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Too big to fail and Basel III: Switzerland at the forefront

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The banking industry is of major importance to the Swiss economy, accounting for about 9% of Swiss Gross Domestic Product (GDP). With a combined market share of more than one third of the domestic lending and deposit business, and a combined balance sheet total of about five times the size of Switzerland's GDP, the country's largest banks Credit Suisse and UBS play an important role. The relative size of Switzerland's financial sector and its concentration is not without risks.

While Credit Suisse managed to remain relatively unaffected by the global financial crisis, UBS had to write off more than CHF50 billion (as at 1 January 2011, US$1 was about CHF0.95) on subprime mortgage securities between 2007 and 2009. To prevent contagion following the collapse of Lehman Brothers in 2008, the Swiss Government and National Bank intervened, transferring part of UBS's toxic assets to the National Bank and injecting CHF6 billion in the form of convertible notes.

The intervention was ultimately successful. While the National Bank still holds part of the transferred toxic UBS assets, the Swiss Government sold its UBS stake for a profit of CHF1.2 billion after less than a year. However, the potentially devastating consequences of the failure of a bank with major systemic importance have prompted the Swiss regulator to take a pioneering role in global financial system reform, taking important regulatory steps well ahead of other financial centres.

To further reduce risks associated with systemically important financial institutions (SIFIs), the government proposed in December 2010 comprehensive amendments to the Swiss banking rules on too big to fail and Basel III (Swiss TBTF-Legislative Proposals). The consultation period runs until 23 March 2011. After then, the government is expected to submit a (revised) draft bill to the Swiss parliament. The final version of the revised law may therefore vary from the current draft though the new Basel III standards, and related initiatives on SIFIs set certain limits. The new law could be enacted as early as 1 January 2012 and phased in until the end of 2018.

If made law, the Swiss TBTF-Legislative Proposals will require Swiss SIFIs to hold more and better quality capital, meet more stringent liquidity requirements and improve their risk diversification. SIFIs would have to be organised so that systemically important functions can be maintained even in insolvency.

Importantly, to implement the more stringent capital and liquidity requirements applicable to Swiss SIFIs and to Swiss banks under Basel III generally, the government proposes to introduce two new capital instruments in the Swiss Federal Banking Act, which will be available to all Swiss banks: reserve capital (*Vorratskapital*) and convertible capital (*Wandlungskapital*). The convertible capital would serve as a source of capital for contingent convertible bonds (CoCos), which convert into shares on the occurrence of certain triggering events. The Swiss TBTF-Legislative Proposals also provide for the possibility of write down bonds (that is, bonds that include a write down mechanism on the occurrence of certain triggering events), similar to the write down bonds first issued by Rabobank in January 2011.

The Swiss TBTF-Legislative Proposals would allow SIFIs to hold capital of up to 9% of risk weighted assets (RWA, calculated according to Basel III rules) in the form of CoCos or write-down bonds. These instruments are therefore likely to be a key element of future SIFI capital structures.

The government expects that the issue of CoCos in Switzerland by Swiss issuers will significantly reduce the legal risks in the case of the conversion in a crisis. To boost Swiss debt capital markets, the Federal Council is therefore also proposing tax measures to promote the issue of bonds, and therefore also CoCos, in Switzerland.

The Swiss TBTF-Legislative Proposals and the implementation of Basel III are therefore likely to have a major impact on Swiss capital markets. Indeed, on 14 February 2011 Credit Suisse announced that it entered into an agreement with two strategic investors regarding the issue of an aggregate of about CHF6 billion CoCos in the form of Tier 1 buffer capital notes. This was followed by an announcement on 17 February 2011 that Credit Suisse placed US$2 billion of CoCos in the form of Tier 2 buffer capital notes with investors. The success of the Credit Suisse CoCo issue may boost the European CoCo market as a whole and other international financial institutions may follow suit. Against this background, this chapter examines:

- Other major regulatory steps in Switzerland apart from the Swiss TBTF-Legislative Proposals.
- The Swiss TBTF-Legislative Proposals in detail.
- Important new capital instruments for Swiss banks/CoCos.
- Whether there is a market for Swiss CoCos.
- Proposed changes to Swiss tax law.

OTHER MAJOR REGULATORY STEPS IN SWITZERLAND

The Swiss TBTF-Legislative Proposals are part of a wider reform of the financial system. Before describing the Swiss TBTF-Legislative Proposals and their implications on Swiss capital markets in more detail below, this section provides a short overview of other major regulatory steps taken by the Swiss regulator:

- The Swiss regulator (FINMA) has traditionally applied more rigorous minimum capital requirements in the form of a so-called "Swiss finish" to international standards. At the height of the financial crisis in autumn 2008, FINMA decided on an additional tightening of the capital requirements for Credit Suisse and UBS by substantially raising minimum capital requirements and introducing a minimum leverage ratio. FINMA also introduced new liquidity requirements for Credit Suisse and UBS that became effective on 30 June 2010, and on 1 January 2011 a revised version of the Federal Capital Adequacy Ordinance applicable to all Swiss banks entered into force.

- The Swiss insolvency law for banks is currently being revised.
- Bank pay and bonus structures were widely perceived as contributing to the financial crisis by encouraging excessive risk taking. FINMA was among the first regulators to address this issue and introduced regulations on bank pay and bonuses for Switzerland's largest banks that became effective on 1 January 2010.
- To cover Swiss banks other than Credit Suisse and UBS, FINMA started a consultation period on 31 January 2011 on its circular on *Capital buffer and capital planning*, which will redefine the capital adequacy requirements. FINMA intends to divide the banks into five categories based on total assets, assets under management, privileged deposits and required capital. Each category would be subject to specific target capital and intervention levels based on capital ratios.

THE SWISS TBTF-LEGISLATIVE PROPOSALS

Overview

To mitigate the too big to fail problem, the Swiss TBTF-Legislative Proposals include the following two main elements:

Preventive measures. These aim to reduce the risk of and cost associated with SIFI failure, mainly through increased minimum capital requirements, enhanced liquidity buffers and measures to reduce the dependence of the financial system on SIFIs, to mitigate possible contagion effects from a SIFI failure.

Recovery and resolution measures. These aim to ensure that the regulator has the tools to effect a rapid and orderly resolution in the event of SIFI failure through organisational measures to safeguard vital economic functions, so that the government is not compelled to rescue the entire company in order to maintain its systematically important functions.

In terms of timing, these measures can be implemented in three phases: they can be initiated as preventive measures as part of routine operations, serve to stabilise banks in the event of a crisis, or be focused specifically on insolvency events, with a view to facilitating resolution or winding-down.

Under the Swiss TBTF-Legislative Proposals, SIFIs mean "banks, financial groups and bank-dominated financial conglomerates whose failure would do considerable harm to the Swiss economy and the Swiss financial system". The Swiss National Bank and FINMA will determine whether a Swiss institution qualifies as a SIFI, on the basis of its size, interconnectedness and replaceability of its services in the short-term, and key factors such as market share in the payment transaction, deposit and lending business, balance sheet size, risk profile and amount of deposits.

As discussed in more detail below, the Swiss TBTF-Legislative Proposals also contain:

- Changes to the tax rules to increase the attractiveness of the Swiss debt capital markets.
- Corporate law changes to facilitate the issuance of CoCos.
- Rules on pay and bonus structures following a government bail-out.

The Swiss TBTF-Legislative Proposals are compatible with, and in some respects tougher than, the Basel III regulations and the recommendations of the Financial Stability Board (FSB) regarding global SIFIs (G-SIFIs).

Preventive measures

Increased minimum capital requirements. A core element of the Swiss TBTF Legislative Proposals is a "Swiss Finish" that requires SIFIs to maintain capital standards in excess of Basel III rules. The capital requirements under the Swiss TBTF-Legislative Proposals consist of the three elements set out below:

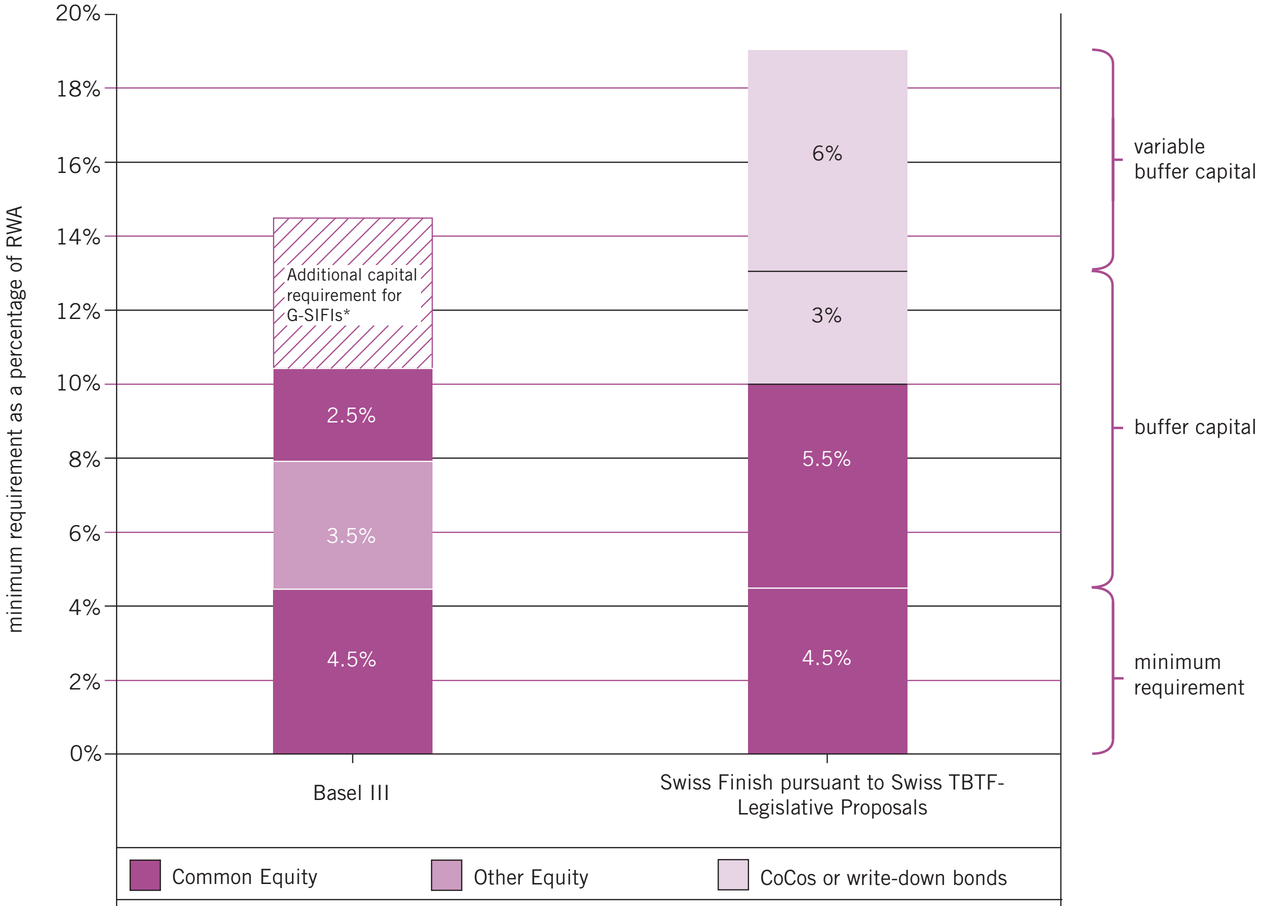
- **Minimum requirement.** As a minimum requirement, SIFIs must hold 4.5% of RWA in the form of common equity (capital of the highest quality in the form of paid-in capital, disclosed reserves and retained earnings following deduction of regulatory adjustments, for example, goodwill and deferred tax assets). This corresponds to the regulatory minimum requirement in accordance with Basel III.
- **Buffer capital.** To further increase loss absorption capacities, SIFIs must hold an additional 8.5% of RWA as "buffer capital". The first 5.5% must be common equity, and the remaining 3% can be in the form of "high-triggering" CoCos or write-down bonds.
- **Variable buffer capital.** Variable buffer capital of up to 6% of RWA (so-called "progressive component") allows FINMA to apply differentiated minimum capital requirements to reflect the specific systemic importance of a SIFI.

Based on the current size of their balance sheets and market position, the total capital requirements for Credit Suisse and UBS would amount to about 19% of RWA as per Basel III (that is, FINMA would require the full 6% of variable buffer capital). The graph compares the Basel III requirements with the "Swiss Finish" according to the Swiss TBTF-Legislative Proposals (*see box, Comparison of Basel III requirements with the Swiss Finish according to the Swiss TBTF-Legislative Proposals*).

Enhanced liquidity buffers. The Swiss TBTF-Legislative Proposals also contain minimum liquidity requirements, designed to strengthen the ability of SIFIs to withstand adverse shocks, and to ensure that SIFIs hold sufficient stable sources of funding to cover their payment obligations, at least until recovery and resolution measures take effect. The Swiss TBTF-Legislative Proposals contain principles that will be implemented through a detailed ordinance.

Risk diversification. The financial crisis brought to light the fragility of the financial system due to linkages between banks as a result of interbank claims. To address this, the risk diversification

COMPARISON OF BASEL III REQUIREMENTS WITH THE SWISS FINISH ACCORDING TO THE SWISS TBTF-LEGISLATIVE PROPOSALS



*The G-20 summit in Seoul in November 2010 endorsed the main features of the Financial Stability Board's recommendations regarding global SIFIs (G-SIFIs) that is, financial institutions that are systematically important for the global financial system. However, an exact additional minimum capital buffer for G-SIFIs has not been set.

requirements will be amended with a view to reducing institutional interconnectedness in the financial sector. In addressing this issue, the primary focus will be on reducing dependency on too big to fail banks, by limiting exposure.

Recovery and resolution measures

While the increased minimum capital requirements, enhanced liquidity buffers and risk diversification measures described above greatly reduce the risk of SIFI failure, a residual risk remains. The Swiss TBTF-Legislative Proposals, therefore, call for organisational measures to ensure the maintenance of systemically important functions (in particular, payment transactions and the domestic deposit and lending businesses) in the event of a failure.

It is the responsibility of each SIFI to organise itself in such way that the continuation of systemically important functions is guaranteed in a crisis. If a SIFI cannot show that systematically important functions can be maintained in a crisis, FINMA can order organisational measures that include:

- Setting up an independent entity in Switzerland.
- Transferring systematically important functions to another group company.
- Restructuring of intra group guarantees and loans.
- Restructuring banks in legally independent business units.
- A geographical matching of assets and liabilities.

If governmental support is still necessary for a SIFI despite the too big to fail measures, the Federal Council plans measures in the area of variable remuneration (for example, bonuses), to ensure that government funds paid cannot be used to cover variable remuneration components. With these provisions, the government would gain control over the variable remuneration in case of governmental support. Variable remuneration could even be cancelled according to legislative proposals. Such measures are to be maintained for the entire duration of the governmental support.

KEY FEATURES OF CONTINGENT CAPITAL INSTRUMENTS

Name of instrument and date	Conversion/writedown features
Enhanced capital notes (Lloyds) 2009.	Conversion into ordinary shares of Lloyds Banking Group plc, if Lloyds Banking Group's consolidated core Tier 1 ratio is less than 5%.
EUR500 million non-cumulative step-up fixed/floating rate subordinated notes (Unicredit), 2010.	Principal write-down if either: ▪ Unicredit's total risk-based capital ratio falls below 6%. ▪ Unicredit or its regulator may require a principal write-down at their discretion. ▪ Principal may be written back up using distributable profits once the trigger event has been cured, and will be reinstated in full in the event of a winding-up.
US$2 billion perpetual non-cumulative capital securities (Rabobank), January 2011.	Principal write-down either: ▪ If Rabobank's Equity Capital Ratio falls below 8%. ▪ On notification from the Dutch regulator.
CHF2.5 billion and US$3.5 billion Tier 1 buffer capital notes (BCNs), announced February 2011 (Credit Suisse Group) (source: Credit Suisse Group press release, 14 February 2011).	Conversion into ordinary shares of Credit Suisse Group if either: ▪ Credit Suisse Group's Basel III common equity Tier 1 ratio falls below 7%. ▪ FINMA determines that Credit Suisse Group requires public sector support to prevent it from becoming insolvent, bankrupt or unable to pay a material amount of its debts, or other similar circumstances.

To ensure that contractual claims of employees entitled to remuneration do not impede measures regarding variable remuneration, SIFIs must include a provision in their remuneration agreements to the effect that if governmental support in accordance with the proposed legislative provision is provided, the Federal Council must be able to intervene in legal claims to variable remuneration.

IMPORTANT NEW CAPITAL INSTRUMENTS FOR SWISS BANKS/CoCos

If made law, the Swiss TBTF-Legislative Proposals will allow Swiss banks to create two new types of equity capital: reserve capital and conversion capital.

- **Reserve capital.** This will be 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.** This will be a new type of conditional capital for Swiss banks, designed as a source of the shares issued to CoCo holders on conversion.

Contingent capital securities can be in the form of either:

- CoCos.
- Write down bonds (sometimes referred to as write down CoCos).

According to the Swiss TBTF-Legislative Proposals, there will be two types of contingent capital securities:

- "High-triggering" contingent capital securities that convert into shares or participation certificates (or are written down), if common equity falls below 7% of RWA.
- "Low-triggering" contingent capital securities that convert into shares or participation certificates (or are written down), if common equity falls below 5% of RWA.

Under the Swiss TBTF-Legislative Proposals, contingent capital securities will be a key element of future SIFI capital structures. A SIFI could issue:

- Up to 3% of RWA in the form of "high-triggering" contingent capital securities as part of the buffer capital.
- The entire variable buffer capital (progressive component) of up to 6% of RWA in the form of "low triggering" contingent capital securities.

In their accompanying report to the Swiss TBTF-Legislative Proposals, the government states that, based on the RWA at the end of 2009 and assuming that Credit Suisse and UBS issue the maximum amount of contingent capital securities permitted under the proposed rules of 9% of RWA, this would amount to a total of about CHF72 billion.

If approved by the Swiss parliament, these new capital instruments will not only be available to SIFIs but to Swiss banks generally. The Swiss TBTF-Legislative Proposals, together with increased capital adequacy requirements resulting from the implementation of Basel III, may therefore have a very significant impact on the capital structure of Swiss banks and Swiss capital markets generally.

IS THERE A MARKET FOR SWISS CoCos?

There has been uncertainty about investor demand for CoCos. However, on 14 February 2011 Credit Suisse Group announced that it has executed an agreement with two strategic investors (Qatar Holding LLC and The Olayan Group) regarding the issue of CHF2.5 billion and US$3.5 billion of Tier 1 buffer capital notes (BCNs) no earlier than October 2013 subject to certain conditions, including implementation of Swiss regulations requiring Credit Suisse Group to maintain buffer capital. The Tier 1 BCNs are designed to qualify as buffer capital under the Swiss TBTF-Legislative Proposals as contingent convertible capital (CoCos). This was followed by an announcement on 17 February 2011 that Credit Suisse placed US$2 billion of CoCos in the form of Tier 2 buffer capital notes with investors.

The Credit Suisse Group Tier 1 BCNs are novel in that they are designed to be the first Basel III compliant CoCos which would convert into shares. Other issuers that have so far issued contingent capital instruments are Lloyds Banking Group, UniCredit and Rabobank. As reported in the financial press, Barclays Capital has considered issuing CoCos to employees as part of their 2010 deferred compensation.

The table sets out the key features of contingent capital instruments issued or announced so far (*see box, Key features of contingent capital instruments*).

PROPOSED CHANGES TO SWISS TAX LAW

In its accompanying report to the Swiss TBTF-Legislative Proposals, the government has expressed a preference for CoCos being issued by Swiss domiciled issuers under Swiss law.

As the current tax regime would be unfavourable in this respect, the legislative proposals also provide for measures in the area of Swiss tax law. If made law, the legislative proposals would not only affect CoCos but also Switzerland's entire debt capital market.

The government proposed three tax-related measures:

- Abolition of the issuance tax on bonds and money market papers.
- Exemption from issuance tax for equity issued on conversion of CoCos.
- Change from debtor principle to paying agent principle with respect to withholding tax on interest on bonds and money market paper.

The Swiss TBTF-Legislative Proposals are still in a consultation process and have not yet been submitted to the Swiss parliament. The final outcome of the Swiss tax related measures is, therefore, still uncertain. However, if made law, the proposed legislative proposals could have a significant impact on the Swiss debt capital markets and result in more debt being issued out of Switzerland under Swiss law governed documentation.

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Recent transactions

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Recent transactions

- Swiss counsel to Qatar Holding LLC in connection with the investment in Credit Suisse Group Tier 1 Buffer Capital Notes.
- Swiss counsel to the Swiss Confederation in connection with the recapitalisation of UBS by way of subscription of CHF6 billion mandatory convertible notes.
- Swiss counsel to Credit Suisse and Goldman Sachs in connection with the rights offering of SIX listed Gategroup.
- Swiss counsel to global co-ordinators in connection with the CHF (equivalent) 1.55 billion high yield notes for financing of the acquisition of Sunrise Communications by CVC.