Based on the Federal Council parameters, which were published on 6 June, FINMA sets out in this information sheet its view of how the Federal Government's parameters should be implemented in a targeted manner.

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Capital backing for foreign participations

What is it all about?

The current **capital requirements** for parent companies of internationally active banks in Switzerland contain a **major gap**:

- Parent companies can use predominantly **debt** to finance the **equity of their subsidiaries.**
- This results in **"double leverage"**, which refers to the **use of debt to finance equity within a group.**
- As a result of the double leverage, **the subsidiary's equity** effectively consists **partly of debt-financed capital.**
- Double leverage thus has an undesirable **negative effect** on the **financial strength** of the bank's parent company. This can **jeopardise the stability of the entire banking group.**

Key points

- There is a **major gap** in the current **capital requirements** for systemically important banks with subsidiaries abroad: Their parent companies can use predominantly debt to finance the equity of their subsidiaries.
- As a result, the equity **of the parent company** can shrink **very quickly** in the event of losses at the subsidiaries, restructuring or crises. This can jeopardise the stability of the entire banking group.
- This regulatory weakness can only be eliminated by introducing a full **deduction of foreign participations** from Common Equity Tier 1 capital.

What is the current situation and why is there a need for action?

The **current regulation** requires only partial capital backing of participations in subsidiaries by the parent company. This means that the parent company's capital can also shrink **very quickly** if there is a deterioration in the business performance of foreign subsidiaries, a major loss event, a restructuring or a crisis situation. As a result, problems at foreign subsidiaries can be passed on directly to the parent company and the entire group can be infected. This can **exacerbate** a **crisis** at **the worst possible** moment and limit the scope for action to stabilise the bank.

In the case of Credit Suisse too, this regulation, i.e. the extensive financing of the equity of subsidiaries abroad using debt, led to a **steady decline** in the **capital ratios of the parent company** and **severely hampered restructuring measures to stabilise the bank.**

What is being proposed?

As part of its report on banking stability published on 10 April 2024 (TBTF report), the Federal Council recognised this weakness and proposed measure 15 to eliminate it: "Strengthen the capital requirements for foreign participations – and thus for parent banks – within a financial group." The Federal Council proposes that participations in foreign subsidiaries be **fully backed by the parent company's capital** (i.e. Common Equity Tier 1, CET1; for example, share capital, reserves and retained earnings). This is achieved by **fully** deducting **participations in foreign subsidiaries** from CET1 for regulatory purposes.

FINMA expressly supports the proposed approach of fully backing participations in foreign subsidiaries with CET 1 capital (participation deduction). This is for the following reasons:

- Unlike a blanket or progressive increase in capital requirements, the **measure specifically addresses** the problem of financing foreign subsidiaries with debt.
- **Only full backing with CET1 capital** can effectively eliminate the **regulatory weakness** and its undesirable effects.
- Any regulation that continues to allow partial backing with CET1 merely postpones the problem and there is a risk that the same weakness will become a problem again in the next crisis.
- The **measure thus prevents equity from being used for multiple purposes simultaneously.** Other countries also recognise the principle of a capital deduction for participations in their regulations. The rule does not go beyond the international standards of the Basel Framework. It is **specifically tailored to the situation in Switzerland** (where a globally active systemically important bank has a very large proportion of foreign business compared to the small domestic market).

How does FINMA assess the impact?

The proposed measure affects **systemically important banks** with **subsidiaries abroad.** At present, only UBS is significantly affected by this:

- The measure **specifically** regulates the regulatory **capital requirements** for holding **foreign subsidiaries.** The **domestic banking business** and, in particular, **lending** and the **products offered** in Switzerland are **not directly affected** by the regulation. Accordingly, FINMA sees **no market distortion** or other **effects** on national **competition** if the additional capital requirement is correctly allocated within the group.
- The amendment to the regulation, according to which participations in foreign subsidiaries must be fully backed by CET1 capital, leads to **additional capital requirements** for the parent company.
- This in turn **increases the reported regulatory capital ratio** for the entire banking group.
- Based on the current situation, the proposed regulatory adjustment would lead to an **additional capital requirement** of around USD 23 billion for UBS's parent company. In absolute terms, this would appear to be a very high additional requirement. **However, it is primarily a reflection** of the extent of the current **regulatory weakness**. It is therefore all the more important that **targeted** and **decisive** action is taken by implementing the measure.
- Based on our analyses, UBS is currently in a position to implement these additional **capital requirements** to **strengthen its financial resilience** with an **appropriate transitional period**. In our opinion, this does not require **external capital procurement or** a substantial or even permanent **restriction on dividend payments** and **other distributions**.

- Higher regulatory capital requirements can lead to a lower return on invested capital. Any lower returns on capital for investors in UBS equity securities are the **consequence of a** correspondingly **higher financial resilience of the UBS Group** and a lower risk.
- By increasing its **regulatory capital**, UBS can in turn **save on high-interest debt capital in the form of bonds.** This **reduces** the **interest burden** for the bank, which **partly compensates for the higher economic costs of capital.**
- The financial resilience of the entire banking group, which will be strengthened by the higher capital ratios, should **promote confidence** in the client business and can also represent a competitive advantage. Competitors that concentrate on the wealth management business sometimes have significantly higher capital ratios.
- In addition, a **higher capital requirement** for UBS as the only global systemically important bank in Switzerland with substantial foreign business is also appropriate in relation to Switzerland's gross domestic product from a stability perspective and to protect taxpayers.
- FINMA notes **that the Federal Council has already examined other possible measures to tighten the capital requirements for systemically important banks in the TBTF report, but rejected them** (for example, a blanket increase of capital requirements via an increased leverage ratio, higher capital requirements via a tightened progressive component or fundamental restrictions on the group structure of the UBS Group). Compared to these rejected measures, FINMA considers the planned tightening of capital requirements for participations in foreign subsidiaries to be a more proportionate and targeted requirement.

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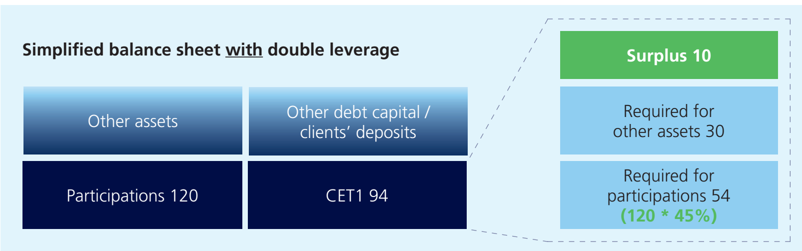
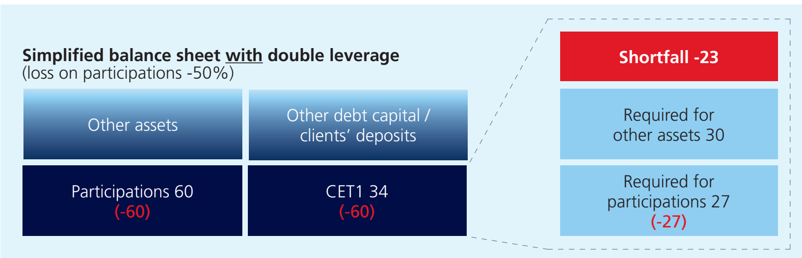
Simplified explanation of the effect of the debt financing of participations in subsidiaries ("double leverage")

Double leverage refers to the situation where a bank partially finances the participation in its subsidiary with debt. This situation typically arises when purchasing a new subsidiary, which is partly financed with debt.





The current regulation stipulates that foreign subsidiaries must be financed with around 45%[1] of the bank's own funds (Common Equity Tier 1 capital, CET1). Around 55% can be financed with debt. The current regulation therefore permits double leverage.

The following diagrams illustrate the effect of a loss on participations in foreign subsidiaries with and without the possibility of double leverage.

Starting situation: Bank with double leverage before a loss on participations

The current regulation requires that approximately 45% of a participation in a foreign subsidiary is financed with the bank's own funds (i.e. Common Equity Tier 1 capital, CET1[2]).

This means that 54 Common Equity Tier 1 capital is required for a participation of 120.

In this example, the bank requires a further 30 Common Equity Tier 1 capital for direct client business.

The remaining 10 Common Equity Tier 1 capital corresponds to the excess above the requirements.

Bank with double leverage after a loss of 50% on participations

A loss of -50% on the participations leads to a loss of 60 and reduces Common Equity Tier 1 capital by the same amount.

[1] A risk weight of 400% combined with a requirement of 11% Common Equity Tier 1 capital means that around 45% of a participation in a foreign subsidiary must be financed with Common Equity Tier 1 capital.

[2] The current requirements for going concern capital (Common Equity Tier 1 and Additional Tier 1 capital) are around 60%. This also includes AT1 bonds (Additional Tier 1 capital), which cannot directly cover losses. However, Common Equity Tier 1 capital (CET1) is relevant for double leverage.

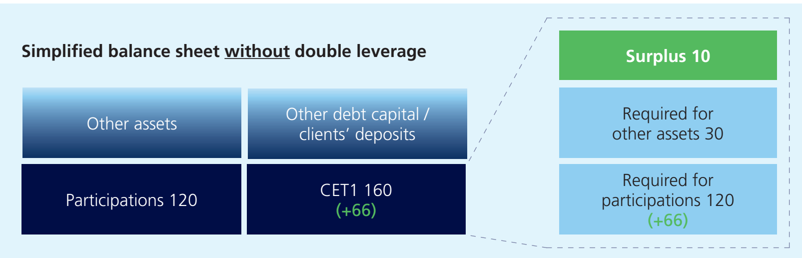
The Common Equity Tier 1 capital required for participations also falls by -50%, but only by -27 in absolute terms.

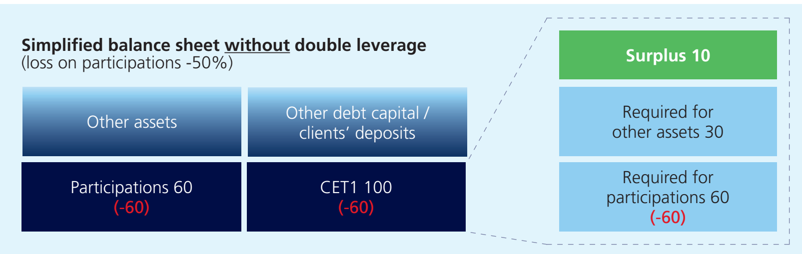
The required Common Equity Tier 1 capital for participations is therefore 27 (still corresponds to 45% of participations).

Together with the unchanged Common Equity Tier 1 capital requirements for other assets, this results in a shortfall in Common Equity Tier 1 capital of -23.

A decrease in the value of the participations therefore not only leads to a loss, but leads to a significant reduction in the surplus of Common Equity Tier 1 capital and thus has a dampening effect on a bank's Common Equity Tier 1 capital.

Only the full financing of participations in foreign subsidiaries with the bank's own funds (Common Equity Tier 1) ensures that losses on these participations do not have a negative impact on the Common Equity Tier 1 capital of the parent company. Here, too, an exemplary illustration – the same as the previous one, but now without double leverage – aids understanding.





Starting situation: Bank without double leverage before a loss on participations

Under the envisaged regulation, participations are to be deducted from Common Equity Tier 1 capital. This means that the participations must be financed entirely with the bank's own funds (Common Equity Tier 1 capital).

The bank must therefore now have 120 Common Equity Tier 1 capital instead of 54 for its participations.

In this example, the bank also requires a further 30 Common Equity Tier 1 capital for direct client business.
The remaining 10 Common Equity Tier 1 capital corresponds to the excess of Common Equity Tier 1 capital above the requirements.

Without double leverage, the bank must therefore hold a total of 160 Common Equity Tier capital in future.

Bank without double leverage after a loss of 50% on participations

In this example too, a decrease in the value of the participations by -50% leads to a loss of -60 and reduces the Common Equity Tier 1 capital by the same amount.

The required Common Equity Tier 1 capital for participations is also reduced by -60 if the participation is fully financed with Common Equity Tier 1 capital (without debt financing and therefore without double leverage) and now amounts to 60.

This leaves an unchanged surplus of Common Equity Tier 1 capital of 10.

If the participations are fully financed with Common Equity Tier 1 capital – and therefore without debt financing – decreases in the value of the participations do not affect the Common Equity Tier 1 capital ratios. They therefore strengthen the bank's financial resilience. In times of crisis, this enables a bank to realign itself better and take measures to remain stable.