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Proposed Swiss Bank Deposits Protection Law



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In response to the recent crisis in global credit markets and the insolvency of numerous banks worldwide, the Swiss Parliament passed an emergency law in December 2008 to expand protection for Swiss bank depositors. On 14 September 2009 public consultation on permanent legislation has begun. This NewsLetter summarizes and appraises the proposed Federal Law on the Protection of Bank Deposits (the "Deposits Protection Law" or "DPL").

Background

Deposit protection in Switzerland is currently based on:

- a bankruptcy privilege that gives depositors a preferred claim in the bankruptcy of a Swiss bank, now a maximum of CHF 100,000 per depositor, which must be paid from the assets of the bank in priority to its other unsecured creditors;
- a guarantee for certain deposits from the Swiss Banks' and Securities Dealers' Depositor Protection Association (the "DPA"), a banking industry self-regulatory organisation (www.einlagensicherung.ch/en). Swiss banks that accept deposits are required to become members 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. These contributions are then transferred by the DPA to the administrator of the failed bank for payment to depositors.

Although these two protections, established in the Banking Law, are interrelated, their scope is different. For example, a depositor with a non-Swiss branch of a Swiss bank would be protected by the bankruptcy privilege, but not by the DPA's deposit guarantee. The DPA guarantee also has been criticised as a potentially weak, even dangerous form of depositor protection because member banks might be further impaired during a wide-spread banking solvency crisis by the payment of DPA guarantee contributions.

The emergency legislation of December 2008

On 19 December 2008, the Banking Law was amended by emergency legislation which, among other things:

- increases the depositors' bankruptcy privilege to CHF 100,000 from CHF 30,000 per depositor and bank;
- increases the maximum amount covered by the DPA to CHF 6 billion from CHF 4 billion;
- provides for a fast disbursement to depositors in the event of a bank failure out of the liquidity available at the failing bank;
- requires banks to hold assets in Switzerland in an amount equal to 125% of the amount of the deposits protected by the bankruptcy privilege.

These changes remain in force until the end of 2010.

Proposed Deposits Protection Law

The now proposed DPL would make the 2008 emergency amendments to the Banking Law permanent and replace the DPA's deposit protection with a funded deposit protection fund ("DPF").

The DPL would require the banks to contribute cash and to pledge assets to the DPF in a total amount equal to 3% of the protected deposits of all Swiss banks. Two-thirds of this amount is to be funded by annual contributions paid by the banks with the remainder covered by the banks pledging assets to the DPF that would be acceptable to the Swiss National Bank in securities repurchase ('repo') transactions. Swiss banks currently hold approximately CHF 325 billion in deposits that would be protected by the DPF, so the target amount for the DPF is approximately CHF 9.75 billion.

Full funding of the DPF is to be achieved over a period of more than 20 years. Each bank would make an annual contribution in an amount equal to 4% of its share of the target amount for the cash portion of the DPF, subject to an adjustment for the bank's risk profile (i.e., 4% of two-thirds of the target amount

for the DPF, an industry-wide contribution of approximately CHF 260 million per year [approximately eight basis points 8/100s of a percent]). The Swiss Federal Department of Finance has estimated that risk-adjusted contributions of cash and pledge assets will be required in a range of 9 to 33 basis points, depending on the risk profile of an individual bank.

If the DPF sustains a loss before it is fully funded, the banks are required to contribute an amount equal to a maximum of 2% of protected deposits to the extent needed to cover deposit protection payments made by the DPF. The DPL also requires each bank to maintain an additional reserve to secure this additional DPF contribution obligation. Because these measures may be inadequate to cover the full amount of a protected loss, the DPL allows the DPF to either request a loan (at market-based interest rates) or a guarantee from the Swiss federal government to cover unfunded deposit protection payments. In each case, the DPF is required to pay an annual fee to the federal government for these commitments and the DPF shall then charge each bank its proportional share of this fee.

Appraisal of the proposed Deposits Protection Law

According to the International Association of Deposit Insurers, explicit bank deposit protection measures have been adopted in more than 100 countries and many countries have recently increased these protections, but arguments continue about the wisdom of their use. Critics contend that deposit protection:

- increases the ‘moral hazard’, the risk that bankers will not act prudently;
- cannot cope with systemic financial crises 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;
- imposes undue costs on banks, resulting in lower interest rates on deposits or higher interest rates on loans, or both, and hinders a bank’s accumulation of additional capital;
- results in the unproductive hoarding of funds by a governmental agency.

It is doubtful that explicit deposit protection significantly increases the moral hazard in banking. The current crisis shows that governments are reluctant to allow banks to fail and this implicit deposit insurance seems a greater contributor to moral hazard than the existence of deposit protection or a limited increase in its amount. The economic arguments against deposit protection – it penalizes profits, hin-

ders capital accumulation and misallocates funds – are more arguments about the extent of the deposit protection, how and when it will be funded, and by whom, rather than arguments against deposit protection as a matter of principle.

Deposit protection seems marginally relevant for a bank that is ‘too big to fail’ or ‘too interconnected to fail’ because it is perceived to have an implicit governmental guarantee and – in the event such bank will nevertheless be wound up – a deposit protection fund is unlikely to be large enough to protect all of its depositors. If so, then deposit protection is really an instrument to protect depositors in banks that are small enough to fail and the size of a deposit protection fund can be scaled accordingly.

Funding a deposit protection fund before a bank failure occurs is prudent because it spreads the cost of losses over a longer period of time and, depending on the circumstances, funding a deposit protection fund after a bank failure may be more difficult. Conversely, a fully funded deposit protection fund in an environment in which bank failures are infrequent and usually involve small institutions is not an optimum use of capital.

These considerations, coupled with the fact that bank failures in Switzerland have been relatively rare and small, suggest that a deposit fund of roughly two-thirds of the size contemplated by the DPL – perhaps CHF 1 to 1.5 billion funded in advance with a maximum of another CHF 4.5 to 5 billion collected from the industry after a bank failure – would provide adequate industry-funded protection for depositors with greater cost efficiency than the DPL affords.

The ww&p NewsLetter provides comments on new developments and significant issues of Swiss law. These comments are not intended to provide legal advice. Before taking action or relying on the comments and the information given, addressees of this NewsLetter should seek specific advice on the matters which concern them.

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