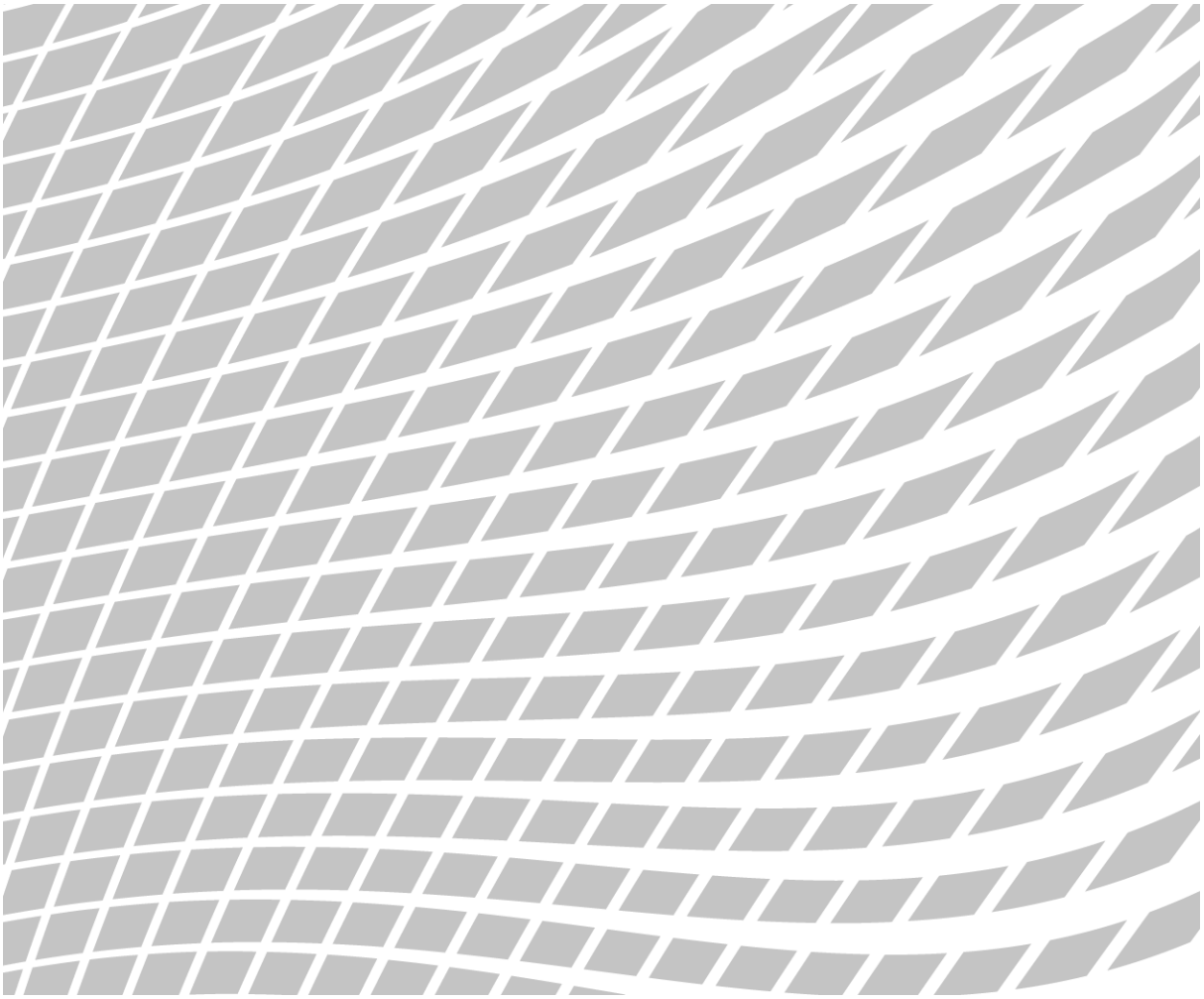
Eidgenössische Finanzmarktaufsicht FINMA
Autorité fédérale de surveillance des marchés financiers FINMA
Autorità federale di vigilanza sui mercati finanziari FINMA
Swiss Financial Market Supervisory Authority FINMA

Reto Schiltknecht, 22 October 2012

New FINMA Banking Insolvency Ordinance

A key element in the effective restructuring and orderly market exit of banks



Einsteinstrasse 2, 3003 Bern
Phone +41 (0)31 327 91 00, Fax +41 (0)31 327 91 01
www.finma.ch

/

With the FINMA Banking Insolvency Ordinance (BIO-FINMA) Switzerland becomes one of the first countries to introduce comprehensive restructuring regulations for banks. The BIO-FINMA grants FINMA comprehensive powers to restructure and resolve banks. This means that Switzerland is among the first countries to meet the requirements set by the Financial Stability Board (FSB).

The revised restructuring provisions of the Banking Act (BA) came into force on 1 September 2011. They provide an important basis for maintaining systemically critical functions in the event of a crisis by obliging owners and creditors to share in losses and by accelerating the procedure. As a second step, FINMA has now produced the BIO-FINMA. Starting on 1 November 2012 the BIO-FINMA brings together the provisions on bank bankruptcy and restructuring, thereby creating an effective and coherent set of regulations. The BIO-FINMA makes FINMA's actions transparent and therefore increases legal certainty, an especially important factor in critical situations.

New regulation of bank restructuring

The BIO-FINMA defines regulations in *four* key areas. *Firstly,* the *General Provisions* describe the scope of application, the general principles and the procedural rules. The BIO-FINMA applies to banks, securities dealers and central mortgage bond institutions. In line with the principle of universality it covers all assets held in Switzerland and abroad. It also regulates public notices, communications, the inspection of documents and the place of insolvency. FINMA undertakes to coordinate its insolvency procedures in particular with foreign authorities and governing bodies. If it is in the interests of creditors, FINMA can now also recognize the bankruptcy decrees and insolvency measures of other countries, even without reciprocity.

Secondly, the current provisions on *bank bankruptcy* are adopted essentially unchanged from the current FINMA Bank Bankruptcy Ordinance. The regulations cover the procedure, the bankruptcy assets (drafting of an inventory, surrender and reporting obligations, segregation of the assets of third parties etc), the bankruptcy liabilities (schedule of claims, privileged deposits etc) as well as the sale and distribution.

Thirdly, the actual core of the revision comprises the provisions on *bank restructuring*, which are now dealt with in four sections:

- Restructuring can occur only if creditors are likely to be better off in restructuring than in bankruptcy. The restructuring plan sets out the basic elements of the restructuring including the bank's future capital structure and business model after restructuring. FINMA approves the restructuring plan and discloses it to the public. A capital majority of the creditors can reject the restructuring plan. In the case of systemically important banks the creditors do not have the power to reject the restructuring plan approved by FINMA. They may, however, be entitled to compensation.

- The *corporate actions* are a core feature of restructuring. They must ensure that creditors take precedence over owners while at the same time generating so much new capital that, following restructuring, the bank meets the capital adequacy requirements. Equity capital and debt instru-

ments that the bank has issued for such cases (Additional Tier 1 or Tier 2 capital) have to be completely reduced before debt capital is converted into equity capital. Subordinated claims, then all other claims, and finally deposits are to be converted into new share capital. As a matter of principle, all claims are convertible. However, all privileged claims in classes 1 and 2 under bankruptcy law (i.e. the claims of employees in particular) are excluded. Also excluded from conversion into new equity capital are client deposits up to the limit of the depositor guarantee of 100,000 Swiss francs per depositor. Secured claims and claims subject to offset are also not convertible. Partial or full reductions in claims are possible in addition to or instead of the conversion of debt capital into equity capital. In this case there is no fixed order of rank among the various claim categories.

- The *continuation of certain banking services* is also possible if no restructuring of the other parts of the bank comes about. The BIO-FINMA stipulates that the new legal entity to which the services and assets are transferred is to be specified. Which banking services are to be transferred, which corporate actions are to be taken, and how the assets are to be shared between the bank and the new legal entity or an independent bridge bank must also be specified. Especially in the areas of payments and financial market infrastructures, the bank and its successor organisation and the bridge bank respectively must conclude service level agreements and come to an agreement regarding any compensation. The license of a bridge bank is limited to a term of two years which can be extended.

A certain amount of time is necessary to enable the transition from an insolvent bank to a new legal entity or a bridge bank. *Fourthly,* therefore, the BIO-FINMA stipulates that contracts between the affected institution and its counterparties may not be terminated for a maximum of 48 hours. Once this deferral period has expired, counterparties are entitled to make use of their contractual (termination) rights.

International standards met

In publishing the BIO-FINMA, which met with a predominantly positive response during consultation, Switzerland is one of the first countries to introduce comprehensive restructuring regulations for banks. FINMA, as the restructuring and bankruptcy authority, is granted comprehensive powers to restructure and resolve banks. With a few minor exceptions the BIO-FINMA meets the requirements set out in the FSB Key Attributes of Effective Resolution Regimes of Financial Institutions as of October 2011. At the same time, the BIO-FINMA is compatible with the proposal for an EU directive on the "Recovery and Resolution of Credit Institutions and Investment Firms" (EU RRD) which was published by the European Commission at the beginning of June 2012.

In publishing the BIO-FINMA, FINMA has closed the last remaining regulatory gap and enhanced its ability to deal with the restructuring and orderly wind-down of banks. It should be possible to maintain the systemically critically functions on this legal basis. This enhances financial stability not only in Switzerland but in all foreign economies in which internationally active Swiss banks provide systemically critical functions.

The restructuring section of the BIO-FINMA

Recent regulatory developments in leading countries such as the US and the UK suggest that it could become an international standard to oblige creditors to share significantly the burden of a bank restructuring. Capital restructuring does not rule out other (restructuring) measures, but it seems likely that corporate actions will in future become a core element of every bank restructuring. This applies in particular to the issuing of compulsory instructions to convert debt capital into equity capital, thereby turning creditors into shareholders. There is also the option to oblige creditors to bear a share of losses. A decree issued by the relevant authority could require them to waive some or – in the extreme case – all of their claims. These two measures are known internationally under the keyword "bail-in".

In addition to the substantially increased international capital requirements defined under Basel III and in addition to the Swiss requirements for systemically important banks, the "bail-in" debt will form an additional "firewall" which is intended to make the restructuring of banks without state aid more realistic. "Bail-in" measures complement the convertible capital ("CoCos"), of which the Swiss systemically important banks are obliged to hold a considerable amount. The CoCos may make it possible for creditors (i.e. their "bail-in" capital) to be called upon to bear losses at a later stage and to a reduced extent.

The effectiveness of the BIO-FINMA corporate actions depends on whether the restructuring authority has access to a sufficient amount of "bail-in" debt in the right place. The solution that the BIO-FINMA provides is appropriate and balanced and is based on the availability of the "bail-in" debt.

Fundamentally, all claims vis-à-vis banks – with a few clearly defined exceptions – are subject to the regime of compulsory conversion of debt into equity or compulsory waiving of claims. The measures defined in the BIO-FINMA can be combined. When FINMA instructs creditors to waive their claims, it is not obliged – in contrast to the procedure for converting debt into equity – to completely wipe out the junior creditors before calling on the next senior category of creditors to share in the loss. This means that FINMA can distribute a loss across a range of creditor groups, which substantially boosts flexibility. From a quantitative perspective many Swiss banks are likely to have adequate "bail-in" debt. However, it remains to be seen whether this debt is in the "right" legal entity and in the right form (e.g. as a subordinated bond).

As far as these questions are concerned, opinions remain divided, particularly at international level. It is important therefore to pay close attention to (international) developments. The EU's proposal (EU RRD), for example, specify a minimum level of "bail-in" capital. Irrespective of these developments, Switzerland has achieved significant and internationally compatible improvements through the BIO-FINMA. Moreover, the corporate actions envisaged in the BIO-FINMA are appropriate to provide increased transparency for investors.

Interpretation and application of the BIO-FINMA

The BIO-FINMA can be applied to all claims which exist when it becomes effective and which have not been reimbursed in full. These claims can therefore be converted into equity or written off. However, this changes nothing in respect of the legal position. Article 31 para. 3 BA, which provides FINMA with

the power to convert debt into equity, has been in force since 1 September 2011. Furthermore, the Swiss authorities have consistently taken the position that a conversion could already have been ordered on the basis of Article 26 BA (Protective measures). Finally, the BIO-FINMA is only effective for claims which were justified before the BIO-FINMA became effective and which extend beyond the point at which the BIO-FINMA became effective (e.g. bonds with long maturities). Changes to the law are generally reserved as part of the issuing conditions for instruments of this kind.

FINMA has deliberately not excluded deposits from the "bail-in" and has instead placed the deposits last in the order of ranking. In other words, all other options must be exhausted before depositors are obliged to waive their claims or before a conversion into equity takes place. This is an appropriate solution. It represents a viable compromise between the creation of a "super-privilege" covering deposits which are not privileged and which are not covered by the depositor guarantee on the one hand and an undifferentiated equal treatment with other creditors on the other hand. It is based on the fundamental decision of the legislator not to protect investors against losses above the privileged amount of 100,000 Swiss francs.

It is likely that special situations will arise in the case of banks under public law and consequently do not have loss-absorbing equity as an initial "firewall". In the case of these institutions the focus is also likely to fall increasingly on the "bail-in" debt alongside additional tier 1 and tier 2 capital, provided with so-called "point of non-viability" clauses.