to systemically important banks in the US in the future (5-6%)[59].

Given this background, the capital requirements should be adjusted in line with the following three principles[60]:

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[58] The "going concern" capital requirements include both the basic requirement and the overall capital buffer.

[59] Comprising the eight Bank Holding Companies (BHCs) with consolidated total assets of more than USD 700 billion or more than USD 10 trillion of assets under custody.

[60] Minority position: "The big banks are essentially in agreement with the principles for the recalibration of the capital requirements, but consider the following qualifications to be necessary: The fulfilment of the third principle should not lead to an increase in risk-weighted capital requirements. Furthermore, it should be noted that an international leverage ratio comparison should only be undertaken on a like-for-like basis, and that any recalibration must take into account the totality of all impending regulatory tightenings."

- Switzerland should rank among the countries that have high "going concern" capital requirements for G-SIBs. This should be the case with respect to both risk-weighted capital requirements and the leverage ratio.
- The increases necessary to preserve this first principle should be introduced in consideration of any measures taken under recommendations 1 and 6.
- The leverage ratio should continue to be conceived as a safety net when determining the capital requirements that apply in normal scenarios.

3. *Adjustments to capital quality*

According to the international standard, the leverage ratio is calculated on the basis of core capital (Tier 1). Under Swiss TBTF regulation, however, the "going concern" capital requirements include not just the basic requirements but also the entire capital buffer, which may be fulfilled in part with high-trigger CoCos. Swiss regulation allows the banks to combine both Tier 1 and Tier 2 instruments with high-trigger and low-trigger CoCos. The banks have made use of this allowance. For this reason, the Swiss leverage ratio requirement cannot be easily compared with requirements that are based on the Basel standard. For the Swiss approach to be more readily comparable with international standards, therefore, the proportion that may be fulfilled with high-trigger CoCos should exhibit capital quality of Tier 1 at least. The appropriate transitional provisions (e.g. grandfathering) should be envisaged for these adjustments.

4. *Amendment of Article 125 CAO for systemically important individual institutions*

In order to ensure an appropriate level of capitalisation in the entities that contain the systemically important functions, Article 125 CAO should be amended, and in particular should not apply to the *ex ante* hived-off Swiss bank that forms the basis of the emergency plan. Irrespective of foreign requirements for other entities, the Swiss bank established for the emergency plan should fulfil the capital requirements envisaged at group level without rebates.

Organisational measures

5. *Determination of a date by which the Swiss emergency plan and the improved global resolvability should be implemented*

The TBTF legislation stipulated a specific date (beginning of 2019 at the latest) by which the required level of capitalisation must be in place. By contrast, there is no clear timeline or publicly communicated deadline for the completion of emergency planning (and therefore the guaranteed continuation of the systemically important functions), or for the measures designed to bring about improved resolvability. In other words, it could be a number of years before measures are taken that reduce financial and operational interconnectedness in these two areas. This should be corrected through the establishment of a binding and publicly communicated target date. When determining the timeline, it should be taken into consideration on the one hand that for every year in which the recovery and resolution plans are not yet implementable, there is a risk of the state having to step in once again in the event of a severe shock. On the other, it must be conceded that the organisational measures of the big banks require a certain period of implementation.

When designing the measures, it should be taken into account that only a certain internal operational and financial *ex ante* unbundling can guarantee the resolvability of a bank, as this is what makes it possible to hive off individual entities in the event of a crisis.

FINMA should assume a rigorous controlling role with respect to implementation of the emergency plans, and inform the authorities regularly about the status of planning and implementation of these plans and the work taking place within the Crisis Management Colleges on global resolution plans.

Measures for a crisis scenario

6. *Expansion of the TBTF regime to include binding TLAC requirements so that sufficient liabilities are available to facilitate a restructuring or orderly resolution.*

The magnitude of these additional requirements should at least be aligned with the key figures contained in the FSB proposal, which were published for purposes of consultation on 10 November 2014 and are set to be finalised by the end of 2015. In the event of the FSB being unable to agree on a standard during the process that follows the Brisbane G-20 Summit, Switzerland would nonetheless have to take regulatory action. This would be justified due to the crucial importance of this measure for the elimination of the TBTF problem. Moreover, it is likely that countries such as the US and the UK will issue regulations in this area in any case. Under the Swiss TBTF regulations, the progressive component has a role to play in providing such a liability substrate, among other things[61]. The level of the progressive component is unlikely to be high enough to fulfil this function at the moment, however, particularly bearing in mind the fact that it can fall to as low as 1%. The TLAC concept is essentially compatible with Swiss capital requirements for systemically important banks. With the introduction of the progressive component and the low-trigger convertible capital instruments (CoCos), the TBTF regulation has already anticipated the TLAC to a certain degree through the creation of contractual "resolution capital". The work on putting the binding TLAC requirements into concrete terms must be continued swiftly by including all parties involved.

In the view of the group of experts, two additional flanking measures – one of a legal nature, one of a tax nature – are required for the bail-in strategy to be successful and for losses to be borne by creditors in the event of a crisis:

7. *Legal adjustments to strengthen the Swiss toolkit for a crisis scenario*

Legal certainty and enforceability are crucial factors if a crisis is to be successfully managed. This is the only way of ensuring that resolution plans will actually work in practice. Even the most recent international investigations have identified certain weaknesses in Switzerland's legal toolkit in the area of crisis measures. For example, the reduction in claims is only mentioned in Swiss legislation in the context of a conversion of debt capital into equity capital (Article 31 para. 3 BankA). According to the current wording of the Banking Act, a bail-in would only be possible as a last resort, which is not compatible with the preferred resolution strategy.

8. *Adjustments to withholding tax to increase the appeal of bail-in bonds issued in Switzerland*

An important prerequisite for the improved enforceability of a bail-in by FINMA is the issuance of such instruments in Switzerland. Adjustments to tax parameters would be helpful in this respect. The tax conditions for the issuance of bail-in bonds in Switzerland should be improved. Only an attractive Swiss capital market can facilitate the issuance of the corresponding volumes at competitive prices. A central flanking measure envisaged is therefore the conversion of Swiss withholding tax into a paying agent tax, and – depending on how long this reform takes – a fixed-term exemption of bail-in bonds from withholding tax for a transitional period (cf. the recommendations of the group of experts in the tax sphere).

[61] In addition to the incentive effect to reduce balance sheet size and market share, there is also an incentive to improve resolvability.

Regular review of effectiveness of overall package

As things stand at the moment, it cannot be evaluated whether a fully implemented Swiss TBTF regime, including the changes recommended here, will suffice to eliminate the implicit enforced intervention on the part of the state and the associated implicit subsidies that the big banks enjoy. Such an evaluation cannot take place until the big banks have implemented their announced and initiated restructuring projects, and the additional measures outlined in the section above have been implemented. The group of experts therefore recommends regular reviews of the effectiveness of this regime.

9. *The effectiveness of the regime should be reviewed at two-yearly intervals as envisaged by legislation (Art. 52 BankA), with any additional measures required to be taken on this basis.*

At the same time, FINMA should regularly assess the progress made in the preparation and implementation of the emergency plans and global resolvability as per the Banking Ordinance, as well as taking into account the criteria drawn up by the Financial Stability Board. On the basis of the available indicators and analysis, the authorities should review the extent to which emergency plans and an orderly resolution of entire banks can be credibly implemented, and whether an implicit state guarantee still exists.

If these reviews reveal that there are still indicators of an implicit state guarantee and major obstacles to securing resolvability, additional measures will have to be taken – e.g. higher capital requirements and/or more rigorous requirements with respect to the emergency plan and resolvability.

5 Appendix

5.1 Appendix 1: Overview of G-SIBs (FSB list as per Nov. 2014)

Relevance level / (additional core capital requirements)	Name	Headquarters
5 / (3.5%)	Empty	-
4 / (2.5%)	HSBC	UK
	JP Morgan Chase	USA
3 / (2.0%)	Barclays	UK
	BNP Paribas	France
	Citigroup	USA
	Deutsche Bank	Germany
2 / (1.5%)	Bank of America	USA
	Credit Suisse	Switzerland
	Goldman Sachs	USA
	Mitsubishi UFJ FG	Japan
	Morgan Stanley	USA
	Royal Bank of Scotland	UK
1 / (1%)	Agricultural Bank of China	China
	Bank of China	China
	Bank of New York Mellon	USA
	BBVA	Spain
	Groupe BPCE	France
	Group Crédit Agricole	France
	Industrial and Commercial Bank of China Limited	China
	ING Bank	Netherlands
	Mizuho FG	Japan
	Nordea	Sweden
	Santander	Spain
	Société Générale	France
	Standard Chartered	UK
	State Street	USA
	Sumitomo Mitsui FG	Japan
	UBS	Switzerland
	Unicredit Group	Italy
	Wells Fargo	USA

5.2 Appendix 2: Glossary

Term	Meaning
para.	paragraph
Art.	Article
AT1 (additional tier 1 capital)	According to Article 20 CAO, additional Tier 1 capital must be subordinate to the senior claims of all other creditors, must be fully paid-in or internally generated, may not be financed by the granting of bank loans, and may not be secured or offsettable against assets of the bank. Moreover, according to Article 27 CAO, such capital may not be issued with a fixed term or with the expectation of repayment. It may be paid back after five years at the earliest, and only at the bank's initiation with the approval of FINMA. Dividends or interest on such capital may only be distributed if sufficient reserves are available, and on the condition that the payment of such dividends remains at the bank's discretion. Furthermore, payments to investors may not be made dependent on the bank's credit rating, nor may there be any "step-up" payments during the term. If AT1 capital falls below the ratio of 5.125% vis-à-vis total capital or if – insofar as this occurs at an earlier stage – any other predefined trigger should be reached, Article 27 para. 3 CAO stipulates that one of the following must occur: (i) AT1 capital is to be converted into debt capital (i.e. with no additional core capital in the form of preferred shares or participation certificates) or (ii) a waiver of claims is triggered. The acceptance of such losses must be prescribed in the issuing conditions of the AT1 instrument.
Bail-in	In the Banking Insolvency Ordinance (BIO-FINMA), FINMA prescribes that in the event of a restructuring procedure (e.g. if there are justified grounds for restructuring a bank that has ended up in dire straits, or at least if there is a prospect of continuing certain individual business activities) it may decree the conversion ("bail-in") of other debt capital or a waiver of claims (irrespective of the existence of any contractual regulation in this respect), if it deems this to be necessary, on the basis of which the bank may once again fulfil regulatory capital requirements following conclusion of the restructuring process. Such a statutory bail-in is considered a measure of the last resort, and should only be decreed if the losses borne by the bank's issued capital instruments are insufficient to restore the bank's capital base to the prescribed statutory level. Moreover, creditors must be placed in a better likely position than if bankruptcy proceedings were to be immediately launched. (See also Appendix 3)
Bail-out	In economic science, the term bailout describes the process whereby a third party or third parties – typically the state or state-owned institutions – assume liability for a company's debts and their repayment, as well as other liabilities, as a result of an economic, financial, or corporate crisis.
BankA	Federal Law on Banks and Savings Banks of 8 November 1934 (Banking Act, SR 952.0)
BankO	Ordinance on Banks and Savings Banks of 17 May 1972 (Banking Ordinance, SR 952.02)
Basel III	Package of measures drawn up by the BCBS for the Bank for International Settlements (BIS) to reform the existing set of bank regulations known as "Basel II". Valid from 2013, this represents the response to the weaknesses of the existing regulatory regime (which applied to all banks) when these became evident as a result of the global financial and economic crisis from 2007 onward.
BCBS	Basel Committee on Banking Supervision
GDP	Gross domestic product
BIS	Bank for International Settlements

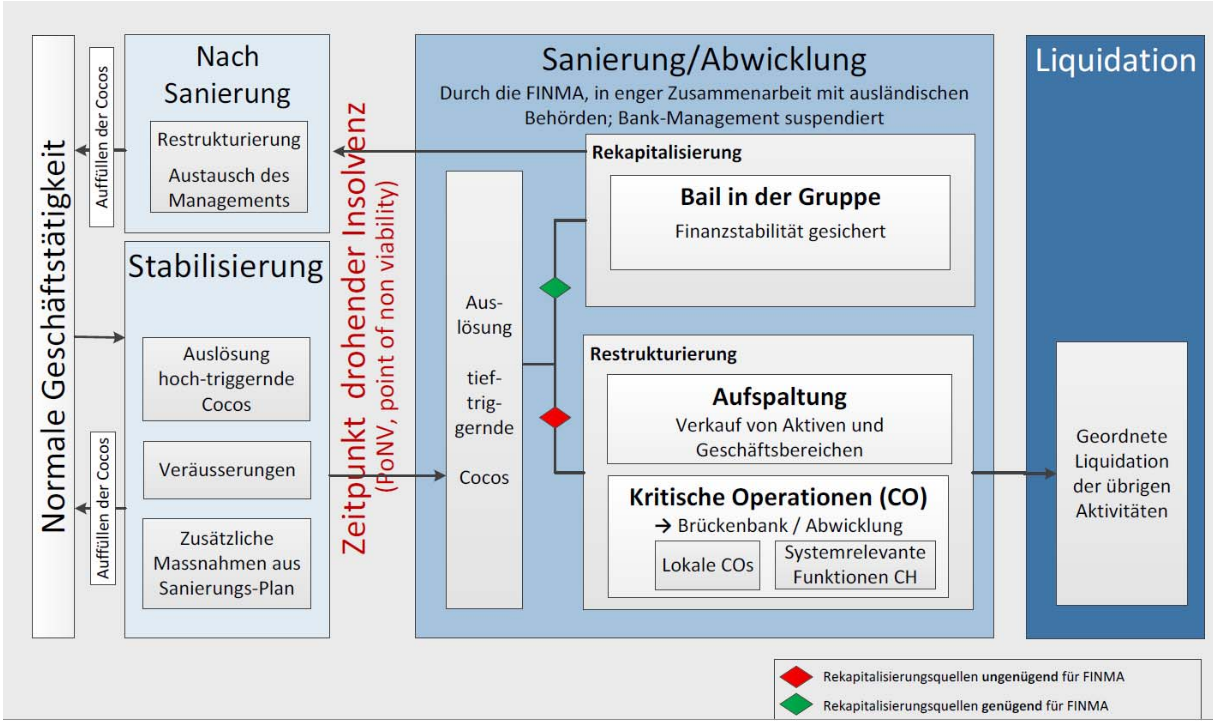
CCP	Central counterparty, or the legal entity acting as a contracting party between buyer and seller on stock exchanges and other trading platforms for (particularly OTC) derivatives. The CCP effectively assumes the role of buyer vis-à-vis each seller, and vice versa.
CET 1 (hard core capital)	Common Equity Tier 1 capital: according to Article 21 et seq. of the revised Capital Adequacy Ordinance (CAO), this includes common equity, paid-in share capital, disclosed reserves, reserves for general banking risks, profit carried forward, and profit for the current financial year after deduction of the estimated profit distribution amount. In order to qualify as CET 1, capital must not have any preferential rights associated with it (e.g. no privileged position with respect to the liquidation proceeds).
CFTC	Commodity Futures Trading Commission: based in Washington D.C., the CFTC is an independent authority of the United States and regulates futures and options markets in the US.
CMG	Crisis Management Groups = mechanism for the exchange of information, cooperation, and coordination between the relevant "home" supervisory authorities and "host" supervisory authorities.
CoCos	Contingent convertible capital instruments are hybrid capital securities that absorb losses in accordance with their contractual terms when the capital of the issuing bank falls below a certain level.
CRD IV	EU Directive 2013/36 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms
CRR	EU Regulation 575/2013 on prudential requirements for credit institutions and investment firms
CS	Credit Suisse Group AG
DFA	Dodd-Frank Act
D-SIB	Domestic systemically important bank
EBA	European Banking Authority
EMIR	"European Market Infrastructure Regulation": an EU regulation that addresses over-the-counter (OTC) trading in derivative products. Like the international guidelines laid down by the G-20 and the FSB, the core of this regulation is to oblige market participants to ensure clearing of their standard OTC derivative transactions through a central counterparty, and to record all derivative transactions in a so-called trade repository (i.e. a transaction register). EMIR took immediate legal effect for EU member states with the adoption of EU Regulation no. 648/2012 on OTC derivatives, central counterparties and trade repositories. The implementation of EMIR is being overseen by the EU authority ESMA.
CAO	Ordinance of 1 June 2012 on Capital Adequacy and Risk Diversification for Banks and Securities Dealers (SR 952.03)
ESM	European Stability Mechanism: an international financial institution based in Luxembourg, the ESM entered into force on 27 September 2012 when Germany deposited its formal ratification document with the General Secretariat of the Council of the European Union. The ESM is part of the "euro safety net" and will replace the European Financial Stability Facility (the EFSF).
ESMA	European Securities and Markets Authority: established with effect from 1 January 2011 by EU Regulation No. 1095/2010, the ESMA is commonly seen as the successor institution to the Committee of European Securities Regulators (CESR), but has a much broader remit as well as a wider range of powers. This authority is an integral part of the European System of Financial Supervisors. The task of the authority, which is based in Paris, is to protect the public interest by contributing to the short-term, medium-term, and long-term stability and effectiveness of the financial system on behalf of the European Union, its citizens, and companies.
EU	European Union

ECB	European Central Bank
et seq.	Abbreviation of the Latin *et sequentes* or *et sequentia*, meaning "and the following"
FBO	Foreign Banking Organization
FED	Federal Reserve = US central bank
FDIC	Federal Deposit Insurance Corporation
FMIA	Federal Market Infrastructure Act. Due to enter into force in 2015, this new Swiss legislation is to increase market transparency through global regulations for the reporting of derivatives and through the central clearing and risk reduction of OTC-traded derivatives, as well as to systematically reduce counterparty risks. At the same time, the prompt harmonisation of Swiss regulations with new international standards is designed to ensure the continuous access of the Swiss financial centre to international financial markets and the EU financial market in particular (see EMIR).
FSAP	Financial Sector Assessment Program: established in 1999, the FSAP is a comprehensive and in-depth analysis of a country's financial sector. FSAP assessments are the joint responsibility of the IMF and World Bank in developing and emerging market countries, and the responsibility of the IMF alone in advanced economies. They include two major components: a financial stability assessment, which is the responsibility of the IMF and – in developing and emerging market countries – a financial development assessment, which is the responsibility of the World Bank.
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
G-20	The world's 20 leading economic nations (key industrialised and emerging countries).
Going concern	The "going concern" principle is originally an accounting term, and expresses the assumption that a company will be able continue its business activities on the basis of a valuation of its balance sheet items, as long as there are no material or legal obstacles to undermine this assumption.
Gone concern	Company in the process of being liquidated. The debts of such companies are immediately due in their entirety, and the market value of these debts is determined on the basis of an auction or the liquidation value of tangible assets.
G-SIB	Global systemically important bank
G-SII	Global systemically important insurer
IAIS	International Association of Insurance Supervisors
ICH	Intermediate holding company
IMF	International Monetary Fund
Living Will	Plan that describes the bank's strategy for rapid and orderly resolution in the event of material financial distress or failure, comprising a public and a confidential section. See also "RRP".
LCR	Liquidity Coverage Ratio
LR	Leverage ratio
MiFID	"Markets in Financial Instruments Directive": an EU regulation designed to harmonise financial markets in the European domestic market. Existing national regulations on the processing of financial services are to be enhanced through provisions to protect investors, greater transparency of financial markets, and increased integrity on the part of financial services providers.
MPE	Multiple point of entry
MREL	Minimum requirements for own funds and eligible liabilities, see BRRD
NSFR	Net stable funding ratio
OCC	Office of the Comptroller of the Currency
OECD	Organisation for Economic Co-operation and Development
OLA	Orderly Liquidation Authority: a critical component of the effort to end the "too big to fail" doctrine in the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA), the OLA oversees a procedure that enables the federal government to wind up a failing financial institution that presents a systemic risk, rather than support the institution, its shareholders and unsecured creditors with new capital or loans from the government.
OTC	"Over the counter": describes the trading of securities or derivatives outside of an exchange.
PLAC	Primary Loss Absorbing Capacity. The UK Independent Commission on Banking (ICB) has stressed the importance of banks being able to absorb losses by having sufficient PLAC – i.e. equity and potentially loss-absorbing liabilities. A bank can continue to operate provided its losses do not exceed its PLAC, so the larger the PLAC, the more resilient a bank is likely to be.
Raiffeisen	Raiffeisen Schweiz Genossenschaft
RCAP	Regulatory Consistency Assessment Program
BRRD	EU Directive establishing a framework for the recovery and resolution of credit institutions and investment firms (2014/59/EU)
RRP	Recovery and resolution plan

RWA	Risk-weighted assets
SBA	Swiss Bankers Association
SEC	United States Securities and Exchange Commission: the US supervisory body entrusted with overseeing securities trading in the US. It was founded on 6 June 1934 by the Securities Exchange Act as a response to the New York stock market crash of 1929, in order to establish state oversight with respect to securities dealing, which had previously been unregulated.
SIFI	Systemically important financial institution
SPE	Single point of entry
SRM	EU Regulation No. 806/2014 establishing a Single Resolution Mechanism (SRM) for the Banking Union
SRR	Special Resolution Regime. Created by the UK's 2009 Banking Act, the SRR gives the UK authorities a permanent framework and tools for dealing with failing UK banks, building societies, investment firms and central counterparties. It gives the Bank of England a key role in implementing a resolution with the statutory resolution tools.
SSM	EU Regulation No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions
Subordinated debt	Subordinated loans form part of a company's mezzanine capital, and are financial instruments that rank below other claims against the indebted company in the event of liquidation or insolvency.
Tier 1 (core capital)	Core capital (CET1 and AT1) comprises capital elements that are permanently available to the institution and fully eligible for the covering of liabilities.
Tier 2 (supplementary capital)	According to Art. 30 CAO, supplementary capital must fulfill the requirements that are generally applicable to equity capital as per Article 20 CAO. Supplementary capital must have an original term of at least five years, and should not involve any incentive for the bank to repay it. Supplementary capital may only be paid back after five years at the earliest, and even then only at the bank's initiation with the approval of FINMA. No "step-up" payments to investors during the term should be envisaged. The purpose of supplementary capital is to absorb losses in the event of a company discontinuing operations ("gone concern").
TBTF	Too big too fail
TLAC	Total loss-absorbing capacity: quantitative and qualitative FSB minimum standards should apply to loss-absorbing capital (in both "going concerns" and "gone concerns"). Earlier drafts of this minimum standard were discussed in the FSB using the abbreviation GLAC (going concern loss-absorbing capacity).
UBS	UBS AG
UK	United Kingdom
USA or US	United States of America
ZKB	Zürcher Kantonalbank

5.3 Appendix 3: Bail-in as a resolution tool

Process to be followed in the event of a crisis enveloping a systemically important financial institution, including resolution measures



In the event of a crisis, a bank will first of all – with the involvement of FINMA – initiate the measures that it has already drawn up in a stabilisation plan. The high-trigger CoCos will be converted as soon as the bank's hard core capital (CET 1) falls to (or below) seven percent of risk-weighted assets. After this, the company has fresh equity capital which may suffice to prevent it being restructured or wound up. In addition, further measures would be triggered to strengthen the capital and liquidity base, up to and including the divestment of certain business areas.

If the group cannot be successfully stabilised, FINMA will implement the restructuring strategy based on the provisions of the Banking Act that cover the measures that apply in the event of a threatened insolvency. If there are justified concerns that a bank is excessively indebted or has serious liquidity problems, or if the bank does not meet its statutory capital requirements upon expiry of a deadline set by FINMA, FINMA may initiate resolution proceedings. FINMA has a certain freedom of manoeuvre with respect to its assessment of whether the trigger point has been reached or not (as per Art. 21c para. 2 BankO). This trigger point is generally described as the point of non-viability (PONV).

When the PONV is reached, the low-trigger contingent capital instruments would generate fresh capital.[62] CoCos therefore have loss-absorbing potential. At the same time, FINMA will assume control of the financial group. It will then initiate an official resolution procedure. The key issue here is whether there is a real prospect of a successful restructuring so that market confidence can be restored. The preferred resolution strategy of FINMA is a bail-in, whereby providers of debt capital are involved in the restructuring of the bank.[63]

[62] Depending on the level of the progressive component.
[63] See: FINMA Position Paper on Resolution of G-SIBs, 7 August 2013.

According to the Swiss bank insolvency regime, all liabilities – with a few clearly defined exceptions – are subject to mandatory conversion from debt to equity capital, or are written down. However, any "privileged" claims (e.g. the claims of employees) are excluded, as are client deposits up to the protected ceiling of CHF 100,000 per depositor. Secured and offsettable claims may likewise not be converted or written down.

A bail-in is therefore preceded by the elimination of existing equity capital and remaining regulatory capital, including any capital from the conversion of CoCos.[64] These are followed by subordinate claims, then all other claims. Only as a last resort may unsecured and unprivileged deposits be converted into new equity capital. In addition to (or instead of) the conversion of debt to equity capital, partial or full reductions in claims ("haircuts") are possible. If reductions in claims are effected, however, FINMA has the option of deviating from this principle and distributing the losses between several creditor categories. This has the effect of increasing flexibility.

Non-privileged deposits (amounts exceeding CHF 100 000 per depositor) are also theoretically subject to the bail-in, but only once all other liabilities have already been held liable. In conclusion, it may be said that the combination of the conversion of CoCos and an SPE bail-in would suffice to cover very high losses.

If it turns out that a bail-in is out of the question, and that the entire bank – for example as a result of a sale – cannot be saved, and the existing group structure cannot be preserved, it is likely that both the Swiss and local emergency plans would have to be triggered.

[64] In other words, Tier 1 (CET1 and AT1) and Tier 2.

5.4 Appendix 4: Members of the Economic Risks Subgroup

Economic Risks Subgroup:

- Aymo Brunetti, Professor, University of Bern (Chairman of the Subgroup)
- Jean-Pierre Danthine, Vice Chairman of the Governing Board of the SNB
- Mark Branson, Director, FINMA
- Urs Rohner, Chairman of the Board of Directors, Credit Suisse
- Axel Weber, Chairman of the Board of Directors, UBS
- Volcker Bätz, Recovery & Resolution Office, Credit Suisse
- Christian Hott, Economic Advisor, Government and Industry Affairs, Zurich Insurance

  Henrique Schneider, Head of Economic Policy, Energy and Environment subdepartment, Swiss Trade Union Association (SGV)
- Daniel Roth, Head of Legal Services, FDF
- David S. Gerber, Deputy Head of Markets Division, SIF
- Gabriele Puglisi, Financial Market Policy Section, SIF, Secretariat
- Marc Zahner, Monetary and Financial Stability Section, SIF, Secretariat

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