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The Swiss regime for large banks: setting the pace for international capital regulation

National level

One year ago, we announced that once the crisis subsided, we would require Switzerland's large banks to retain a much higher capital buffer, and outlined a combination of risk-weighted requirements plus a leverage ratio as our future regime.[1] On the day of our annual media conference, UBS had announced its second, successful private recapitalisation as well as new write-downs and losses. In the three quarters since the crisis emerged, these had already climbed to the enormous sum of CHF 40 billion. By this time, it was clear to us that the current **international minimum standards** of the Basel Committee on Banking Supervision – even with an additional conservative 'Swiss finish' – could not even come close to covering the trading risks of global investment banks. Hence they could not be repaired merely by some punctual fine-tuning such as by increasing capital requirements for complex securitisations. In particular, the framework introduced under Basel I in 1996 that was meant to cover **market risks in the trading book** via Value at Risk (VaR) models led to a severe underestimation of risks from traded loans. It assumed functioning, liquid markets (an assumption which the crisis has proved to be incorrect) and took as little account of extreme events as the complementary stress tests. It was also highly pro-cyclical in nature: extremely low capital requirements in boom periods but skyrocketing requirements in times of crisis when capital levels are already severely depleted by losses. A specific Swiss problem however is the particularly high **systemic risk** for our small economy as a result of the global activity and the dominant domestic market share of the two large banks – as we well knew from years of crisis preparations. **Switzerland** is therefore a **special case**, which is why we took corrective measures at an earlier stage and were less willing to compromise: not because we are smarter than foreign supervisory authorities, central banks or international organisations, but because we have so much more to lose. This rapid reaction was also facilitated by the flexible legal framework in our existing Banking Law and the Capital Adequacy Ordinance, which allows the supervisory authority to increase capital requirements in special cases.

We therefore quickly drafted the new capital regime together with the Swiss National Bank and presented it to the two large banks for comment at the start of July 2008. At that time our proposals seemed quite radical and were opposed by both banks, to varying degrees but chiefly using the

[1] http://www.finma.ch/archiv/ebk/e/publik/refer/pdf/referat-mk08-zuberbuehler-e.pdf

standard argument of disadvantages in global competition. A majority of Swiss politicians were also sceptical. Our colleagues in the Basel Committee responded to our unilateral approach with a mixture of incomprehension and admiration. However, the resistance came to an end when US investment bank Lehman Brothers filed for bankruptcy in mid-September 2008, worsening the financial crisis and necessitating a raft of bailout measures by many governments. On 20 November 2008, the Banking Commission defined the higher capital requirements and special regulations for both large banks via a formal decree. These are summarised in the 2008 annual report[2] and were also recognized by the Swiss Federal Council along with the package of measures to strengthen the Swiss financial system[3].

Work of the Basel Committee on Banking Supervision

The Swiss Federal Banking Commission's annual report outlines the work of the Basel Committee and IOSCO in repairing the damage done to the regulatory system. These repairs are broad-based, in line with the reform agenda set by the Financial Stability Forum and the G20.[4] In a short press release of 12 March 2009[5] the Basel Committee summarised its **initiatives for capital regulation.** These go beyond the proposals it submitted for public comment in January 2009. The message is short and to the point, and goes in the same direction as the Swiss large banks regime:

- The **level of capital** in the banking system needs to be strengthened to raise its resilience to future episodes of economic and financial stress. This will be achieved by a combination of measures.

- In financially healthy times, additional **anti-cyclical capital buffers** must be built up which can be drawn down in periods of stress. Our Swiss, risk-weighted target levels provide for a buffer of 100% above the international minimum, which can be run down to an intervention level of 50% above the minimum. In other words, depending on earnings, the buffer can fluctuate within a range from 200% to150% of the risk-weighted requirements under Basel II. The Basel Committee will need to discuss whether the buffer should, as in the Swiss system, be based solely on the flexible second pillar, the supervisory review approach with a lot of room for discretion, or on a combination of mandatory and discretionary criteria. There is also the issue of how to ensure international consistency and what role capital planning coordinated with the supervisory authority – which is what is envisaged in Switzerland – should play in managing the buffer.

- A **non-risk-based capital measurement tool** will be introduced to complement, but not replace, risk-weighted requirements. This will help limit the build up of leverage in the banking system, independently of the sophisticated, risk-weighted requirements of Basel II, and put in place a simple floor under the risk base measure. It must also be transparent, comparable and simple to implement. The most likely choice (although not unchallenged) for such a measurement tool is the **leverage ratio**, i.e. a minimum ratio of core capital to total assets. A leverage ratio of this kind is already in place in the USA and Canada, and has now also been

[2] SFBC Annual Report 2008, p. 17f.

[3] Dispatch on a package of measures to strengthen Switzerland's financial system of 5 November 2008, p. 35f

[4] SFBC Annual Report 2008, p. 72f. (German version)

[5] http://www.bis.org/press/p090312.htm

applied to the large Swiss banks, albeit with a somewhat problematic, conceptually contradictory exemption for domestic lending business. If the Basel Committee does reach agreement on a leverage ratio, the details of which still need to be refined, this exemption – which was implemented on the grounds of caution in terms of domestic policy – will have to be reviewed. There should also be discussions at an international level to determine whether the leverage ratio should follow the planned Swiss concept and feature anti-cyclical ranges.

- The **quality of the eligible bank capital** must be enhanced: in good times the elements of core capital (Tier 1) capable of absorbing losses in ongoing operations, namely paid in ordinary share capital and disclosed reserves or retained earnings, should represent the predominant part. This is already in line with market expectations, which focus on an increasingly narrow definition of core capital. In the case of the large banks we have taken a first step in this direction in that subordinated debt (lower Tier 2 capital) will no longer be eligible – although there are very long grace periods.

- **Risk coverage** under Basel II is to be improved, partly through a – currently completely open – fundamental and long-term review of trading book rules. This will follow a range of initial emergency repairs to the market risk regime due to be concluded this year and implemented by the end of 2010.

- The Basel Committee will decide on the **level of the minimum requirements** and evaluate all the factors mentioned above as part of a total package in 2010. A clear objective has already been defined, however. The goal is that the total amount and the quality of the capital must ultimately be higher than the current requirements of Basel II. On the other hand the Committee's statement is just as unequivocal: it does not wish to increase capital requirements in the middle of this difficult crisis period, but at some later point in time. This is also in line with the long-term focus of the Swiss regime for large banks. The targets will have to be achieved on a step-by-step basis by 2013, with the possibility to extend this deadline.

There is still a long way to go, but we are now heading in the right direction, also at the international level. This does not mean, however, that we – from the Swiss side – claim to take the lead in all matters. The flood of reports, recommendations and resolutions from international bodies and committees in response to the crisis is overwhelming. We do not feel affected by all issues to the same degree, and as a supervisory authority our personnel resources would not allow us to play a leading role on all issues.