

Banking - Switzerland

FINMA's position paper on the salvaging of large banks

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Purpose of the paper
Preferred resolution strategy

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On August 7 2013 the Swiss Financial Market Supervisory Authority (FINMA) published a position paper on the resolution of global systemically important banks.⁽¹⁾ The paper explains FINMA's emergency strategy for such banks in Switzerland. It outlines the ways in which salvage or break-up can be implemented operationally in cooperation with foreign supervisory and resolution authorities. The comprehensive legislation addressing the 'too big to fail' issues in the Swiss banking industry, which was initiated in the aftermath of the 2008 financial crisis, and the salvage measures drawn up by the Swiss government and Swiss National Bank have recently entered into force, and provide the legal basis for the measures that FINMA may have to take when faced with a large Swiss bank in serious financial distress.

The paper outlines how large Swiss banks with significant cross-border business can, in the event of a crisis, be salvaged in such a way that the integrity of the group as a whole is preserved, avoiding a disorderly *de facto* break-up with insolvency proceedings in several jurisdictions, leading to potentially contradicting measures. Given the structure and nature of the largest Swiss banks, measures to salvage the parent bank are likely to be the best strategy to achieve this goal. In addition, any rescue or resolution plan must:

- ensure either the continuity or – if unavoidable – the orderly wind-down of systemically important functions of the affected bank;
- prevent a negative impact on global and national financial systems; and
- minimise the need for state aid to the furthest extent possible.

Preferred resolution strategy

FINMA's preferred salvage strategy for global systemically important banks headquartered in Switzerland is a single point of entry bail-in. The salvage or resolution plan will be spearheaded by the home supervisory and resolution authority (in this instance, FINMA itself), which shall lead and coordinate the necessary measures. The plan will focus on the parent bank and, where appropriate, also the highest-level non-operating holding company of the affected group.

As a first step, a bank in financial distress would need to implement the recovery measures detailed in its recovery plan under its own responsibility. However, this would be under FINMA's close supervision. Such a plan would, in particular, include:

- the triggering of high strike contingent convertible bonds;
- the disposal of business lines or other assets; and
- further measures provided for in the recovery plan.

Only if the recovery measures initiated by the affected bank will not or are unlikely to lead to a permanent stabilisation of the group (the point of non-viability) will FINMA step in with its emergency strategy.

The emergency strategy provides for a thorough recapitalisation of the top-level entity, forcing shareholders and creditors to bear the bulk of the losses so as to make a thorough restructuring of the group possible while business operations in all or most parts of the group are maintained, at least in the initial phase.

As opposed to a single point of entry approach, the multiple point of entry approach

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involves salvage and resolution measures by several supervisory authorities of different countries to different banking subsidiaries or branches of the group. This approach is more likely to result in a break-up of the group into separate parts with, most likely, different fates – bail-in, sale in entirety, break-up and transfer of parts of business or wind-down – and new owners.

After protection measures have been issued and implemented, and after analysing both the application of incurred losses and potential additional losses⁽²⁾ on the one hand, and the available 'bail-inable' debt, the scope of the bail-in and potential obstacles (in particular legal and operational risks) on the other, if it becomes clear that a bail-in is not sufficiently likely to lead to a sustainable stabilisation of the banking group, the break-up of the banking group comes into play as a fall-back strategy. This is the case if there are reasonable grounds to assume that the bank cannot meet its capital adequacy requirements to an extent that even a bail-in will be unable to cure the situation or will experience liquidity problems that seem too serious to overcome with the measures available in a restructuring.⁽³⁾ Although, in this case, significant additional risk capital will be available for the affected bank as a result of the conversion of the first layer of contingent convertible capital, the emergency plan by FINMA (and other local supervisory authorities) will be executed and the necessary emergency measures for protecting critical functions would be mandated in order to maintain the relevant business lines of the affected bank in order to be sold off or wound down in an orderly manner in a second stage. Remaining parts which are not systemically relevant will be wound down or liquidated within a short timeframe. If FINMA concludes that the point of non-viability for a particular bank has arrived, it will assume control of the banking group by:

- appointing an administrator;
- issuing directives to the governing bodies of the bank; and
- forbidding any payments on certain debt subject to bail-in.⁽⁴⁾

Rationale for application of single point of entry approach

Since the two major Swiss banks are active on a global scale and structured (in contrast to the US-style holding concept) as highly integrated wholesale institutions with concentrated funding and risk management structures, a central booking policy and strong Swiss-based parent banks that cover almost the entire internal financing needs of the group, the single point of entry approach seems more advantageous. Since debt instruments are issued mainly by the parent bank and its foreign branches, while funding is distributed in the form of intra-group loans, there is a liability overhang in Switzerland, with large intra-group positions existing with foreign subsidiaries. Since both large banks have subordinated and senior unsecured debt at the parent level amounting to between 30% and 40% of their risk-weighted assets, a bail-in at that level (ie, at the highest level of the group) is likely to be more successful on an overall basis and lead to more satisfactory results than a bail-in at the level of the different subsidiaries, often leaving the parent bank and its counterparties worse off.

However, the fact that a significant part of the liabilities that would be subject to a conversion into equity or to a haircut is issued out of foreign branches of the Swiss parent bank and governed partly by foreign law increases the execution risks of a bail-in, as well as the need for FINMA's cooperation with the host supervisory and resolution authorities in the jurisdictions of such branches in order to assure that the FINMA-led bail-in will be recognised in the host jurisdictions. Even though, from a Swiss law perspective, FINMA is in principle competent (ie, it has personal as well as subject-matter jurisdiction) for a bail-in for the assets and liabilities of these branches, the competent host authorities may, according to the applicable local laws of the affected branches, need to ratify the measures ordered by FINMA or themselves issue administrative orders in order to support the bail-in measures ordered by FINMA to prevent – to the extent legally possible under applicable local laws⁽⁵⁾ – actions by local creditors that would thwart FINMA's resolution plan. Further, foreign banking subsidiaries and their assets and operations might – even though ear-marked to be preserved on a going-concern basis, without any bail-in measures – be subject to measures by local authorities. Therefore, the challenge when following a single point of entry approach is to put the bail-in plan into operation on an international basis with a high degree of legal certainty, and without too much negative interference by local authorities and creditors in other jurisdictions where the banking group is active, in order to avoiding significant conflicts with the principle of equal treatment of the affected bank's creditors in all affected jurisdictions. In order to achieve that goal, FINMA must – as stated in the position paper – further improve the certainty of implementation of a single point of entry bail-in by concluding cooperation agreements with host supervisory and resolution authorities, in order to assure that the single point of entry bail-in will be recognised not only in Switzerland, as the home jurisdiction of the affected bank, but also in all significant host jurisdictions.

Legal basis

Following the 2008 financial crisis and the UBS bailout by the Swiss government and Swiss National Bank,⁽⁶⁾ Switzerland amended the existing special regulatory regime

applicable to banks in distress by amending the Banking Act and its implementing ordinances, providing FINMA with the necessary tools to more effectively manage the stabilisation, rescue and resolution of ailing banks or securities dealers. FINMA will supervise and coordinate any measures relating to the stabilisation, recovery and resolution of banks and securities dealers, including the implementation of protective measures, as well as the coordination and cooperation with other supervisory and resolution authorities – in particular, the host authorities in charge of supervising branches or subsidiaries of the affected bank.

The key elements of a successful bail-in which can restore market confidence and allow the restructured bank to return to a business-as-usual mode are capital measures. Within the legal framework FINMA can, in particular, mandate a bail-in or transfer assets and liabilities between legal entities in order to ensure the continuation of essential banking services. Apart from triggering the conversion of low strike contingent convertible bonds, bail-in measures include the issue of compulsory instructions by FINMA to certain (other) groups of creditors of the affected bank to convert their debt claims into equity capital, thereby turning such creditors into shareholders of the bank. FINMA also has the option to oblige creditors to bear a share of the losses incurred by the bank, by waiving a portion or all of the principal of their debt claims (ie, by a partial or full waiver of such claims).

When planning and implementing a bail-in, FINMA must observe certain mandatory principles. First, the hierarchy of creditors must be taken into consideration. A bail-in requires the prior cancellation of existing shares and other regulatory capital, including capital obtained through the conversion of contingent capital instruments. Subordinated claims are next, followed by all other unsecured (and unsubordinated) claims against the affected bank, although FINMA may deviate from this principle and spread the losses between several categories of creditor. Only as a last resort will deposits be included in the bail-in; however, deposits with preferential treatment (ie, deposits⁽⁷⁾ which fall under the Swiss deposit protection system⁽⁸⁾) are excluded and thus cannot be subject to the bail-in measures. Secured claims and claims subject to a set-off cannot be converted into equity; neither will they be subject to a haircut in the framework of the bail-in.

Second, in case of a bail-in, all creditors must receive at least the same amount that they would have received in case of involuntary liquidation of the affected bank, based on the hypothetical recovery rate or liquidation dividend.⁽⁹⁾ If the proposed restructuring plan for the affected bank does not fulfil this requirement for each class of creditor, the plan can nevertheless be implemented, but any negatively affected creditors must be compensated *ex post*.

Third, the principle of equal treatment of creditors in the same class or category of debt remains applicable in general, to the extent that legal or economic reasons do not require a deviation from the principle to secure the success of the bail-in. Different from the ordinary bankruptcy regime applicable to non-banks, the relevant legal framework provides for further distinctions or allows for exceptions within narrow limits in order to maintain the stability of the financial system and allow a continuation of banking operations by leaving some liabilities from trading or other banking transactions – as opposed to financing liabilities – outside the scope of the bail-in.⁽¹⁰⁾

The supremacy of system protection over individual creditors' rights is also reflected in the new procedural restriction on creditors' rights to approve or appeal the restructuring plan of systemically important banks. Even if one of the three principles is violated, the creditors have no remedy to halt the implementation of the restructuring plan. A group of creditors representing the majority of unsecured and unsubordinated debt cannot reject or prevent implementation of the restructuring plan. Any successful appeal by a creditor or a shareholder against the restructuring plan will lead only to an award of *ex post* compensation, but not to suspension or reversal of the plan or any individual measures ordered or already implemented.

Raised concerns

FINMA's proposed strategy raised some concerns. In online forums and blogs several people have proclaimed their fear that in case of a single point of entry bail-in, there will be a run on the bank by small savers. However, these concerns are without cause for two reasons.

First, the hierarchy of creditors must be observed. A bail-in requires the prior cancellation of existing shares and other regulatory capital, including capital obtained through the conversion of contingent capital instruments. Subordinated claims follow, then all other claims, and only as a last resort are uninsured and unprivileged deposits to be converted into new share capital. In the case of applying haircuts, FINMA has the discretion to deviate from this principle and share the losses between several categories of creditor.

Second, privileged deposits in the name of the investor (including medium-term notes) to an amount not exceeding Sfr100,000, as well as certain deposits by vested benefits foundations up to a maximum of Sfr100,000 per creditor, qualify as privileged deposits

and are protected by the Swiss deposit protection system, with the aim of protecting small depositors in order to prevent a run on the bank. This deposit protection system will remain applicable.

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Endnotes

(1) See www.finma.ch/e/aktuell/pages/mm-pos-sanierung-abwicklung-20130807.aspx.

(2) See Position Paper, Section 7 – the most important and most volatile assets of the units in which losses have arisen must be valued, and a loss forecast for at least the following year must be prepared to assess the amount of recapitalisation required.

(3) The capital trigger is met for financial groups on a consolidated level or on the level of the individual parent bank entity if total capital falls below 8% of the risk-weighted assets or the level of Common Equity Tier 1 falls below 5% of the risk-weighted assets.

(4) See Position Paper, Section 6.3 and Article 26(1) of the Banking Act.

(5) As set forth in Position Paper, Section 7.2(17). For example, according to applicable laws in the United States, the competent regulators can seize the assets of US branches and other assets in the United States of an insolvent foreign bank, liquidate such assets and apply the proceeds first to satisfy creditors of the US branches before returning any excess to the jurisdiction of the headquarters of the affected bank. As a result, the recovery of the creditors of the respective branches is generally significantly higher than if their claims were treated equally to the other unsecured creditors within the framework of the involuntary liquidation of the affected bank.

(6) On October 16 2008 UBS announced that it had placed Sfr6 billion of new capital, through mandatory convertible notes, with the Swiss Confederation. Further, the Swiss National Bank and UBS established a separate fund entity and entered into an agreement to transfer approximately \$60 billion of then illiquid securities and various assets from UBS to such an entity. In accordance with the agreement, UBS had to finance 10% of the transfer amount and the Swiss National Bank the remaining \$54 billion. In early 2009 the maximum volume of assets to be transferred was reduced from its original level of \$60 billion to \$39.1 billion, thereby reducing the amount to be financed by the Swiss National Bank to \$35 billion. The assets transferred mainly comprised securities, loans and derivative positions.

(7) Deposits in the name of the investor (including medium-term notes) to an amount not exceeding Sfr100,000, as well as certain deposits by vested benefits foundations, also up to a maximum of Sfr100,000 per creditor.

(8) The Swiss deposit protection system, which aims to protect small depositors in order to prevent a run on the bank will remain applicable.

(9) The no-creditor-worse-off test – see Article 31(1) of the Banking Act.

(10) See Position Paper, Page12, Footnote 18.

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