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Banking rehabilitation and insolvency reform in Switzerland

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The current Swiss bank rehabilitation and insolvency regime was enacted in 2004, on the basis of lessons learned from the crisis of Swiss cantonal and regional saving banks in the 1990s. The turmoil of the financial markets in 2007 and 2008 resulted in the two major Swiss banks, UBS and Credit Suisse, suffering significant loss. This crisis has led to the proposal of significant amendments to the 2004 regime.

This chapter:

- Sets out the background to the reform proposals.
- Briefly describes the current Swiss bank insolvency regime.
- Sets out the proposed amendments made to the Banking Act to formalise the emergency laws.
- Examines the proposals made to regulate the too big to fail (TBTF) banks to mitigate insolvency risk.

BACKGROUND TO THE REFORM PROPOSALS

2004 regime

The Swiss bank rehabilitation and insolvency regime of 2004 was based on the lessons learned from the crisis of Swiss cantonal and regional saving banks in the 1990s. This crisis was a result of the burst of the housing bubble. Between 1991 and 1996, Swiss banks were forced to depreciate about 8.5% of the total outstanding credit amount. More than one-half of the regional saving banks (about 180 banks) vanished from the market.

The 2004 regime was only in play very recently. The following liquidations, started in 2008, were the first noteworthy proceedings under the 2004 regime:

- Lehman Brothers Finance Ltd.
- Lehman Brothers International (Europe), London, Zurich Branch.
- The Swiss branch of Kaupthing Bank Luxembourg Ltd.

Background to the current proposals

The turmoil of the financial markets of 2007 and 2008 also originated from a housing bubble. This time, however, it was the two major Swiss banks, UBS and Credit Suisse, rather than the Swiss cantonal and regional saving banks, which were affected. The crisis began to be felt in Switzerland during the fourth quarter of 2007 when the credit quality of US collateralised debt obligations (CDO) based on sub-prime mortgages deteriorated and the effects spilled over to the interbank market. The losses of the big two Swiss banks were substantial; for example, UBS had cumulative write downs of approximately US$53.1 billion until 2009 (as at 1 February 2011, US$1 was about EUR0.7). In comparison:

- The Swiss domestic banking market remained surprisingly stable.
- Only a very small number of foreign banks were taken over, mainly by other foreign financial institutions, and this was the result of the abolition by the Swiss government of the distinction between tax fraud and tax evasion in dealings with foreign clients in March 2009, rather than the financial crisis.

The following factors have led to the amendment proposals:

- The fact that the current deposit protection scheme, as part of the bank insolvency regime, is considered too weak to avoid bank runs.
- The risks that the TBTF status of UBS and Credit Suisse imposes on the Swiss economy. Shortly before the crisis, the two banks:
  - accounted for about 60% of total Swiss bank assets booked domestically and over 3.5 times the gross domestic product (GDP);
  - had total worldwide assets of about six times the Swiss GDP.

  The risk resulting from these figures is comparable to the problems that Iceland is currently suffering. The disproportion between the size of these two banks and Switzerland's GDP underscores the need to get out of the TBTF trap.

THE CURRENT SWISS BANK INSOLVENCY REGIME

Since the introduction of the amendments in 2004, the Swiss Banking Act 1934 (BA) provides for detailed rules concerning the bankruptcy and insolvency proceedings of banks and branches of foreign banks established in Switzerland. The Swiss Federal Act on Debt Enforcement and Bankruptcy 1889 (DEBA), which provides the usual insolvency regime, only applies to banks and securities dealers to the extent the BA does not provide for special rules. In addition, the Swiss Financial Markets Supervisory Authority (*Eidgenössische Finanzmarktaufsicht*) (FINMA) can deviate from the rules of the DEBA where it deems appropriate. However, this derogation power is mostly of a formal nature and FINMA cannot alter existing contractual agreements between the failing bank and a third party.

The BA grants broad powers to FINMA, which is entitled to handle most of the insolvency proceedings against banks (and securities dealers). In particular, FINMA has the authority to implement, in relation to banks:

- Protective measures.
- Rehabilitation proceedings.
- Solvent or insolvent liquidation proceedings.

Protective measures

Protective measures can include a broad variety of measures, such as a bank moratorium or a maturity postponement, and FINMA can order them either on a stand-alone basis or in connection with rehabilitation or liquidation proceedings. FINMA determines at its own discretion the appropriate measures to be taken against a distressed bank, which can consist of:

- Issuing instructions to the bank.
- Appointing an investigator.
- Removing the governing bodies of the bank, or withdrawing their power and authority to act on behalf of the bank.
- Removing the auditors.
- Limiting the business activities of the bank.
- Ordering the bank to pay out or receive funds or to conduct transactions.
- Shutting down the bank.
- Postponing the due dates of the debts of the bank.

Rehabilitation proceedings

The aim of a rehabilitation proceeding is the restructuring and recovery of a bank. A rehabilitation proceeding can be carried out only if there is a prospect for recovery. FINMA orders the proceeding to take place and appoints a trustee to conduct the proceeding.

The trustee will draw up the rehabilitation plan, which requires FINMA's approval. Generally, it will grant approval if the usual requirements for rehabilitation are fulfilled, in particular that:

- There is a possibility of greater improvement of the position of creditors compared to a bankruptcy proceeding.
- It is likely that there will be an effective and controlled rehabilitation procedure.

Finally, the rehabilitation plan must not be rejected by creditors who represent more than 50% of the unsecured and unprivileged claims, as recorded in the bank's books. In the event of a rejection, FINMA can order the liquidation of the bank.

Although these rules are technically still in force, they have in effect been amended by the new bridge bank rules, introduced by the emergency laws and to be formalised by the Banking Act Reform Bill (*see below, Banking Act Reform Bill: Bridge bank rules*).

Liquidation

FINMA will order liquidation if:

- There is no reasonable chance of rehabilitation.
- The rehabilitation fails.
- The bank's operations have been undertaken without a banking licence or after the withdrawal of a banking licence.

On the order of liquidation, the bank is no longer entitled to dispose of its assets. FINMA appoints a liquidator who is responsible for conducting and implementing the liquidation proceedings.

Liquidation in these circumstances differs from the general bankruptcy regime set out in the DEBA in the following ways:

- Claims of bank customers up to the amount of CHF100,000 are privileged under the deposit protection regime and, therefore, treated with priority (as at 1 February 2011, US$1 was about CHF0.9).
- Third-party assets deposited with the bank do not form part of the bank's bankruptcy estate and will be separated and released to the owners.
- Claims against the bank, which are recorded in the books of the bank, do not need to be additionally lodged by the creditors; the liquidator will consider them in each case when drawing up the schedule of claims.
- Creditors' meeting are not mandatory; however, FINMA can appoint a creditors' committee.

Netting arrangements

The BA's rules are not meant to affect close-out netting arrangements (that is, arrangements to settle, by one single payment on the occurrence of an event of default, all contractual liabilities that are not yet due). In particular, in a liquidation procedure ordered by FINMA, the relevant provisions of the DEBA governing netting arrangements, as well as agreements providing for a right to liquidate collateral by private sale, are not affected (*Article 27(3), BA*).

BANKING ACT REFORM BILL

In the midst of the financial crisis, the Swiss Parliament passed an emergency law in December 2008 to enhance protection for Swiss bank depositors as well as to stabilise and strengthen the Swiss financial system. On 18 March 2011 the Swiss Parliament voted for a Banking Act Reform Bill to implement the emergency law (which is still currently in place), almost unchanged, on a permanent basis. The emergency law expires at the end of 2012, and the Banking Act Reform Bill will be set in place on 1 January 2013 at the latest.

The Banking Act Reform Bill's most important elements are:

- Its enhancement of the deposit protection regime.
- The new bridge bank rules.

Enhancement of the deposit protection regime

The Swiss Banks' and Securities Dealers' Deposit Protection Association (DPA) is a banking industry self-regulatory organisation. Any Swiss bank that accepts deposits must become a member of the DPA. If a bank fails, the DPA solicits contributions from its members, based on the relative size of the member's deposit base, to cover the guaranteed amount of deposits. The DPA then transfers these contributions to the administrator of the failed bank for payment to depositors.

The emergency law:

- Increases the depositors' bankruptcy privilege to CHF100,000 from CHF30,000 per depositor and bank.
- Raises the maximum amount that the DPA covers from CHF4 to CHF6 billion.

TAX IMPLICATIONS OF THE TBTF BANKING ACT REFORM BILL

The TBTF Banking Act Reform Bill will have significant effects on the Swiss tax system. To promote CoCo Bonds and to generally strengthen the Swiss bond market the application of the Swiss issuance stamp duty will be limited.

Current system

The Swiss domestic bond market virtually died after the Federal Stamp Tax Act came into force in 1973. Swiss issuance stamp duty must be paid on the issuance of bonds by, among others, a Swiss-resident company or the Swiss-registered branch of a foreign-resident company. The duty is charged at either:

- 0.12% for each full or partial year of its term on loan debentures.
- 0.06% for each full or partial year of its term on cash debentures (money market papers).
- 1% on the issuance of shares where the value of the shares exceeds CHF1 million.

The issuer must declare this tax and remit it to the Swiss Tax Administration.

For stamp tax purposes the term "bond" is broader than under securities law as it also includes book claims and other debt instruments issued for the purpose of collective fund raising.

Proposed changes

The TBTF Banking Act Reform Bill proposes:

- The abolition of issuance stamp duty on loan and cash debentures.
- An issuance stamp duty exemption for participation rights stemming from the conversion of CoCo Bonds (this will be restricted to the CoCo Bonds of systemically important banks).

The proposed abolition of the stamp duty would probably:

- Cause a net revenue shortfall of several hundred million Swiss francs.
- Have a very stimulating effect on the Swiss capital market.
- Greatly encourage the issuance of Swiss bonds, by giving Swiss issuers the possibility of financing themselves on the bond markets at much lower costs than is currently the case.

- Requires banks to hold assets in Switzerland in an amount equal to 125% of the amount of the protected deposits. This is an additional liquidity measure directly aimed at supporting bank creditors, presumably with an indirect additional liquidity cushion effect on the overall liquidity management requirements of Swiss banks. This ring fencing is a direct result of the liquidation proceedings of the Swiss branch of Kaupthing Bank Luxembourg Ltd, where the assets held in Switzerland turned out to be insufficient to pay out the depositors. Enormous efforts were required to get the required additional funds to be transferred from the foreign parent company to Switzerland to cover the losses.
- In the event of bank failure, provides for a fast disbursement to depositors out of the liquidity available at the failing bank.

The Banking Act Reform Bill will transform these measures into permanent law.

Explicit bank deposit protection measures have been adopted in more than 100 countries, and many countries have recently increased their deposit protection schemes (*International Association of Deposit Insurers*). These schemes are often thought to reinforce investors' confidence or strengthen the resilience of the banking sector. Critics, however, contend that they:

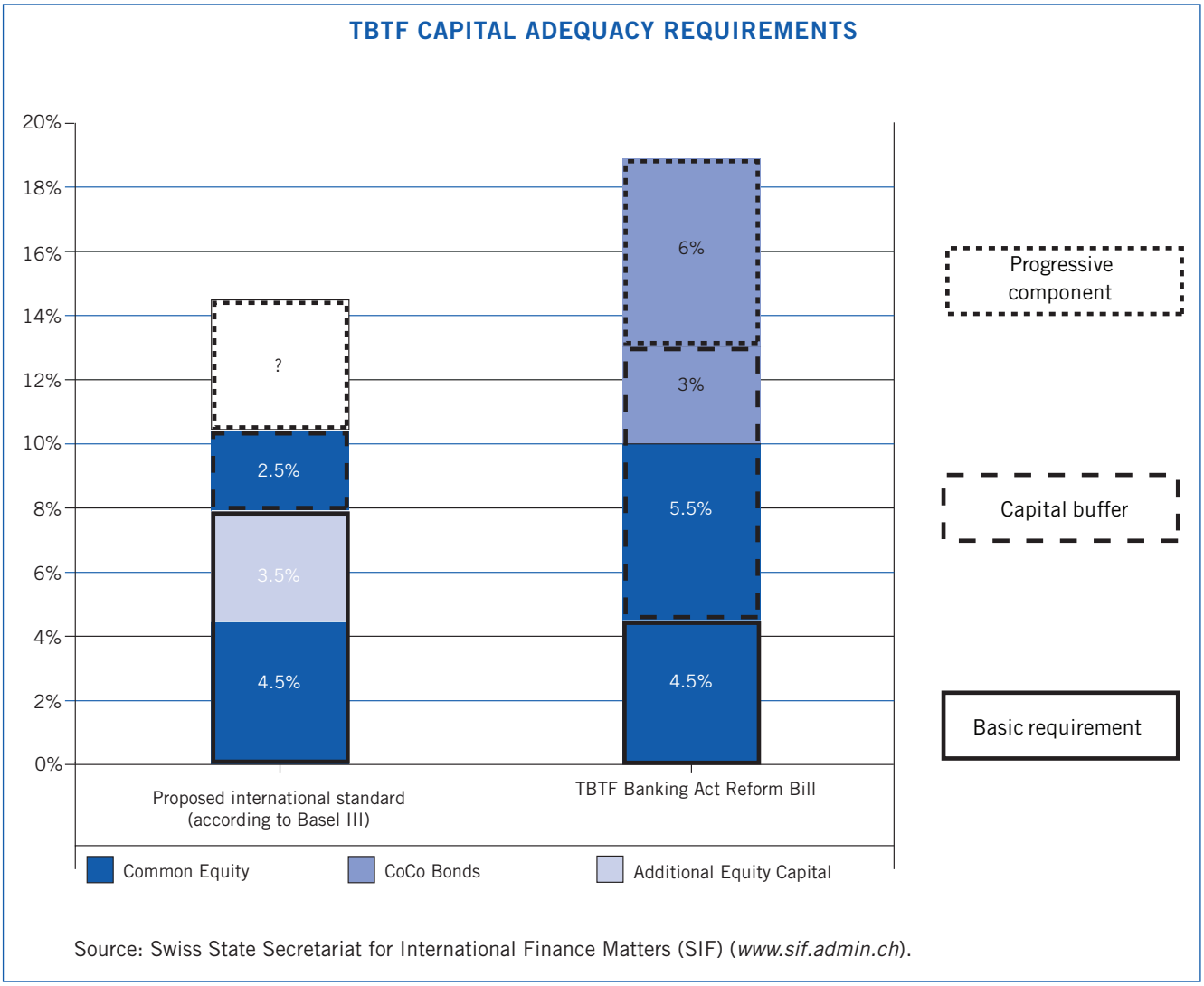
- Increase "moral hazard", that is, the risk that bankers will not act prudently.
- Cannot cope with a systemic financial crisis, because the failure of a single large bank or a few medium-sized banks would result in losses far greater than the deposit protection fund.
- Impose undue costs on banks, which:
  - results in lower interest rates on deposits and/or higher interest rates on loans;
  - hinders a bank's accumulation of additional capital.

It is doubtful, however, that deposit protection significantly increases moral hazard in the banking sector. The financial crisis has shown that governments are reluctant to allow banks to fail. This implicit governmental guarantee would appear to be the greatest contributor to moral hazard theory. Many economic arguments against deposit protection (for example, that it is a penalty on profits, hinders capital accumulation and misallocates funds) are directed at the scope of an existing scheme, how and when it should be funded, and by whom. They are not directed at the core issue: should there be deposit protection at all?

Deposit protection is of marginal relevance for TBTF banks, as they are perceived to have an implicit governmental guarantee and, in the event that they are wound up, a deposit protection fund is unlikely to be large enough to protect all of the depositors. Therefore, deposit protection is an instrument to protect depositors in banks that are small enough to fail, and therefore it could be argued that the limit of a deposit protection scheme should be restricted accordingly.

Bridge bank rules

Apart from the enhancement of the deposit protection scheme, perhaps the most important changes introduced by the emergency law and the Bill concern the new bridge bank rules. These are new powers for FINMA to have certain bank services of a



Source: Swiss State Secretariat for International Finance Matters (SIF) (*www.sif.admin.ch*).

failing bank continued for the benefit of the depositors, as one of the options available under the rehabilitation procedure. This means that rehabilitation proceedings will not only be initiated so as to carry on the bank's business under its current structure, but can now carry on only certain business units of the bank while winding-up others or restructuring them separately.

The proposed rehabilitation proceedings are similar to those under the 2004 legislation (*see above, The current Swiss bank insolvency regime: Rehabilitation proceedings*). As with the 2004 rules, FINMA must approve the rehabilitation plan. If the rehabilitation plan would affect creditors' rights, FINMA must submit the plan to the creditors, who may reject it within the deadline set by FINMA. On FINMA's approval of the plan, continuing businesses and assets or liabilities (including real estate and existing contracts) of the failing bank can either be transferred to:

- A bridge bank established for restructuring purposes.
- An existing third-party bank.

No other measures, approvals, consents and formalities would be necessary for the transfer to be valid. In particular, the provisions of the Swiss Merger Act would not apply.

An earlier proposal to amend the BA provided that change of control and assignment of contract resulting from this transfer were not to be considered as events of default, entitling a third party to terminate the agreement with the failing bank or apply a close-out netting clause (*see above, The current Swiss bank insolvency regime: Netting agreements*). A contractual clause providing this would have been declared void and incompatible with Swiss public order (*ordre public*). This proposal was heavily criticised, including by the authors' firm. The current Bill no longer includes this provision. Article 27(3) of the BA will even be amended to clarify that any contractual close-out netting arrangements and private sale of securities will not be affected by any protective measures, rehabilitation proceedings (including measures related to the establishment of a bridge bank), and solvent or insolvent liquidation proceedings relating to banks.

THE TBTF BANKING ACT REFORM BILL

The Banking Act Reform Bill was only the first step in a far-reaching reform to Swiss banking regulation and, in particular, the Swiss bank insolvency regime. On 30 September 2010, a Swiss TBTF Expert Commission submitted its final report on this

topic to the Swiss government. Based on this report and after executing a public consultation proceeding (which ended in March 2011), the Swiss Federal Council proposed the TBTF Banking Act Reform Bill on 20 April 2011. The TBTF Banking Act Reform Bill basically requires "systemically important" banks (*see below*) to:

- Hold more capital.
- Meet more stringent liquidity requirements.
- Improve their risk diversification.
- Implement organisation measures to ensure the maintenance of systematically important banking functions in case of threatened insolvency.

The aim of the proposed measures, as a whole, and combined with the bridge bank rules (*see above, Banking Act Reform Bill: Bridge bank rules*), is to absorb the negative effects on the Swiss economy in the event of the insolvency of a systemically important bank. This should prevent the Swiss government from having to make the sort of intervention that was required in 2008 to bail out UBS.

According to the TBTF Banking Act Reform Bill, systemically important banks are banks, financial groups and bank-dominated financial conglomerates whose failure would cause considerable harm to the Swiss economy and the Swiss financial system. The Swiss National Bank (SNB) will designate which institutions are systemically important after consultation with FINMA. In its interim report, the TBTF Expert Commission primarily identified the two major banks, UBS and Credit Suisse, as systemically important banks, mainly because their banking service (especially the credit business and payment transactions) is essential for the Swiss economy.

The Swiss Parliament will probably discuss the draft bill during its 2011 summer and autumn sessions. The legislative amendments could come into force at the beginning of 2012 at the very earliest. In any event, a long transition period to 2018 will apply to the systemically important banks.

This section will go on to consider the:

- New capital requirements for systemically important banks.
- Emergency plan that systemically important banks will be required to have in place.

The TBTF Banking Act Reform Bill will also have significant tax implications (*see box, Tax implications of the TBTF Banking Act Reform Bill*).

Capital requirements

Large Swiss banks are currently required to provide for a capital adequacy target in a range between 50% and 100% above the international minimum requirement (pillar 1) of Basel II. In good times, these banks must increase their capital up to a target level of 200% (100% pillar 1 and 100% pillar 2). These buffers will then be available to the banks during crises up to an intervention level of 150%.

To reduce the likelihood of a systemically important bank becoming insolvent, the TBTF Banking Act Reform Bill proposes that capital adequacy requirements become more stringent. Systemically important banks will need to hold equity of at least 19% of the risk-weighted assets. This equity capital must be divided into three different components (*see box, TBTF capital adequacy requirements*):

- **Basic requirement.** This consists of an equity ratio of 4.5% of the risk-weighted assets (Common Equity).
- **Capital buffer.** This consists of a minimum of another 5.5% of Common Equity and a maximum of 3% contingent convertible bonds (CoCo Bonds). These CoCo Bonds will be converted into equity if the Common Equity falls below 7% of the bank's risk-weighted assets (debt equity swap).
- **Progressive component.** This consists of a minimum of 6% of the risk-weighted assets. It is made up entirely of CoCo Bonds, which will be converted into equity if the Common Equity falls below 5% of the bank's risk-weighted assets.

This means that 10% of the risk-weighted assets must be issued by Common Equity and the remaining 9% may consist of CoCo Bonds. These proposals are considerably more stringent than the international standard provided under Basel III. Basel III will implement a capital requirement of 10.5% only, with an additional requirement for systemically important banks of about 1% to 3% of the risk-weighted assets (the latter figures have not yet been agreed).

This additional equity requirement is intended to ensure sufficient capital for the financial consolidation of systemically important banks and therefore relieve the government from having to give support in a financial crisis.

Systemically important banks also face stricter liquidity requirements and specific rules on risk diversion. These have already been introduced, as of 1 January 2011, when implementing more stringent Basel capital adequacy provisions for market risks and securitisation in the wake of the financial and economic crises, as well as the supervision of liquidity risk.

Emergency plan

A systemically important bank must decide on organisational measures required to ensure proper continuation of systemically important functions in the event of insolvency. To ensure this, it must draft an emergency plan.

The emergency plan will generally only be triggered if the bank's capital ratio falls below 5% of risk-weighted assets. The emergency plan should provide for possible transmission of the systemically important functions to a new independent legal entity (bridge bank) (*see above, Banking Act Reform Bill: Bridge bank rules*). At the same time, the CoCo Bonds as part of the progressive component will be converted into common equity (*see above, Capital requirements*). This conversion should ensure the implementation of the emergency plan and sufficient capitalisation for the reorganised bank.

FINMA may reward a bank with discounts (up to 5%) from the progressive capital requirements if the bank can demonstrate compliance with the required organisational measures and present an accurate emergency plan.

If a systemically important bank is unable or unwilling to present an adequate emergency plan, FINMA may request the necessary measures from the bank by, for example, ordering the bank to:

- Establish a bridge bank in Switzerland.
- Outsource relevant infrastructure to another entity within the group.
- Unbundle certain functions within the group.
- Structure the group in a way which will facilitate transfer of the relevant banking services to a bridge bank when required in insolvency.

According to the TBTF Banking Act Reform Bill, the Swiss Federal Council will provide in an ordinance, at a later stage, for the details of the requirements for the emergency plan and the measures that FINMA can implement.

SUMMARY

The 2004 Swiss bank insolvency regime has only recently been brought into play. However, the problems suffered as a result of the recent financial crisis meant that further reforms were inevitable. In contrast to the crisis suffered in the 1990s, the problems were not concentrated around the Swiss domestic banking market, which remained relatively stable. Rather, the problems were suffered by the TBTF banks, UBS and Credit Suisse, which have a huge status in the Swiss economy.

Some significant reforms have already been introduced by an emergency law. The BA's amendments, which will formalise these reforms, will enhance deposit protection schemes and implement bridge bank rules. The former of these, although of general importance, is of limited significance to the TBTF banks.

Therefore, further significant reform proposals have been made, under the TBTF Banking Act Reform Bill, which will specifically address issues which are of importance to the TBTF banks: capital requirements, the need to have an emergency plan in place in the case of insolvency, and positive taxation changes to stimulate the Swiss bond market. These reforms are still subject to discussion in the Swiss Parliament and will, in any event, not be introduced before 2012. Due to the considerable importance of Swiss banking regulation, these changes will continue to prompt considerable interest both inside and outside Switzerland.

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Recent transactions

- Swiss transaction counsel in a large car leasing financing transaction.
- Swiss counsel to the dealers in UBS AG's covered bond programme for the issuance of covered bonds by UBS AG, London Branch.
- Advising Barclays in a large cross-border restructuring and sale of a financing of a pool of hotel properties across Europe.
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- Counselling the Swiss Bankers' Association on the revision and implementation of different self-regulation code of conducts as well as on the revision of the deposit protection scheme.
- Advising JP Morgan Chase on various asset-based lending transactions, including subsequent takeout securitisations.
- Advising Barclays in a large cross-border restructuring and sale of a financing of a pool of hotel properties across Europe.

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