Schweizerische Eidgenossenschaft
Confédération suisse
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Swiss Confederation

Der Bundesrat
Le Conseil fédéral
Il Consiglio federale
The Federal Council

Basic information

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Dispatch on strengthening financial sector stability (too big to fail)

Definition

"Systemically important banks are banks, financial groups and bank-dominated financial conglomerates whose failure would do considerable harm to the Swiss economy and the Swiss financial system." (Article 7 para. 1 of the preliminary draft of the Banking Act)

Capital

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

- The basic requirement is to be fulfilled as a minimum in order to comply with the licensing prerequisites for normal business activities.
- The capital buffer allows banks to absorb losses without falling short of the basic requirement and without having to suspend normal business activities.
- Finally, the progressive component ensures that banks with increasing systemic importance are more strongly capitalised. It thereby gives banks the financial freedom of manoeuvre to deal with a crisis by implementing a previously drawn-up emergency plan.

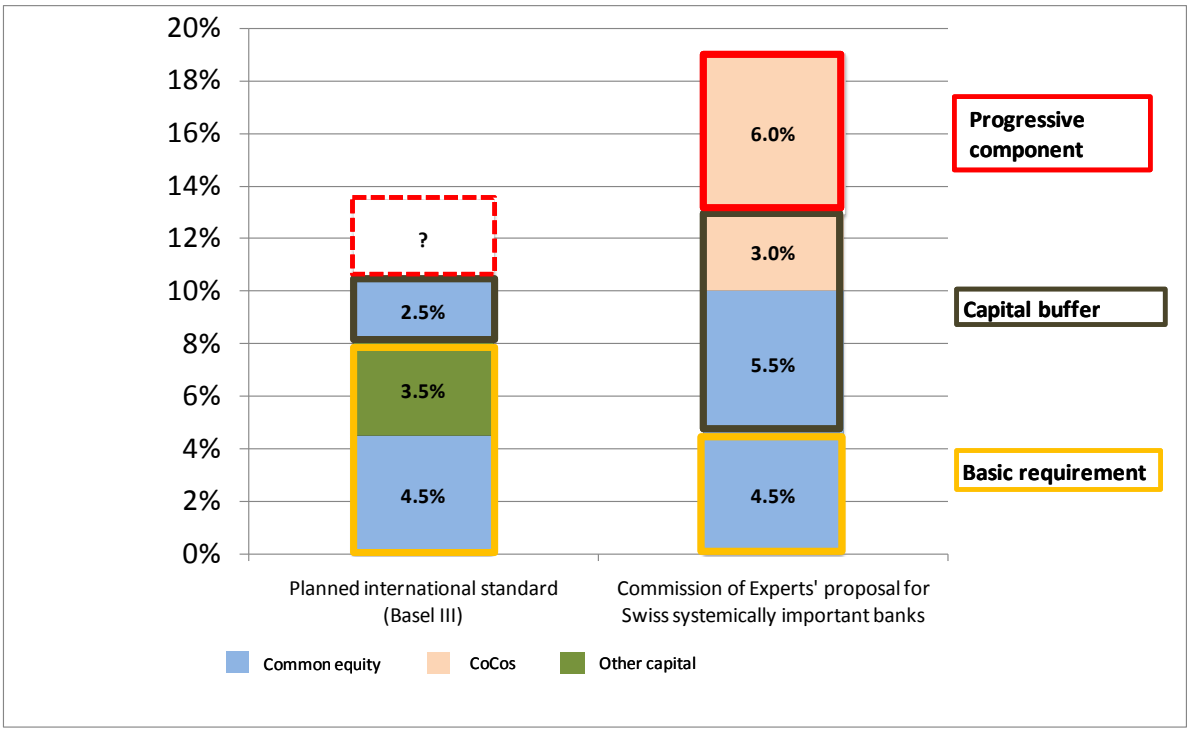
The concept applies both to the risk-weighted equity ratio and to the minimum level of equity capital as a proportion of the balance sheet total ("leverage ratio"). In addition, banks are given incentives to lower these requirements by adjusting their risk.

CoCos

CoCos are bonds that are converted into equity capital or written off after a specific event occurs (when a threshold, or trigger, is reached). CoCos constitute a significant element for strengthening capital. CoCos are beneficial for stability reasons: the higher the risk of a bank, the greater the risk premium demanded by CoCo investors. This means that banks that issue CoCos have an incentive to lower their risk. Moreover, CoCos have the advantage of constituting debt capital for banks, which is more favourable in tax terms than equity.
A distinction is made between two different types of CoCo. On the one hand, CoCos with a

trigger of 7% of risk-weighted assets (RWA) serve as a supplementary capital buffer. On the other, CoCos with a trigger of 5% of RWA should ensure the necessary capital reserve to finance the maintenance of systemically important functions in the event of threatened insolvency. Based on the current systemic importance of the two big banks, this so-called progressive capital component amounts to approximately CHF 24 billion each.

Capital requirements for systemically important big banks



Basel III:

Basel III is a package of reforms drawn up by the Basel Committee on Banking Supervision (BCBS) to strengthen regulation in the banking sector. The new set of regulations should replace the current international standard of Basel II and be introduced from 2013 at the national level, i.e. also in Switzerland, albeit with a transition period up to 2019 during which the requirements to be met will gradually increase. The regulations define capital and liquidity requirements in particular. Accordingly, a bank's common equity Tier 1 (CET1) must now be at least 4.5% of risk-weighted assets (RWA) instead of 2% up to now. The minimum requirement for total eligible capital (Tier 1 and Tier 2) is still 8% of RWA. However, banks must now maintain a capital conservation buffer of 2.5% of RWA in common equity Tier 1 in addition, and they may temporarily fall short of this only in times of stress.

The state and government heads of the G20 countries reiterated their intention in last year's summit in Seoul to implement Basel III fully and within the stipulated period. For systemically important financial institutions (SIFIs), additional requirements above and beyond Basel III are envisaged also at the international level such as in the area of capital or resolvability. The Financial Stability Board (FSB) is to draw up corresponding recommendations by the end of 2011 which will make provision for supplementary capital amongst other things for globally active SIFIs. The amount will depend on the systemic importance of the bank.

Tax-related accompanying measures

The conversion of CoCos should run as smoothly as possible in a crisis in order for the

instrument to prove effective. Therefore, the tax framework for the Swiss bond market, and particularly for CoCos, is to be improved so that these instruments can be issued in Switzerland at internationally competitive conditions.

Aside from the reduction in legal risks achieved with the issue of CoCos under Swiss law, there are also economic arguments in favour of issuing in Switzerland.

Concretely, two tax measures are proposed:

- Abolition of the issue tax on bonds and money market paper
- Issue tax exemption for participation rights stemming from the conversion of CoCos

The third tax measure contained in the consultation draft, the switch from the debtor principle to the paying agent principle for the withholding tax on bond and money market paper interest, will be dealt with in a separate draft. This should be launched no later than September 2011 – after the outstanding technical issues have been examined – under the working title "Dispatch on stimulating the Swiss capital market".

The Federal Council is basically standing by all of the tax measures. However, it is incorporating the criticisms expressed during the consultation concerning the structure and implementation of the withholding tax measures and dividing the tax measures into two separate bills.

Irrespective of this separation, the Federal Council is in favour of bringing the withholding tax measures into force one year later than the stamp duty measures. This will give the paying agents affected by the withholding tax changes sufficient time for implementation of the new legislation without any disadvantages arising regarding target achievement.

All three tax measures will help improve the attractiveness of Switzerland's CoCos and capital market.

Liquidity

The liquidity requirements ensure that even in a crisis systemically important banks have sufficient liquidity for an adequate amount of time until measures to maintain systemically important bank functions can take effect. A new liquidity regime agreed between FINMA and the big banks entered into force already on 30 June 2010. Adequate liquidity – in addition to equity – is indispensable for big banks' resilience. At group level, the quantitative liquidity requirements should be based on the calculation of liquidity gaps that a systemically important bank would exhibit in an exceptionally stressful situation (stress scenario). These liquidity gaps should not be negative for a period of at least 30 days. In addition, FINMA will define principles for the management and supervision of the liquidity risk.

Risk diversification

The main objective of the measures in the area of risk diversification is to reduce the degree of interconnectedness within the banking sector so as to limit the dependence of other banks on systemically important banks. A revision of the Capital Adequacy Ordinance (CAO) entered into force on 1 January 2011, thereby implementing the first more stringent Basel Committee capital adequacy provisions for market risks and securitisation in the wake of the financial and economic crisis, as well as risk diversification standards.

Organisational structure

Organisational measures are designed to ensure the maintenance of systemically important

functions (particularly payment transactions, the deposit business and the lending business) in the event of the insolvency of a systemically important bank. As they constitute substantial interventions in economic freedom and the guarantee of ownership, the subsidiary principle should apply. It is the responsibility of each systemically important bank to organise itself in such a way that the continuation of systemically important functions is guaranteed. The Federal Council will define the supplementary requirements for systemically important banks in an ordinance. Systemically important banks must demonstrate by means of an emergency plan that systemically important functions can be maintained in the event of threatened insolvency. The bank is basically free to formulate its plan as it wishes. The Federal Council will also set out in an ordinance the criteria for assessing the proof of such a plan as well as the measures FINMA can prescribe if proof is not provided.

The combined impact of the measures relating to capital and organisation has a key role to play. If a systemically important bank's capital ratio falls below a certain level, the emergency plan is generally triggered, which should ensure the continuation of systemically important functions. At the same time, the CoCos that generally have to be held as part of the progressive component are converted. This ensures that the emergency plan can be implemented with an adequate capital base.

Variable remuneration

If, despite all measures, state support should prove necessary for a systemically important bank, measures in the area of variable remuneration are also planned. With these provisions, the state would gain control of the variable remuneration in the case of state support. The proposed measures can go as far as the cancellation of variable remuneration. They are to be maintained for the entire duration of the state assistance.

At the same time, in the case of state support, it should be ensured that contractual legal claims of the bank's employees entitled to remuneration do not impede the measures to be ordered and that the federal funds paid out cannot ultimately be used to pay variable remuneration components. It is essential in this regard that systemically important banks include a proviso in their remuneration agreements: if state support in accordance with the proposed legislative provision is provided, the Federal Council must be able to intervene in legal claims to variable remuneration.

Economic implications

The regulatory impact assessment (RIA) was introduced by the Federal Council guidelines for presenting the economic implications of federal bills dated 15 September 1999. The RIA is thus an instrument for improving legislation in that it subjects legislative texts to an analysis of the economic implications before they are adopted.

The Federal Council decided in 2006 that important legislative projects should be subject to a joint, in-depth RIA of the leading agencies and SECO. The amendment of the Banking Act in view of the TBTF problem is such a project. Consequently, the Federal Council included an RIA in the objectives for 2011. The RIA was coordinated by SIF and SECO and prepared in collaboration with the FTA and FFA, as well as the SNB and FINMA. The analysis also takes into account the outcome of the consultation procedure.

The analysis shows that the measures in the TBTF bill are suitable for reducing massive consequential costs of severe financial crises for the entire economy. Competition will ensure on balance that there is not a reduction in lending, at least in the medium term. The tax measures will facilitate the establishment of a CoCo market in Switzerland. This is important for legal certainty in times of crisis. In addition, a more attractive capital market will counter

any negative consequences for corporate financing as a result of the TBTF measures. If need be, systemically important banks' lower profit and return potential will be countered by markets that function better and greater client and investor confidence. The analysis assumes that the long-term benefits for the national economy will exceed the cost of the measures.

In the long term, the abolition of the issue tax on debt capital will result in a net revenue shortfall of CHF 220 million p.a. for the Confederation (i.e. less the accruing revenue share of this tax due to the Confederation's issue activity). In the case of the communes and cantons, however, the abolition will lead directly to annual tax relief of approximately CHF 30 million. Moreover, they will benefit from the fact that the burden for companies owned by the public sector, in particular, will also be reduced by the abolition of the tax.

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