BANKERS' *Law* ®

Marke Raines - Re SMP Trustees, and corporate trustees
Phung Pham & George Williams - 2002 ISDA Master Agreement Close-out provisions
Matteo Allena & Jacopo Crivellaro - Italian Banking during Sovereign Debt Crisis
Peter Isler, Urs Pulver & Patrik Peyer - New Swiss Rules on Banks' Financial Stability
Ben Valentin - Case-note on National Merchant Buying Society v Bellamy

£ ₰ d ₱ ₮ € $ 元 ₨ 圓 ₩ S/. ƒ

VOLUME 4 NUMBER 4

New Swiss Rules to enhance Financial Stability of Banks – Capital Requirements; Recovery and Resolution Regime

Peter R. Isler, Urs Pulver and Patrik R. Peyer (Niederer Kraft & Frey, Zurich (left to right)) report on recent developments in the area of regulatory capital requirements for Swiss banks.

Introduction

Both the Swiss Federal Department of Finance and the Swiss Financial Market Supervisory Authority FINMA ("FINMA") launched projects for the revision of the relevant provisions on capital adequacy for banks in Switzerland in order to implement the rules promulgated by Basel III and to add a certain (stricter) "Swiss finish". They submitted simultaneously in late 2011 drafts for the revised Capital Adequacy Ordinance (the "CAO") and, among others,[1] for a new FINMA Circular on eligible equity capital (the "CEEC") for public consultation. These initiatives resulted in the following changes in regulations:

- On 1 July, 2012, the amendments of the CAO in respect of countercyclical capital buffers entered into force;
- On 1 January, 2013, the revised CAO containing the new Swiss rules on capital adequacy for Swiss banks enters into force.[2] Via the CAO the Basel III rules are implemented into Swiss law. The Federal Council grants the Swiss banks an implementation period extending to the end of 2018.
- Simultaneously with the CAO, the new CEEC enters into force.[3]

This article briefly outlines in the first part the key features of the Swiss regulatory capital framework for Swiss banks including the revision of the CAO and the new CEEC (together the "Swiss Capital Adequacy Rules" or the "SCAR") and to show in what respect the new Swiss Capital Adequacy Rules go beyond the Basel III requirements.

In the second part, an overview of selected issues of the Swiss recovery and resolution laws is given. These laws were implemented by a new Ordinance on the Insolvency of Banks and Securities Dealers of 14 August, 2012 issued by FINMA (the "Banking Insolvency Ordinance" or "BIO-FINMA") that entered into force on 1 November, 2012.[4]

Part I - Purpose of the new Swiss Capital Adequacy Rules

The main purpose of the new Swiss Capital Adequacy Rules is to reinforce and improve the resilience of the Swiss banking sector to losses, in comparison to the Basel II framework, by raising not only the ***quantity*** but also the ***quality*** of the regulatory equity capital eligible for Swiss banks.

[1] In parallel, FINMA proposed to revise and amend certain existing circulars such as the FINMA Circular 08/19 Credit Risk Banks, FINMA Circular 08/20 Market Risk Banks, and FINMA Circular 08/23 Risk Diversification Banks.

[2] The Swiss Capital Adequacy Ordinance (CAO) is currently only available in German, and can be accessed via the following link: http://www.admin.ch/ch/d/sr/9/952.03.de.pdf.

[3] The FINMA Circular 2013/1 Eligible Equity Capital for Banks (CEEC), is currently only available in German, and can be accessed via the following link: http://www.finma.ch/d/regulierung/Documents/finma-rs-2013-01-d.pdf.

[4] The BIO-FINMA is available in English, and can be accessed via the following link: http://www.admin.ch/ch/e/rs/9/952.05.en.pdf.

The new rules shall also serve the following purposes:

1. Adding clarity and transparency by replacing the patchwork of the current provisions by clearer and straightforward international compatible provisions and by reducing the sub-division of eligible capital components;

2. Improving the comparability of the capital ratios at Swiss banks with the applicable international standards under Basel III;

3. Increasing the accuracy by allocating the banks to specific categories which have corresponding capital requirement according to the banks' size and risk exposure and

4. Building up, overall, a better risk control.

Swiss Capital Adequacy Rules: Key Features and Main Novelties

i) Regulatory Capital Structure

In respect of eligible capital, the Swiss Capital Adequacy Rules implement the regulatory capital structure according to Basel III by providing for tier 1 **(T1)** and tier 2 (**T2**) capital. Under this structure only the tier 1 capital is subdivided, i.e. into common equity tier 1 (**CET1**) and additional tier 1 capital **(AT1**). Tier 3 (**T3**) capital is no longer eligible as regulatory capital.

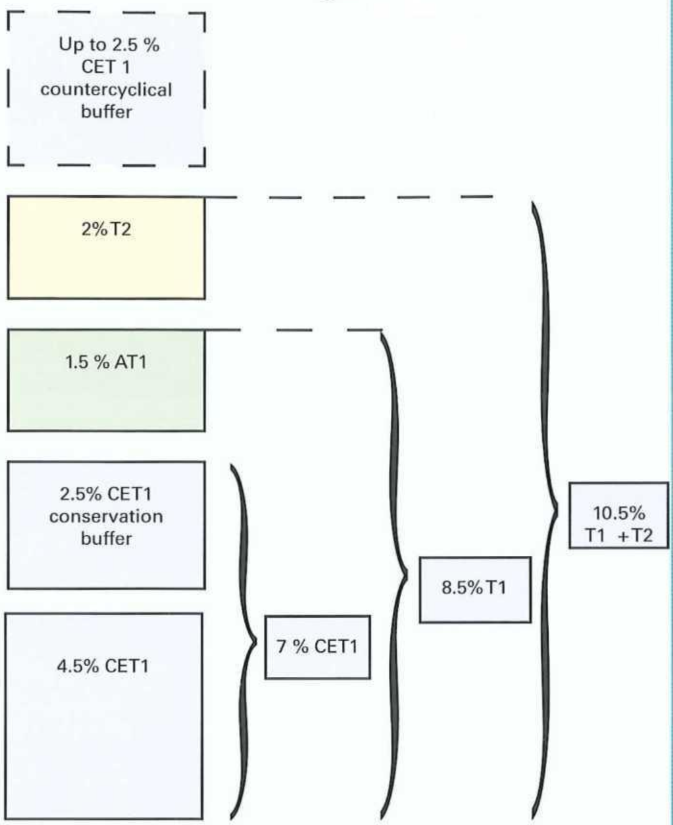
The **CET1** includes actual paid-in capital (excluding any share capital with preferential rights), disclosed reserves, reserves for general banking risk, and retained and current earnings after deduction of expected distributions.

AT1 can be issued in the form of a fully paid-in equity or debt instrument which must be subordinated to any non-subordinated debt. Instruments which

- are financed through a loan by the bank,
- are subject to set-off with claims of the bank,
- are secured by assets of the bank,
- have a fixed term,
- provide for a repayment before five years,
- are issued with the intention of an early repayment, or
- contain features which may hinder future rights offerings of the bank,

are ***not*** eligible as AT1 capital.

Figure 1



T2 capital may only be repaid after five years at the earliest and only at the bank's initiative and with FINMA's consent. The T2 capital must not be subject to incentives for the bank to repay it.

ii) Regulatory Capital Requirement

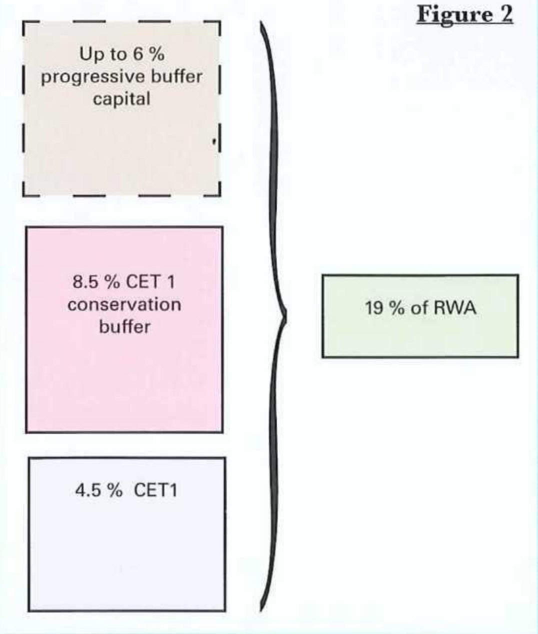
While the SCAR do not change the required ***total*** capital (not taking into account the buffers), which remains at 8 per cent of risk weighted assets (RWA), its ***composition*** changes significantly. In line with Basel III the banks are required to have a minimum CET1 ratio of 4.5 per cent of RWA and a minimum T1 (CET1 plus AT1) ratio of 6 per cent of RWA. The T2 capital will amount to up to 2 per cent of RWA.

Furthermore, the banks are required to permanently hold **additional CET1** of 2.5 per cent of RWA as a **capital conservation buffer** resulting in a total CET1 ratio of 7 per cent respectively a total T1 ratio of 8.5 per cent of RWA. With the aim to further improve the resilience of the banks in an excessive credit environment and in order to limit **excessive** credit growth, the CAO provides for a **countercyclical buffer** of up to 2.5 per cent of RWA in the form of CET1. In case a bank's CET1 ratio falls into either the capital conservation buffer by an unexpected event or special circumstances, e.g. a crisis of the financial sector, or falls into the countercyclical buffer, FINMA sets the bank a deadline for restoring the respective buffer. This capital structure can be illustrated as above (**Figure 1** - the dotted box shows the countercyclical buffer which was introduced by the amendments of the CAO which entered into force on 1 July, 2012).

iii) Special regime for UBS and Credit Suisse

For the (currently) two systemically relevant Swiss banks, UBS and Credit Suisse, substantially stricter rules on capital adequacy apply. The required capital of these two banks must be composed of a **basic capital requirement** in CET1 ratio of 4.5 per cent of RWA and a **capital conservation buffer** of 8.5 per cent of RWA. This conservation buffer can be subdivided into an additional CET1 ratio of 5.5 per cent of RWA and up to 3 per cent of RWA in the form of high-triggering Contingent Convertible Bonds (CoCo's) or write-down bonds, and a **variable progressive buffer** capital of up to 6 per cent of RWA depending on the systemic importance of the respective bank. In case FINMA requires the full variable progressive buffer capital, the total capital required for the systemically relevant banks would amount to 19 per cent of RWA. These capital requirements clearly go beyond what is required under Basel III. This capital structure can be illustrated (**Figure 2**) as follows:

Figure 2



iv) Loss absorbing function of the regulatory capital

The Swiss Capital Adequacy Rules differentiate the loss absorbing function of the regulatory capital between situations of prevention and of recovery. In case the CET1 capital falls in a prevention situation below a level of 5.125 per cent of the total capital, FINMA may require that AT1 capital in the form of debt instruments is converted to CET1 or a respective write-off is triggered. A conversion is, however, only possible for AT1 capital that does not grant any preferential rights. In a recovery situation, i.e. when insolvency of the bank is imminent, the consequences of loss absorption at the point of non-viability (PONV) are triggered when FINMA considers it necessary but at the latest prior to accepting governmental support. The PONV features which must be included in the contractual framework of the AT1 and T2 capital instruments, may result in either a write-down or the conversion of the AT1 and T2 capital instruments into CET1 capital.

Swiss Finish to the Basel III Framework

Certain provisions of the Swiss Capital Adequacy Rules result in even stricter requirements for Swiss banks than those required by Basel III. For example in the area of regulatory capital requirement the SCAR introduce additional capital buffers. Furthermore, in the area of loss absorption, the PONV feature does apply to all Swiss banks whereas the corresponding rule under Basel III only applies to globally active banks.

This so-called Swiss finish, which was, in the past, primarily justified by the importance of the financial sector for the Swiss economy, has a long-standing tradition. It seems that the regulator does not intend to deviate from its general philosophy which is to implement more stringent rules than required by the international regulatory frameworks in the near future. FINMA explicitly states in its Key Points document on new Basel III rules on capital adequacy and revision of various FINMA circulars

> "The prudential basic philosophy that the Swiss capital adequacy regulations are to go beyond the international minimum standards is therefore maintained and strengthened further."[5]

Certain elements of the Basel III regulatory framework have not been implemented by the Swiss Capital Adequacy Rules. For example, the introduction of an unweighted leverage ratio and the new minimum standards for liquidity risks have not been adopted so far in Switzerland.

The following table (see opposite - **Figure 3**) shows the Swiss Systemically Important Financial Institutions ("SIFI") policy mix. This leads neatly into the second part of the article regarding the new Swiss recovery and resolution laws.

[5] The FINMA document "New Basel III rules on capital adequacy and revision of various FINMA circulars – Key points" is available in English and can be accessed via the following link: http://www.finma.ch/e/regulierung/anhoerungen/Documents/kp-erv-e.pdf.

Intensification of crisis

Start of crisis ⟶ Insolvency

Prevention Going concern	Going concern/ crisis management	Stabilisation (Recovery)	Going concern/ threat of failure	Compulsory restructuring or liquidation (resolution/wind-down)
Core measures equity capital & liquidity to build up comprehensive buffer.	Buffer engaged	Conversion of CoCos in equity capital component II if the common equity ratio of 7.0 per cent is undershot	Conversion of CoCos in equity capital component III if the common equity ratio of 5.0 per cent is undershot	Easier restructuring or resolution thanks to preventive organisational measures
Core measure risk distribution to diversify risks.				
Preparatory organisational measure to facilitate restructuring/resolution in potential crisis scenario.		Restocking of CoCos after their conversion	Compulsory triggering of emergency plan systemically important functions split off and transferred to a carrier company and work starts on the restructuring/ resolution of the rest of the business	
Living wills: Measures regarding maintenance of systemically important functions, esp. emergency plan.				
Introduction of convertible capital by AGM and issue of CoCos by board of directors			Potentially further issue of CoCos if bank is continued.	
Approval of reserve capital	⟵	Capital increase based on reserve capital	⟶	
Control by bank's management	Less control by management ⟶		Intensification of supervision	Control by supervisory authority

Figure 3 - Source: final report of the "too big to fail" commission of experts, p51.*

**The Final report of the Commission of Experts for limiting the economic risks posed by large companies, dated 30 September, 2010, is available in English and can be accessed via the following link: http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en.*

Part II - Swiss recovery and resolution laws implemented by new Banking Insolvency Ordinance

On 1 November, 2012, the BIO-FINMA entered into force. It replaced the former ordinance on the bankruptcy of banks. It contains detailed regulations, among other regulations, regarding recent amendments of the provisions of the Swiss Federal Banking Statute of 8 November, 1934 (the "Banking Statute") on the recovery and resolution of banks and securities dealers. These statutory provisions were substantially amended in 2004 and have been revised by further amendments which entered into force on 1 September, 2011 and 1 March, 2012, respectively. With this legislation Switzerland has introduced comprehensive regulations on preventive intervention, restructuring and resolution.

Key characteristics of the Swiss recovery and resolution regime

The Banking Statute and the BIO-FINMA grant FINMA comprehensive powers in connection with early intervention, restructuring and resolution of banks (including also *Pfandbriefzentralen*) and securities dealers (hereinafter, *pars pro toto*: "Banks"). The following are selected key characteristics of that legislation:

i) Exclusive competence of FINMA

FINMA has sole responsibility for the restructuring and resolution of Banks. It can:

- Order protective measures (*Schutzmassnahmen)*;
- Open restructuring proceedings (*Sanierungsverfahren*);
- Open bankruptcy proceedings (*Bankenkonkurs*);
- Appoint and supervise an investigator, restructuring administrator or liquidator.

ii) Early intervention through protective measures

Since 2004 the Banking Statute has contained express regulations providing an essential preventive tool which allows FINMA to intervene at an early stage. If there is a justified concern that a bank is over-indebted or has serious liquidity problems or that the bank no longer fulfils the capital adequacy requirements after the expiry of a deadline set by FINMA, the regulator can order protective measures, including (*inter alia*) the following:

- Give instructions to the bank's corporate bodies;
- Appoint an investigator (*Untersuchungsbeauftrager*) who, for instance, can be authorised to act instead of the corporate bodies and can be given control of the financial institution;
- Withdraw from corporate bodies the power to act on the bank's behalf, or remove them from office;
- Remove the auditors from office;
- Restrict the bank's business activities;

and the following particularly severe measures:

- Prohibit the bank from:

  o making or receiving payments; or

  o effecting securities transactions;

- close the bank;
- in relation to a debt, order a:

  o deferment of payment (moratorium (*Stundung*)); or

  o postponement of maturity (*Fälligkeitsaufschub*).

The appointment of an investigator is frequently FINMA's first action. Based on the findings of the investigator, the FINMA may order further measures, as appropriate.

Restructuring proceedings (Sanierungsverfahren)

In the event that FINMA opens restructuring proceedings, the regulator may appoint an administrator (*Sanierungsbeauftragter*) and regulate the business activities of the bank during the restructuring. The following are some cornerstones of the regulation:

i) Restructuring of the entire business or parts only

The opening of restructuring proceedings shall be possible not only if the entire financial institution can be successfully restructured but also to ensure the going-concern of only certain parts or services of the financial institution in question.

ii) Restructuring plans

Among many other things, a restructuring plan can provide for:

- the transfer of the entire business of the financial institution or certain parts of the assets and liabilities as well as contracts to another legal entity, e.g. to a bridge bank (a "Transfer");
- a debt/equity swap;
- a reduction or increase of the share capital;

without that an approval by the board of directors or a shareholders' meeting would be required.

A transfer of real estate, rights *in rem* and obligations regarding a real estate or changes in the share capital provided

Photo credit - © HappyAlex-Fotolia.com

for by the restructuring plan become effective by virtue of the restructuring plan upon FINMA's approval of the plan.

iii) Bail-in by a debt/equity swap

The BIO-FINMA specifies the pre-requisites, order of priority and limitations for a forced debt/equity swap. Before a conversion of debt (other than contingent convertible bonds) into equity can be ordered by FINMA, the entire share capital and regulatory capital (AT 1 or T2 capital, including contingent convertible bonds and write-off bonds) must have been reduced to nil or converted into equity. If that is not sufficient, FINMA can order that debt is converted into equity in the following order of priority:

1. subordinated debt instruments (other than regulatory capital);
2. other debt instruments; and
3. client deposits which are not protected by the statutory depositor guarantee.

As a rule, any type of debt can be converted into equity, save for the following exemptions:

- secured debt (to the amount it is secured);
- indebtedness subject to set-off;
- client deposits which benefit from the statutory deposit guarantee up to the statutory limitation (currently Swiss francs 100,000);
- debt which ranks prior to other unsecured creditors claims under the general bankruptcy laws of Switzerland (e.g. claims of employees; claims derived from accident insurance, pensions claims, family law, social security and certain tax claims).

iv) Bail-in by a "haircut"

In addition to, or in lieu of, a debt/equity swap, the FINMA is also given the power to order a "haircut", i.e. a reduction or cancellation of the debt of the Bank. In the event of a haircut, the afore-mentioned order of priority among the various claims categories does not need to be followed.

v) Continuation of certain banking services by way of a Transfer

The BIO-FINMA specifies the elements which the restructuring plan must address in the event of a Transfer (e.g. identification of the new legal entity or independent bridge bank; banking services, assets, liabilities and contracts to be transferred; corporate actions to be taken, including availability of capital). The restructuring plan, based on an independent evaluation, must also indicate whether compensation is owed by the transferee or the transferor and how it is to be calculated. A core requirement is that the restructuring plan provides evidence that the new legal entity or bridge bank has access to payment and other financial market infrastructures. In order to ensure that the continuation of certain banking services can be achieved, the legal and commercial unity or interdependence of certain assets, liabilities and contracts shall be respected. Therefore, the restructuring plan must ensure that:

- rights and obligations, receivables and payables of the Bank vis-à-vis a certain counterparty or several counterparties which are subject to netting arrangements, including in particular close-out netting agreements, are transferred only collectively;
- secured rights and obligations are transferred only together with the security; and
- structured financings or similar capital market agreements to which the Bank is a Party are transferred only together with all related rights and obligations.

To facilitate a Transfer, FINMA may deviate from the ordinary licence requirements of a Bank. The licence will be granted for two years, subject to extension.

vi) Limited objection rights of creditors

Creditors may only reject a restructuring plan if they represent more than half of the non-privileged claims. In case of rejection by the creditors, FINMA will order the bankruptcy liquidation of the bank. However, the restructuring plan is not submitted to a vote by the creditors unless it has an impact on their rights. The BIO-FINMA provides, in this respect, that a Transfer of liabilities and contracts, and the consequential substitution of the debtor, are deemed not to impact on the creditors' rights. In the event of the restructuring of a SIFI, i.e. a Bank of systemic relevance, there is no right of the creditors to vote on the restructuring plan at all. The creditors may, however, be entitled to compensation.

Bankruptcy Proceedings

The new Banking Insolvency Ordinance adopts the provisions of the former Bank Bankruptcy Ordinance substantially unchanged.

Living Wills

The Banking Statute requires SIFIs to prepare their recovery and resolution plans ("RRPs" or "Living Wills") and to provide them to FINMA. They must prove that they can continue their systemically important functions in the event of impending insolvency. In the event of a failure to provide proof, FINMA would impose the measures it deems necessary.

System Protection

There are specific provisions on the protection of contractual risk reduction clauses and of financial market infrastructure systems (FMIs) against systemic risks:

i) Advance information of payment systems and securities settlement systems

A specific provision requires that operators of financial market infrastructure (payment systems and securities settlement systems), if possible, are informed by FINMA before protective measures, restructuring measures or the opening of bankruptcy take effect.

ii) Finality protection

The same provision provides for finality protection applicable to payments systems and securities settlement systems. The protection broadly mirrors Art. 3(1) of the EU Settlement Finality Directive. The BIO-FINMA clearly determines which insolvency measures may have an impact on finality (i.e. the opening of bankruptcy and the particularly severe protective measures mentioned above). It further expressly extends the protection to both:

- Orders that directly relate to the settlement of payments or securities transactions; and
- The provision of the necessary funding or security as required by the rules of the system.

iii) Protection of certain contractual risk reduction arrangements

The Banking Statute protects netting agreements as well as agreements on the private sale of security in the form of securities which are traded on a representative market against measures taken by FINMA, provided that these agreements have been entered into prior to the opening of insolvency proceedings. The scope of the protection of pre-agreed netting arrangements is clarified by the BIO-FINMA. It encompasses, among others, close-out netting mechanism under the common master agreements and includes also bilateral netting arrangements as well as set-off and netting provisions and default arrangements of payment or securities settlement systems.

iv) Temporary suspension of contractual termination

The BIO-FINMA gives FINMA the power to suspend the termination of certain financial contracts and the exercise of termination rights thereunder, respectively, triggered by protective or restructuring measures ordered by the regulator. The suspension is limited to 48 hours and can be ordered only in the event of a Transfer, i.e. the transfer of the entire business or parts thereof to another legal entity.

Recognition of Foreign Insolvency Decrees and Measures

Provisions on the recognition of foreign insolvency decrees and measures, facilitate the handover of assets located in Switzerland by FINMA to a foreign insolvency administrator. There are two routes: FINMA may either

i) order the transfer of the assets set aside in Switzerland which remain following the conduct of a domestic ancillary insolvency proceeding ("mini-insolvency proceeding") or

ii) subject to certain requirements, make available the assets set aside in Switzerland without conducting domestic proceedings.

If a domestic ancillary proceeding is conducted, all creditors including those resident abroad may be included in the claims schedule.

Conclusion

Switzerland has enacted comprehensive legislation on capital requirements and on the recovery and resolution of banks, thereby enhancing financial stability. The Swiss capital requirements go significantly beyond those under Basel III by imposing stricter rules and tighter deadlines, specifically insofar as Swiss SIFIs are concerned.

The Banking Insolvency Ordinance specifies the statutory provisions on restructuring and resolution and (*inter alia*) forms a basis to maintain systemically critical functions.

The Swiss legislation meets international standards, including the requirements of Basel III, the FSB Key Attributes of Effective Resolution Regimes of Financial Institutions and the proposal for an EU Directive on the Recovery and Resolution of Credit Institutions and Investment Firms.