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The Swiss response to the Basel III framework and other regulatory initiatives aimed at reinforcing financial sector resilience

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The financial services industry is of major importance to the Swiss economy, accounting for approximately 10.7% of value added. Total assets of the entire Swiss banking sector at year-end 2010 were approximately 6.6 times gross domestic product (GDP), and total assets of each of Switzerland's two largest banks (Credit Suisse and UBS) were more than twice Swiss GDP. Due to the relative size of Switzerland's financial sector and its concentration, Swiss regulators have taken a proactive approach in implementing financial sector regulation aimed at reinforcing its resilience.

At the height of the financial crisis in Autumn 2008, the Swiss Financial Market Supervisory Authority (FINMA) substantially increased the minimum capital requirements of Credit Suisse and UBS and introduced a minimum leverage ratio. To reduce incentives towards excessive risk taking, FINMA introduced new rules for compensation and bonuses on 1 January 2010. In June 2010, FINMA introduced increased liquidity requirements applicable to Credit Suisse and UBS. On 1 January 2011, amendments to the Federal Capital Adequacy Ordinance (CAO) and related FINMA circulars entered into force that implemented the changes to trading book capital and market risk framework commonly known as Basel 2.5.

The international standards on bank capital recommended by the Basel Committee on Banking Supervision (commonly known as Basel III) are not a legally binding framework at national level. One key focus of current regulatory initiatives is therefore on the implementation of the Basel III framework into Swiss law. Another key priority for current Swiss regulatory initiatives are measures aimed at mitigating systemic financial risk and containing the "too big to fail" problem.

As discussed in more detail below, the Swiss Regulator requires "too big to fail" banks to issue substantial amounts of contingent capital instruments. It has also implemented the "non-viability" loss absorbency requirements one year ahead of their proposed implementation date under the Basel III framework. Because these are novel features that were largely untested, there has been considerable uncertainty with respect to investor acceptance. However, recent successful transactions by Swiss banks indicate that there is a market for these instruments, and have set important precedents for other markets.

PROPOSED IMPLEMENTATION OF THE BASEL III FRAMEWORK INTO SWISS LAW

Implementation timeline

On 24 October 2011, the Federal Department of Finance (FDF) submitted proposed amendments to the Federal Capital Adequacy Ordinance (CAO) for public consultation. Simultaneously, FINMA conducted a public consultation in relation to proposed amendments to its circulars on:

- Credit risk banks: regulatory capital requirements for credit risk positions (circular 08/19).
- Market risk banks: regulatory capital requirements for market risk positions (circular 08/20).
- Risk diversification banks: risk weighting of credit derivatives and short-term interbank loans (circular 08/23).
- Disclosures in relation to regulatory capital (circular 08/22).

The FINMA consultation also included a proposed new circular on regulatory capital. The FDF subsequently submitted additional proposed CAO amendments concerning the introduction of countercyclical buffer capital and increased risk weighting of residential mortgage loans for public consultation.

The public consultations on the proposed amendments closed on 16 January 2012, and final rules are expected to be published later this year. The final rules will enter into force on 1 January 2013 and will be phased in subject to transition periods substantially similar to the Basel III framework. Where necessary, amendments will be made to the online version of this article to describe any material amendments to the proposed rules resulting from the public consultation.

The proposed amendments include neither minimum liquidity requirements (that is, a Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)) nor leverage ratios. Minimum liquidity requirements and leverage ratios are subject to supervisory monitoring periods under the Basel III framework and will, therefore, be implemented into Swiss law at a later stage. However, the "too big to fail" rules described below include an unweighted leverage ratio for systemically important banks (SIBs) that is expected to be introduced on 1 January 2013, well ahead of its proposed implementation date under the Basel III framework.

KEY LOSS ABSORBENCY FEATURES OF CONTINGENT CAPITAL INSTRUMENTS	
Name of instrument and date	**Loss absorbency features**
Credit Suisse Tier Two Buffer Capital Notes (2011/2012)	Conversion into ordinary shares both: ▪ If 7% Common Equity Tier One (CET1) to Risk Weighted Assets (RWA) trigger is breached (subject to certain conditions). ▪ On non-viability.
EFG International AG Tier Two Notes (2011)	100% principal write-off upon non-viability.
UBS Tier Two Subordinated Notes (2012)	100% principal-write off both: ▪ If 5% CET1 to RWA trigger is breached (subject to certain conditions). ▪ On non-viability.
Zurich Cantonal Bank Tier One Bonds (2012)	Write-downs of 25% of the original notional amount or multiples thereof (as determined by Regulator) both: ▪ If 7% CET1 to RWA trigger is breached (subject to certain conditions). ▪ On non-viability. Notional amount cannot be lower than CHF1 (as at 1 February, US$1 was about CHF0.92).

Eligibility requirements and early adoption of "loss absorbency" requirement

Under the proposed rules, there are the same three classes or "tiers" of regulatory capital as under the Basel III framework, that is Common Equity Tier One Capital (CET1), Additional Tier 1 Capital (AT1) and Tier 2 Capital (T2). The regulatory capital eligibility requirements closely follow the Basel III framework, including its implementation dates and phase-in periods.

However, FINMA requires loss absorbency at the point of "non-viability" (PONV) (often referred to as either the "loss absorbency" or "non-viability" requirement) since 1 January 2012, one year ahead of their proposed implementation date under Basel III. The application of the PONV requirement to all banks in the proposed rules also goes beyond the Basel III framework, which only requires its application to "internationally active" banks.

The loss absorbency at the point of "non-viability" requirement has been implemented in Switzerland, by requiring the terms of AT1 and T2 instruments to include a contractual loss absorption mechanism, which is triggered at the relevant bank's point of PONV and must result in a principal write-down or the conversion of the instrument into CET1 capital. For preference shares (*Vorzugsaktien, Vorzugspartizipationsscheine*), the loss absorption mechanism may be a waiver of any preferential rights over common stock. PONV is typically defined as either:

- The determination by FINMA that a write-down or conversion into CET1 is an essential requirement to prevent the issuer from becoming insolvent or bankrupt or unable to carry on its business.
- The bank receiving financial support from the government or another public entity.

Rationale for the early adoption of the contractual PONV loss absorption mechanism was to prevent banks from issuing substantial amounts of T2 instruments in 2012 without PONV triggers. However, the early adoption may lead to competitive disadvantages for Swiss banks in terms of access to funding, particularly since the current version of the proposals to implement the Basel III framework in the European Union (CRD IV) does not provide for a contractual PONV loss absorption mechanism, and it is unlikely that all 27 EU member states will have statutory resolution regimes in place by 1 January 2013 that include Basel III-compliant PONV triggers.

In addition to the contractual PONV loss absorption mechanism, AT1 instruments that are classified as debt for accounting purposes must include a contractual loss absorption mechanism (again meaning principal write-down or conversion into CET1) if CET1 falls below 5.125% of risk weighted assets (RWAs) or any higher level pre-specified in the terms and conditions of the AT1 instrument.

The Basel III framework is largely silent as to whether an instrument, which has had its principal amount written-down following a PONV trigger, can be written-up again when the bank's situation improves. The proposed rules clarify that the write-down following a PONV trigger must be permanent but allow the participation of investors in a potential improvement of the bank's financial situation following a (permanent) write-down under certain circumstances, provided that it is included in the original terms of the instrument and has been approved by FINMA.

A principal write-down on AT1 instruments if CET1 falls below 5.125% of RWAs or a higher "pre-specified trigger" can be temporary. However, the explanatory report notes that, depending on applicable accounting standards, a write-down may be ineffective if it is only temporary.

Regulatory capital requirements and Swiss finish

When fully phased in, Swiss banks will be subject to the regulatory capital requirements of the Basel III framework, that is:

- A minimum CET1 ratio of 4.5% of RWAs (3.5% in 2013; 4% in 2014).
- A minimum Tier-1 (T1) ratio of 6% of RWAs (4.5% in 2013; 6% in 2014).
- A minimum total regulatory capital ratio of 8% of RWAs (applicable from 1 January 2013).

The proposed rules will also require a capital conservation buffer in form of CET1 of 2.5% of RWAs and will allow the Federal Council to require a countercyclical capital buffer of up to 2.5% of RWAs in certain circumstances discussed in more detail below (*see below, Early implementation of countercyclical buffer capital*).

The Swiss Regulator has traditionally applied more rigorous regulatory capital requirements in the form of conceptual changes to the earlier versions of the Basel framework known as the "Swiss finish" that were intended to increase minimum regulatory capital requirements applicable to Swiss banks, partially by increasing risk weighted assets relative to their calculation under the applicable version of the Basel framework.

The implementation of the Basel III framework into Swiss law still applies more rigorous regulatory capital requirements for certain banks. However, to ensure transparency and international comparability of capital ratios, the implementation of the Basel III framework into Swiss law takes a different approach. It does not include conceptual changes to RWA calculation methods and implements stricter regulatory capital requirements through additional capital buffers instead.

Depending on the size of a bank, the proposed rules will require regulatory capital buffers beyond the Basel III minimum requirements. In circular 11/2 on capital buffer and capital planning for banks, FINMA has divided Swiss banks into five categories based on:

- Total assets.
- Assets under management.
- Privileged deposits.
- Regulatory capital.

Systemically important banks (SIBs) fall under category one and will be subject to the additional regulatory capital requirements of the "too big to fail" package discussed below (*see below, New rules for systemically important banks*). Banks that qualify for category five (approximately two thirds of all Swiss banks) will not be required to hold regulatory capital beyond the Basel III minimum requirements. Banks that fall into any other category will be subject to a target total regulatory capital ratio ranging from 11.2% of RWAs for category four to 14.4% of RWAs for category two and certain specified intervention levels based on total regulatory capital. Under the proposed rules, these new requirements will be phased in until 31 December 2016.

The proposed rules will also implement other aspects of the Basel III framework, including additional regulatory capital requirements resulting from the use of stressed inputs in assessing credit risk, with respect to mark-to-market losses associated with counterparty risk on over-the-counter (OTC) derivatives and in relation to central counterparties, as well as higher standards for collateral management and margination of OTC derivatives.

Early implementation of countercyclical buffer capital

On 18 November 2011, the FDF initiated an additional public consultation process that closed on 16 January 2012 concerning the introduction of countercyclical buffer capital and increased risk weighting of residential mortgage loans. As a result of perceived signs that the Swiss housing market was overheating amid expansionary monetary policy and a low interest rate environment, the FDF has the option to introduce the countercyclical buffer capital rules in the first quarter of 2012, ahead of the proposed implementation date under Basel III.

Under the proposed rules, the maximum buffer capital requirement will be 2.5% of RWAs. The Swiss National Bank (SNB) will be responsible for monitoring the credit markets for imbalances and for proposing the activation of, or changes to, required countercyclical capital buffers to the federal council following consultation with FINMA.

New rules on large exposures

The revision of the rules on risk diversification and large exposures (*Klumpensriken*) that entered into force on 1 January 2011 only reflected changes to the international large exposures diversification approach which was used by approximately 40 banks, and therefore did not apply to more than 260 other Swiss banks that applied the Swiss risk diversification approach. Under the proposed rules, the international risk diversification standard will be introduced for all Swiss banks, and Swiss banks will be subject to a risk diversification standard that is equivalent to the relevant EU standard.

The Swiss risk diversification approach had certain conceptual weaknesses, for example, the fact that positions with a lower probability of default had a lower weighting. Further, a portfolio/diversification approach was applied, whereas the financial crisis has proven that to mitigate concentration risks, regard should be given to the largest positions on an unweighted basis. In addition, the current regime allowing for taking risk concentrated interbank positions at up to 100% of the eligible capital could lead to a domino effect in the case of a default of a larger bank counterparty. These weaknesses will be eliminated, since the 25% limit on large exposures will apply on a non-weighted basis. Further, FINMA will have the competence to specifically regulate intra-group positions to the effect that, among other things, cross-border positions with a foreign group company must be limited to a degree that a default of that position will not lead to the insolvency of the Swiss bank (or, in other words, the Swiss bank must be in a position to continue its operation in an ordinary course notwithstanding a default of that intra-group position).

The complex new rules also contain regulation to abolish exemptions from the 25% limitation on large exposures as far as positions *vis-à-vis* Swiss and foreign SIBs are concerned, on related counterparties and the taking into account of collateral, and so on.

NEW RULES FOR SYSTEMICALLY IMPORTANT BANKS (SIBS)

Timeline for implementation

A key priority for the Swiss Federal government, FINMA and the Swiss National Bank (SNB) were measures aimed at reinforcing the stability of Switzerland's SIBs (currently, Credit Suisse and UBS have been qualified as SIBs by FINMA). Despite the absence of an internationally agreed framework at the time, the Swiss regulator proposed a comprehensive set of new rules for SIBs. This so-called "too big to fail" package of amendments to the Banking Act (BA) was adopted by the Swiss parliament in Autumn 2011 and declared effective by the Federal Council on 1 March 2012. Core measures of the "too big to fail" package are increased regulatory capital requirements, improved risk diversification and organisational measures to facilitate restructuring or resolution to maintain vital economic functions in the event of SIB failure. The "too big to fail" package has been controversial because it goes beyond international standards, particularly with respect to regulatory capital requirements, and could therefore negatively affect the international competitiveness of Swiss SIBs.

To implement the regulatory capital requirements, risk diversification principles and organisational rules of the "too big to fail" package, together with the international framework and recommendations for addressing the systemic and moral hazard risks associated with systemically important financial institutions, the Federal Council submitted proposed amendments to the Federal Banking Ordinance (FBO) and the Federal Capital Adequacy Ordinance (CAO) for public consultation. The public consultation closed on 16 January 2012, and final rules are expected to be approved by the Federal Parliament later this year. The final rules will enter into force on 1 January 2013 and will be phased in subject to certain transition provisions. Where necessary, amendments will be made to the online version of this article to describe any material amendments made to the proposed rules resulting from the public consultation and deliberations in the Federal Parliament.

Liquidity minimum standards are not part of the proposed amendments. The FDF intends to submit a draft ordinance for public consultation in 2012 that codifies liquidity minimum standards for SIBs, which are expected to be substantially similar to the liquidity minimum standards that were introduced by FINMA for Credit Suisse and UBS in June 2010.

In addition to the new rules under the "too big to fail" package, Swiss SIBs will also be required to comply with the minimum regulatory capital requirements and with the risk diversification requirements that apply to all Swiss banks under the proposed rules for implementation of the Basel III framework into Swiss law (*see above, Proposed implementation of the Basel III framework into Swiss law*).

New types of capital

Under the proposed new rules, SIBs can hold up to 9% of RWAs in the form of contingent capital securities. Contingent capital securities are therefore likely to be a key element of future SIB capital structures and are expected to have a major impact on the Swiss capital markets. Contingent capital securities must provide for a principal write-down or the conversion into CET1 instruments upon certain regulatory capital triggers. There are two types of contingent capital instruments for SIBs:

- "High-trigger" contingent capital, which must convert into CET1 or be written off when CET1 reaches or falls below 7% of RWAs or any higher pre-defined threshold.
- "Low-trigger" contingent capital, which must convert into CET1 or be written off when CET1 reaches or falls below 5% of RWAs or any higher pre-defined threshold.

In addition to the proposed new "too big to fail" rules, contingent capital issued by Swiss SIBs must also comply with applicable international minimum standards, for example, the proposed minimum requirements for going-concern contingent capital set out in Annex 3 of the November 2011 rules on global systemically important banks (G-SIBs), issued by the Basel Committee on Banking Supervision.

On that basis, the FDF stated in its explanatory report that upon breach of a trigger, the full principal of the contingent capital instrument must be permanently written-down or converted into CET1. Partial write-downs or write-ups when the bank's situation improves will not be possible. Option elements (for example, warrants) will be possible if their upside potential is not higher than that of common equity of the issuing bank. However, the explanatory report specifically excludes the issuance of rights to participate in future profits in exchange for a write-down.

The G-SIB proposals regarding contingent capital instruments also require a cap on the number of new shares that can be issued when the trigger is breached, and that all prior authorisation necessary to immediately issue the relevant number of shares upon breach of a trigger must be in place at all times. To facilitate the issue of shares when a trigger is breached, and to allow banks quicker access to the capital markets in a crisis, the "too big to fail" rules have created two types of new capital that are not subject to many of the traditional corporate law limitations of authorised and conditional capital. These new types of capital have been available to all banks since 1 March 2012, when the "too big to fail" amendments to the BA became effective:

- **Reserve capital (*Vorratskapital*).** Reserve capital is a new type of authorised capital, designed to allow a Swiss bank in the legal form of a share corporation (*Aktiengesellschaft*) to quickly issue new shares or participation certificates to strengthen its capital base.
- **Conversion capital (*Wandlungskapital*).** Conversion capital is a new type of conditional capital designed as source of shares issued when a trigger is breached under a contingent capital instrument that converts into CET1 (including a PONV or pre-specified trigger).

SIB regulatory capital requirements

The regulatory capital requirements for Swiss SIBs are in excess of the minimum requirements under the Basel III framework and also go beyond the regulatory capital requirements applicable to other Swiss banks. The SIB regulatory capital requirements consist of three elements:

- **Minimum requirement.** As a minimum requirement, SIBs must at all times hold at least 4.5% of RWAs in the form of Common Equity Tier 1 (CET1).

- **Capital conservation buffer.** The capital conservation buffer of 8.5% of RWAs, up to 3% of which may consist of "high-trigger" contingent capital instruments. (In the event of a loss, a SIB may temporarily go below the capital conservation puffer minimum requirements.)
- **Variable progressive component.** The purpose of the variable progressive component is to ensure that banks with higher systemic importance hold higher regulatory capital buffers and to provide incentives to reduce systemic importance. The variable progressive component is therefore designed as a progressive systemic surcharge that increases in relation to systemic importance (measured by domestic market share and total exposures). Under certain circumstances, FINMA can grant discounts for organisational measures aimed at improving resolvability. The variable progressive component should consist of "low-trigger" contingent capital. The main purpose of "low-trigger" contingent capital is to generate the capital necessary to implement crisis management restructuring or resolution measures. Because conversion or write-off takes place just before restructuring or resolution procedures commence, the resulting capital cannot be used for going concern activities.

  CET1 can also be used for the variable progressive component, in which case it is treated as T2 capital for the calculation of CET1 ratios and other purposes.

The regulatory capital requirements apply to SIBs both on a consolidated and stand-alone basis (that is, for each entity in Switzerland that is systemically important). FINMA may reduce stand-alone capital requirements under certain circumstances if the stand-alone requirements would result in consolidated regulatory capital requirements in excess of applicable minimum requirements due to consolidation effects. In accordance with discussions in the Federal Parliament, total regulatory capital requirements for SIBs should not be in excess of 19% of RWAs. In addition to the regulatory capital requirements discussed above, SIBs will also be subject to countercyclical buffer capital requirements if and when activated by the Federal Council.

Early implementation of leverage ratio requirement for SIBs

The leverage ratio restricts the absolute level of exposure (both on and off balance sheet) of a bank for a given amount of capital. The main purpose of the leverage ratio is to provide a simple and non-risk based measure intended as a back stop to the risk-based capital requirements. Under the Basel III framework, the leverage ratio requirements will be subject to supervisory monitoring periods and adjustments and are expected to apply from 1 January 2018. Under the proposed new rules, Swiss SIBs will be subject to a leverage ratio requirement from 1 January 2013.

SIB rules on large exposures

In general, SIB risk diversification/large exposure rules are the same as those applicable to non-SIBs. An important SIB specific purpose of the revision of risk diversification rules consisted in limiting the maximum permitted concentration risks in SIBs. Further, the large exposure limitation percentage range of 25% will also be applicable, but will be calculated not on the basis of overall eligible regulatory capital but on (lower) CET1.

Organisational measures

The "too big to fail" rules also include organisational rules for SIBs. These rules consist of organisational requirements to maintain systemically important functions in the event of a SIB failure. Deemed systemically relevant functions of a SIB are functions that are indispensable and, in the short term, are not substitutable for the Swiss national economy, such as the deposit and loan business or payment transaction services.

In respect of these functions, SIBs must have a contingency plan concerning the bank's structure, infrastructure, management, control, and intra-group liquidity and capital flows allowing for immediate implementation. Such planning requires FINMA's approval, which will be granted provided the SIB can evidence that in implementing the emergency measures, the SIB will be able to fulfil the systemically relevant function even in the case of insolvency. FINMA may allow for certain reductions in terms of the capital requirements to the extent a SIB provides for contingency planning that exceeds the relevant statutory requirements.

Taxation

To facilitate the issuance of new regulatory capital in Switzerland, the stamp duty on the issuance of debt capital and on the issuance of equity upon the conversion of contingent capital instruments has been abolished with effect from 1 March 2012.

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