

**A Swiss Finish for Australia?  
Approaches to Enhancing the Resilience of Systemically Important Banks**

by

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**Key Points:**

- The global financial crisis of 2008-9 placed the ‘too-big-to-fail’ issue at the forefront of public and regulatory debate;
- This paper presents a comparative study of regulatory measures taken to address this issue in Switzerland and Australia;
- Australia’s banking system was distinguished from its peers in advanced economies during the crisis as it did not require substantial injections of public money. Although no Australian banks are global systemically important financial institutions, it does have a sizeable too-big-to-fail problem in the domestic financial system that requires a targeted regulatory response;
- Switzerland offers an interesting comparative study for Australia because Switzerland has responded to its too-big-to-fail problem with a market leading package of measures that go far beyond that required by Basel III, in response to the problems of UBS during the crisis.
- Despite differences in the two countries’ financial systems, this article seeks to identify the lessons that can be drawn for Australia from Switzerland.

I. INTRODUCTION

The global financial crisis of 2008-9 brought into sharp relief the problem of banks which are ‘too-big-to-fail’. Over the last thirty years as the international financial system has globalised, a new breed of bank has emerged which by its global interconnectivity and cross-linkages threatens the stability of national or the international economy. These have been designated as ‘systemically important financial institutions’ (‘SIFIs’) by the Financial Stability Board (‘FSB’)<sup>1</sup>, the international

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regulatory body which has been undertaking intensive work on regulatory measures in this area. SIFIs are banks which are too big and systemically interconnected to be allowed to fail, but which are also potentially 'too-big-to-save' because of the costs this would impose on the public purse.<sup>2</sup> Managing these entities is a critical public policy and regulatory challenge for lawmakers and regulatory authorities around the world.

The FSB describes systemically important financial institutions as: 'financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.'<sup>3</sup> The SIFI can be categorised as either global ('G-SIFI'), domestic or both. In case of a global SIFI, the cross-border consequences of a failure were amply demonstrated by the collapse of Lehman Brothers in September 2008, which sparked panic on the financial markets and led to a slump in world trade, in world GDP, and in employment globally. In contrast, domestic systemically important banks, ('SIBs') are banks of such size, market importance and interconnectedness within their domestic economy that their distress or failure would cause significant disruption to the domestic financial system and to the domestic economy.<sup>4</sup>

This article sets out a comparative analysis of the post-crisis regulatory response to the too-big-to-fail problem in Australia and Switzerland, with the aim of identifying recommendations for enhancing the systemic resilience of systemically important financial institutions in Australia. In 2013, the Australian Treasury initiated a Financial System Inquiry with a mandate to examine a range of issues, including financial stability, prudential regulation, and further international integration, with a view to setting out a blueprint for financial sector development over the next decade.<sup>5</sup> This offers an important and timely opportunity to consider the too-big-to-fail problem in Australia in a comparative perspective.

Australia's major banks are not included in the list of global systemically important financial institutions compiled by the Financial Stability Board<sup>6</sup>, and they were distinguished from their counterparts in other advanced economies because they did not need government-funded capital injections during the global financial crisis of 2008-9. They do, nonetheless, represent a significant too-big-to-fail problem for the Australian economy, which may well be exacerbated by further expansion of the financial sector as Asian financial markets continue to grow. Managing systemically important financial institutions is therefore a critical public policy challenge which must be managed prudently as Australia pursues its objective of enhancing international integration of its financial sector. In contrast, Switzerland has an acute too-big-to-fail problem that came to a head during the post-Lehman Brothers collapse of world financial markets. UBS, the Swiss banking giant, required

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<sup>1</sup> See <https://www.financialstabilityboard.org/> for more information.

<sup>2</sup> 'Too Big To Save: An Interview with Jim Millstein', *The Review*, Henry Davis York, Spring 2012, Issue 12, pp. 6-9.

<sup>3</sup> Financial Stability Board, 'Policy Measures to Address Systemically Important Financial Institutions', (Report, Financial Stability Board, 4 November 2011), at 3.

<sup>4</sup> Rosa Maria Lastra, 'Systemic Risk, SIFIs and Financial Stability' (2011) 6(2) *Capital Markets Law Journal* 197, 199.

<sup>5</sup> See the webpage of the Financial System Inquiry for details, including the Terms of Reference and the [Interim Report](http://fsi.gov.au/), issued 15<sup>th</sup> July 2014: <http://fsi.gov.au/>.

<sup>6</sup> Financial Stability Board: [2013 Update of group of global systemically important banks \(G-SIBs\)](#), 11 November 2013. This list was first compiled in November 2011, and is updated annually. There are currently 29 banks on the list.

substantial government support during the crisis to enable it to continue operating. In response, the Swiss Government has imposed the most stringent package of regulatory measures on its systemically-important financial institutions of all the advanced economies. Switzerland therefore provides an interesting comparative study for the Australian system.

This article will consider whether the approach taken by the Swiss regulatory authorities to their G-SIFIs could be the right approach for the Australian Financial System Inquiry and regulatory agencies to follow. It will commence with a brief discussion of why Switzerland may be an appropriate model for Australia to follow. It will then overview prevailing international regulatory standards addressing SIFIs (and the related problem of 'too-big-to-fail' ('TBTF') institutions), and then analyse the national implementation of SIFI legislation in Switzerland. Lessons of potential relevance to Australia will then seek to be drawn from the analysis of the Swiss measures.

## II. A SWISS FINISH FOR AUSTRALIA?

During the financial crisis of 2008-9, as it became clear just how technically insolvent and systemically interconnected major banks and financial institutions were, Governments in the advanced economies used hundreds of billions of dollars of public money to prevent a wholesale collapse of the world financial system. The Bank for International Settlements has estimated that Governments in 11 advanced economies committed approximately US\$7 trillion, or 18.8% of their GDP, to various support measures for banks and financial institutions.<sup>7</sup> Across the European Union, this was as high as 37% of GDP.<sup>8</sup> Support measures included: capital injections to strengthen banks' capital base; explicit guarantees of liabilities to help banks retain access to wholesale funding; and the purchase or guarantee of impaired assets to help reduce banks' exposures to large losses.<sup>9</sup>

Although not all of these resource commitments were ultimately drawn upon, the legacy of this Government intervention and the economic consequences of financial instability have been high debts in the advanced economies which drag down economic growth and impair funding for the State's social and economic policy objectives. This situation creates a symbiosis of debt dependency between financial institutions and sovereigns in the advanced countries which exacerbates the too-big-to-fail problem: "because ... banks are the primary source of funding for government deficits, government debt represents a large proportion of the asset base of most eurozone banks. Insolvency of one therefore threatens the insolvency of the other."<sup>10</sup> In such a situation Governments cannot allow a major financial entity to fail, and so will increase their own debt burden in order to shore up the solvency of financial institutions.

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<sup>7</sup> Bank for International Settlements: An Assessment of Financial Sector Rescue Programmes, BIS Papers no. 48, p. 1. US\$ figure converted from EUR5 trillion. The 11 countries included in the assessment were: Australia, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Switzerland, the United Kingdom and United States of America. See also Bank of England: Financial Stability Report October 2008, p. 33, Table 2 'Selected government support packages'.

<sup>8</sup> European Commission: 'New crisis management measures to avoid future bank bailouts', Press Release IP/12/570, 6<sup>th</sup> June 2012.

<sup>9</sup> *Supra*, note 7.

<sup>10</sup> J. Millstein: 'Europe's largest banks have become too big to save: Time to end death spiral link with governments', Financial Times, Markets Insight, 14<sup>th</sup> November 2011.

In contrast to banks in other major economies, Australia's banks (none of which qualify as G-SIFIs) survived the financial crisis relatively unscathed. Australia and Canada stand out among their peers as the only advanced economies which did not need to inject capital into their banks, nor to purchase impaired assets or provide asset guarantees in order to stabilise their financial system.<sup>11</sup> This can largely be attributed to the fact that Australia's banks did not have large holdings of US asset-backed securities or other credit derivatives which were at the epicentre of market dislocation. Australian lending standards had not been relaxed to the same degree as elsewhere, which underpinned loan quality and bank balance-sheets as the economy turned down. Australian banks also had far smaller trading divisions than major global banks, which limited their exposure to market risk.<sup>12</sup>

In its Financial System Stability Assessment for Australia in November 2012, the International Monetary Fund generally gave the nation's financial system high marks, describing as it as 'sound, resilient and well managed' and describing the major banks as 'conservatively run, well capitalised and profitable, and ... likely to withstand severe shocks.' However, the Fund noted that a number of risks will need to be closely managed, in particular 'risks from a combination of high household debt and elevated house prices, reliance on offshore funding, and a highly concentrated and interconnected banking system.' In the Fund's words, 'higher minimum capital requirements for systemically important institutions may be desirable' and 'a higher loss absorbency requirement for systemic institutions should ... be considered.'<sup>13</sup> Moreover, 'how much additional capital may be ultimately required will depend on APRA's [the Australian Prudential Regulatory Authority] risk tolerance.'<sup>14</sup>

Following the global financial crisis, Switzerland has imposed some of the highest bank capital requirements in the advanced economies. Swiss banks may now need to hold capital equivalent to up to 21.5% of total risk-weighted assets ('RWA') including the 2.5% counter-cyclical buffer. This is a massive increase over the minimum requirements of Basel III which provides for a highest Common Equity Tier 1 (CET)-ratio of 12% comprised as to 7% CET-capital (4.5%) and the conservation buffer (2.5%) and then up to 2.5% each for a systemic risk buffer and a counter-cyclical buffer.<sup>15</sup>

In seeking to understand this approach by the Swiss regulator and in considering whether it may be the appropriate path for Australia to follow, it is important to understand the particular role that the financial sector plays in Switzerland's economy. Switzerland's economy is dominated by its financial sector. It is a nation of only 8 million people, but it has 297 banks operating on its territory.<sup>16</sup> The financial sector has over US\$6 trillion in assets under management, which is ten times Swiss GDP of

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<sup>11</sup> Bank for International Settlements: *An Assessment of Financial Sector Rescue Programmes*, supra note 7, Table 1.2 'Overview of commitments and outlays'. The Australian Government did provide debt guarantees.

<sup>12</sup> Reserve Bank of Australia: *Financial Stability Review – March 2009*, Chapter 3 'The Australian Financial System', available at: <http://www.rba.gov.au/publications/fsr/2009/mar/html/aus-fin-sys.html> (last accessed 12 March 2014).

<sup>13</sup> International Monetary Fund, 'Australia: Financial Stability Assessment' (Country Report No 12/308, IMF, November 2012), 21.

<sup>14</sup> Ibid 22.

<sup>15</sup> Manfred Plank "Basel III and Its Implications on the financial industry" (Report, Credit Suisse, 14 September, 2012) <[www.ccfz.ch/files/rd\\_plank.pdf](http://www.ccfz.ch/files/rd_plank.pdf)>. See also UBS Annual Report, n 30, p 30. The details of the Swiss measures will be considered below.

<sup>16</sup> Figures from Swiss Bankers Association: [http://www.swissbanking.org/en/home/finanzplatz-link/facts\\_figures.htm](http://www.swissbanking.org/en/home/finanzplatz-link/facts_figures.htm) (last accessed 12 March 2014).

US\$600 billion.<sup>17</sup> It is a major centre for private banking and offshore funds, and according to data from the Swiss Bankers Association, roughly US\$3 trillion in offshore funds are held in Switzerland.<sup>18</sup> Thanks to Switzerland's political neutrality, the Swiss franc plays an important role as a safe-haven currency, strengthening as other currencies weaken, which helps to draw funds into Switzerland.<sup>19</sup> The reputation of Switzerland as a safe, stable financial centre, and the reputation of Swiss banks for soundness, security and stability is therefore vitally important to the Swiss brand as an international financial centre and a destination for offshore funds, as well as to the health of the Swiss economy.

The near collapse of the two giant Swiss G-SIFIs, UBS and Credit Suisse, in 2008 sent shockwaves through the Swiss financial system and threatened to fundamentally undermine this brand. The two banking giants had combined assets of over US\$4 trillion at end 2007, compared to Swiss GDP in 2007 of US\$450 billion and thus their potential insolvency was an enormous economic challenge for Switzerland.<sup>20</sup> Stabilising UBS entailed enormous financial assistance from the Swiss Government, which provided up to US\$60 billion (although in practice only US\$38 billion were used) to the ailing UBS to purchase illiquid and heavily impaired assets as well as underwriting some US\$7 billion of mandatory convertible notes to shore up its capital base. In the longer term some of the assets returned to profitability and the Swiss Government was able to realise a positive return on the loan. Credit Suisse managed to raise US\$11 billion in capital from private investors and the Qatar Investment Authority to bolster its solvency.<sup>21</sup>

The revelations in subsequent reports of the lack of understanding and due diligence of the risks – based on risk-models approved by the regulator and in accordance with ratings – inherent in UBS's credit derivatives exposures threatened to substantially undermine the Swiss reputation for soundness and probity in their banking system. It was clear that UBS in particular had not ensured that adequate due diligence was performed on its credit derivative portfolios, that it had no risk weighted asset (RWA)-limit on balance-sheet size, and that it had heavily relied on credit ratings of asset-backed securities and the outputs of quantitative risk models, without 'looking through' the structures to ascertain the risks of the underlying assets.<sup>22</sup> As a result, there was little foresight of

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<sup>17</sup> Ibid. 2012 figures, converted from CHF5,565 billion.

<sup>18</sup> Ibid. Figures as at end 2012, converted from CHF2,825 billion.

<sup>19</sup> C. Grisse & T. Nitschka: On financial risk and the safe haven characteristics of Swiss franc exchange rates, Swiss National Bank Working Papers 2013-4, April 2013.

<sup>20</sup> UBS: Annual Report and Company Accounts for Financial Year 2007, available at: [http://www.ubs.com/global/en/about\\_ubs/investor\\_relations/agm/previous-agms/2008/agm2008/invagenda/item1.html](http://www.ubs.com/global/en/about_ubs/investor_relations/agm/previous-agms/2008/agm2008/invagenda/item1.html); Credit Suisse: Credit Suisse Group Annual Report 2008, Financial Highlights, available at: [https://www.credit-suisse.com/investors/doc/ar08/csg\\_ar\\_2008\\_en.pdf](https://www.credit-suisse.com/investors/doc/ar08/csg_ar_2008_en.pdf). For a historic trajectory of Swiss GDP see: <http://www.indexmundi.com/facts/switzerland/gdp>.

<sup>21</sup> A. Cowell: 'UBS and Credit Suisse get urgent bailout funds', *New York Times*, 16<sup>th</sup> October 2008, available at: <http://www.nytimes.com/2008/10/16/business/worldbusiness/16iht-17swiss.17006058.html> (accessed 14<sup>th</sup> March 2014); W. Giles: 'UBS Gets \$59.2 Billion Bailout; Credit Suisse Raises Capital', *Bloomberg*, 16<sup>th</sup> October 2008, available at: <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ah0AFa2SEHhw> (accessed 14<sup>th</sup> March 2014). Figures converted from Swiss francs at 14<sup>th</sup> March 2014.

<sup>22</sup> UBS AG: Shareholder Report on UBS's Write-Downs, 18<sup>th</sup> April 2008, a link to the report is available at: [http://www.ubs.com/global/en/about\\_ubs/investor\\_relations/agm/previous-agms/2008/agm2008/invagenda.html](http://www.ubs.com/global/en/about_ubs/investor_relations/agm/previous-agms/2008/agm2008/invagenda.html) (accessed 14 March 2014); UBS AG: Transparency report to the shareholders of UBS AG: Financial market crisis, cross-border wealth management business, liability issues and internal review, October 2010; and T. Straumann: The UBS Crisis in Historical Perspective: Expert Opinion prepared for delivery to UBS AG, 28<sup>th</sup> September 2010, both documents can be accessed at: [http://www.ubs.com/global/en/about\\_ubs/transparencyreport.html](http://www.ubs.com/global/en/about_ubs/transparencyreport.html) (accessed 14<sup>th</sup> March 2014).

the risks building across its exposures to US asset-backed securities, and insufficient capital to absorb the losses. The impact of the losses on the reputation of the Swiss financial services industry was compounded by a major investigation by US authorities into the role of Swiss banks in facilitating tax evasion by US citizens.

The Swiss response to this has been driven by a need to reaffirm the Swiss financial centre as a stable, secure home for international funds: “Preserving and strengthening the reputation of the Swiss financial centre and the institutions operating in it is of vital importance for the long term success of Switzerland as the biggest international wealth management center globally.”<sup>23</sup> It has also been driven by an acute sense of the economic risks which such large G-SIFIs pose to the Swiss economy and by a need to ensure that the Swiss taxpayer is not relied upon as a last resort for the solvency of Swiss financial institutions.<sup>24</sup> The Swiss approach to the too-big-to-fail problem has therefore been conservative and prudent, driven by the important role of the Swiss financial system in the Swiss economy, and based on avoiding such state-funded bailouts in the future. This approach had also, crucially, the support of the Swiss Bankers Association, who felt that in essence it “will markedly strengthen highly-desired systemic stability and ... will also resolve the problem of the state guarantee implicitly enjoyed to date by Switzerland’s two major banks (UBS and Credit Suisse).”<sup>25</sup> This is in contrast to other jurisdictions, where there has been extensive lobbying by the financial sector against higher capital adequacy and other regulatory requirements in response to the crisis.

In the words of the Swiss Bankers Association: “From an international perspective Switzerland has played a pioneer role in the search for a method with which to contain the systemic risks posed by major banks.”<sup>26</sup> Switzerland has not shied away from taking a robust attitude towards the enormous challenge posed by G-SIFIs and the very real risks they pose to the economy and taxpayer. Rather than seeking to placate financial interests, the Swiss Government and financial sector have approached the higher costs of systemic stability requirements for financial institutions as essential to underpinning the Swiss reputation for soundness and security, and hence as a key element of the international competitiveness of the Swiss financial centre. It is therefore pertinent to consider whether this approach offers particular lessons for Australia as it seeks to deepen the international integration of its financial sector.

### III. INTERNATIONAL STANDARDS FOR THE SIFI

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<sup>23</sup> Credit Suisse: Switzerland as a financial center: Enhancing competitiveness through concerted private/public sector efforts, September 2012, p.15, available at: <https://www.credit-suisse.com/media/production/articles/news-and-expertise/docs/2012/09/Finanzplatz/finanzplatz-en.pdf> (accessed 14 March 2014).

<sup>24</sup> State Secretariat for International Financial Matters: Too big to fail – economic risks posed by big banks, 26<sup>th</sup> August 2013, available at: <http://www.sif.admin.ch/dokumentation/00509/00510/00622/00624/00695/?lang=en> (accessed 14<sup>th</sup> March 2014).

<sup>25</sup> Swiss Bankers Association: Swiss Bankers (SBA) Association position on the proposals of the Commission of Experts on the “Too big to fail” issue, 4<sup>th</sup> October 2010, available at: <http://www.swissbanking.org/en/stellungnahme-20101004> (accessed 14<sup>th</sup> March 2014).

<sup>26</sup> Ibid.

Prior to reviewing the Swiss response to SIFIs, we will first briefly set out the key international regulatory requirements for SIFIs. The central international regulatory organisation preparing reports and recommendations for the SIFIs is the FSB, originally on behalf of the G20,<sup>27</sup> and now acting on its own volition. The FSB has extensively reviewed the legal framework for SIFI supervision and delegated the supervision of SIBs to the Basel Committee of Banking Supervision ('BCBS'). The main elements of the FSB recommendations are: the implementation of loss absorbency instruments; the establishment of resolution regimes for SIFIs; and the cross-border supervision of SIFIs.

#### A *Loss Absorbency Instruments*

Loss absorbency instruments aim to strengthen the capital basis of a SIFI. The foundational report in this area is the FSB's 'Reducing the Moral Hazard Caused by Systemically Important Financial Institutions' of October 2010.<sup>28</sup> This requires the creation of loss absorbency instruments beyond the minimum Basel III standards,<sup>29</sup> with the objective of bolstering their solvency situation in case of periods of market stress and this recommendation was taken up by the Basel Committee of Banking Supervision in a report in November 2011.<sup>30</sup> According to the BCBS relevant factors could be the levels of Common Equity Tier 1 capital (CET 1), the amount of debt able to be bailed-in, the amount of capital instruments that absorb losses at the point of non-viability, and the going-concern contingent capital.<sup>31</sup>

The exact calibration of the required amount of loss absorbency instruments depends upon the scope of activities of a SIFI. For a domestic SIB the design of loss absorbency instruments has to be done in view of the domestic systemic importance of the SIB, the given quantitative methodologies, and country-specific factors.<sup>32</sup> In respect of a domestic SIB, the BCBS recommends that higher loss absorbency be fully met by Common Equity Tier 1 capital, calibrated to its domestic structural characteristics.<sup>33</sup> The BCBS recommends meeting these CET 1 standards through an additional 2.5% capital conservation buffer, which will sit atop the Basel III capital buffers and minimum capital requirements.<sup>34</sup>

The BCBS also proposes additional capital requirements (pillar 2) or other policy measures appropriate to addressing the risks posed by domestic SIBs. These additional requirements could consist of limits on material risk exposures that have not been adequately transferred to other

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<sup>27</sup> See Rolf H Weber, 'Legitimacy of the G20 as Global Financial Regulator' (Working Paper No 2012/13, Society of International Economic Law, 20 June 2012).

<sup>28</sup> Financial Stability Board, 'Reducing the Moral Hazard Caused by Systemically Important Financial Institutions: FSB Recommendations and Time Lines' (Report, Financial Stability Board, 20 October 2010) ('Reducing the Moral Hazard').

<sup>29</sup> *Ibid* 3.

<sup>30</sup> Basel Committee on Banking Supervision 'Global systemically important banks: assessment methodology and the additional loss absorbency requirement: Rules Text' (Report, BCBS, November 2011) <<http://www.bis.org/publ/bcbs207.pdf>>. A revised version of this document was published in July 2013: <<http://www.bis.org/publ/bcbs255.htm>>.

<sup>31</sup> *Ibid* 17.

<sup>32</sup> Lastra above n 4, 211.

<sup>33</sup> Basel Committee of Banking Supervision, 'A framework for dealing with domestic systemically important banks' (Report, BCBS, October 2012) 3–4.

<sup>34</sup> *Ibid.* note 33, paras. 44–45.

parties or otherwise mitigated.<sup>35</sup> Furthermore, SIBs need to comply with adequate liquidity requirements corresponding at least to the Basel standards and including a liquidity risk strategy.<sup>36</sup>

For the sake of completeness, it should be noted that loss absorbency instruments are also important for non-bank SIFIs. In this respect the guidelines applicable to financial conglomerates are to be observed. Foremost among these are the Joint Forum's Principles for the Supervision of Financial Conglomerates.<sup>37</sup> These principles recommend that a capital adequacy assessment should, in addition to the requirements for individual sectors, address group-wide risks including those sourced from unregulated entities within the group, excessive leverage sourced from the parent and inter-group transfers of capital.<sup>38</sup>

## *B Resolution Regimes*

If a SIFI is considered to be too-big-to-fail, comprehensive resolution tools need to be implemented to facilitate an appropriate wind-down and restructuring of the business in case of distress and thus enable a viable SIFI resolution which does not place an undue burden on the taxpayer. In its 2011 report 'Key Attributes of Effective Resolution Regimes for Financial Institutions'<sup>39</sup>, the FSB recommended that the competent resolution authority should be empowered and able to maintain the continual functioning of a SIFI as an ongoing enterprise, thereby preserving its essential economic and financial functions while maintaining the authority's ability to sever and sell off viable parts of the institution. Based on that recommendation, the BCBS has proposed that the corrective and remedial powers of supervisors should be expanded to empower supervisors to take early and timely corrective action if a bank becomes distressed.<sup>40</sup>

Another element of an effective resolution regime concerns bail-in powers that would enable the absorption of losses and the recapitalisation of vital or viable parts of a SIB. These steps should be undertaken by resolution authorities with a view to maintaining continuity of systematically vital functions by either re-capitalisations or by capitalising a bridging entity to which systemically vital functions can be transferred.<sup>41</sup> In case of a global SIFI, effective cross-border coordination mechanisms are to be implemented, even if they cannot easily be fulfilled.

Furthermore, for a SIB, sustained recovery and resolution planning is of importance (which was, for example, not in place in the failure of Lehman Brothers). Such planning should encompass a recovery plan (identifying recovery options and ensuring their timely implementation), a resolution

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<sup>35</sup> Ibid. note 33, para. 44.

<sup>36</sup> Basel Committee of Banking Supervision, 'Core Principles for Effective Banking Supervision' (Consultative Document, BCBS, September 2012), 44, 56.

<sup>37</sup> Basel Committee on Banking Supervision Joint Forum, 'Principles for the Supervision of Financial Conglomerates' (Report, BCBS, September 2012).

<sup>38</sup> Ibid 2.

<sup>39</sup> Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (Report, Financial Stability Board, October 2011), 7.

<sup>40</sup> BCBS, 'Core Principles for Effective Banking Supervision,' above n 36, 21 & 25.

<sup>41</sup> Financial Stability Board, 'Effective Resolutions of Systemically Important Financial Institutions: Recommendations and Timelines' (Consultative Document, FSB, 19 July 2011), 11, 12, 36.



plan (facilitating the effective use of resolution powers to protect systemically important functions) and a resolvability assessment including the treatment of subsidiaries.<sup>42</sup>

## C Supervision

A national regulator must see to it that a pro-active supervisory system is implemented which ensures that regulations are backed up by effective SIFI risk assessment and enforcement to reduce the impact of potential stresses on financial institutions.<sup>43</sup> In case of a SIFI, supervisors should have the power to increase the preventive requirements for individual banks (encompassing the right to require additional capital, increased liquidity requirements and/or exposure limits).<sup>44</sup> Furthermore, a SIFI supervisor must identify, assess and mitigate any emerging risks across banks and the banking system.<sup>45</sup> Finally, macro-prudential surveillance is of importance.<sup>46</sup>

## IV. NATIONAL IMPLEMENTATION OF INTERNATIONAL STANDARDS: THE EXAMPLE OF SWITZERLAND

### A Historical Background

In October 2008 the Swiss Government was forced to bail-out the undercapitalised UBS. Switzerland chose to do so by establishing a special purpose vehicle ('SPV') to acquire up to USD 60 billion of illiquid assets from UBS. UBS was obliged by the Government to contribute equity capital to the SPV of 10% of the amount transferred to the SPV. The Swiss Government agreed to lend the balance of the required funds to the SPV (i.e. 90% of the face value of the assets at three month LIBOR plus 2.5%), via the Swiss National Bank (SNB), to be secured upon the assets acquired by the SPV. Following a detailed analysis of UBS's portfolio and negotiations between the bank and the Government, it was decided to transfer some USD 38.7 billion of assets to the SPV. The SPV was enabled to buy these assets by an injection of USD 3.87 billion of equity from UBS and USD 34.8 billion of debt lent by the SNB.

Switzerland also strengthened the capital base of UBS by underwriting some CHF 6 billion of mandatory convertible notes issued by UBS.<sup>47</sup> The proceeds from this note issue funded the contribution of the USD 3.87 billion by UBS to the SPV (SNB StabFund). One year later, in August 2009, the Swiss Government sold the convertible notes on to an underwriting group for CHF 5.48 billion plus additional interest payments (12.5% for the remaining time to maturity of the loan – originally 30 months) in the amount of CHF 1.8 billion. This move aimed to avoid the increased

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<sup>42</sup> Arthur E Jr Wilmarth, 'Reforming Regulation to Address the Too-Big-To-Fail Problem' (2010) 35(3) *Brooklyn Journal of International Law* 707, 709.

<sup>43</sup> FSB 'Reducing the Moral Hazard,' above n 28, 7.

<sup>44</sup> BCBS, 'Core Principles for Effective Banking Supervision,' above n 36, 21–22.

<sup>45</sup> *Ibid* 31–32.

<sup>46</sup> See also Rolf H Weber, 'Multilayered Governance in International Financial Regulation and Supervision' (2010) 13(3) *Journal of International Economic Law* 683, 701.

<sup>47</sup> Federal Council of Switzerland, 'Amendment of the Banking Act: Strengthening the Stability of the Financial Sector; too big to fail', (White Paper BBI 2011 4714, Federal Council, 20 April 2011), 4726 <<http://www.admin.ch/opc/de/federal-gazette/2011/4717.pdf>>; Federal Council of Switzerland, 'Botschaft zu einem Massnahmenpaket zur Stärkung des schweizerischen Finanzsystems' [Message of the Federal Council, Package of Measures in order to strengthen the Stability of the Swiss Financial System] (Report BBI 2008 8945, Federal Council, 2008) 8945 <<http://www.admin.ch/ch/d/ff/2008/8943.pdf>>.

liability and conflicts of interest that would have been entailed by their retention by the Government, and also resulted in a substantial profit for the Government.<sup>48</sup>

The Stabilisation Fund SPV holding the USD 38.7 billion in assets has since been liquidating these assets as market conditions have allowed. At the end of 2012, the Stabilisation Fund's overall exposure to the SNB had been reduced to USD 4.8 billion<sup>49</sup> and, by mid-August 2013, the Stabilization Fund had repaid the loan granted by the SNB in full.<sup>50</sup> Originally, this loan by the SNB was additionally secured by UBS issuing a warrant to the SNB which, should the loan not be fully repaid, enabled the SNB to acquire up to 100 million registered shares in UBS for their nominal value of CHF 0.10 per share. Although this security did not need to be called upon, its extent was troubling.

At the time the loan was made, UBS shares were worth CHF 19.70 (as at 1 October 2008).<sup>51</sup> Consequently, the warrant to purchase the shares was at that time worth less than CHF 1.97 billion when issued, an amount which should be further reduced by the dilution effect of the issue of 100 million new UBS shares and the reduction in their value which this would entail. Furthermore, given the volatile market conditions at the time, the share price could drop further. The loan was made directly to the SPV and therefore, there was no direct link to UBS. The assets were no longer held with UBS, and UBS had immediately written down its stake in the SPV of USD 6 billion. However, even if in theory no further negative effect on UBS' balance sheet could be expected, any negative developments at the SPV could have further influenced the market's perception of UBS. With hindsight, therefore it would seem troubling that the Swiss Government and the SNB were prepared to accept shares probably worth far less than CHF 1 billion for a loan of USD 34.8 billion. However, in reality the security for the loan were the assets transferred to the SPV which were illiquid at the time of the transfer and assessed at fair value, given the prevailing market conditions for those assets.

This Government subscription of the convertible bonds, and the Government funding of the SPV to buy UBS's distressed assets, were both criticized for the moral hazard they encouraged by eliminating what would otherwise have been a massive risk, and potentially large losses, for UBS and the accompanying sanctions from the market.<sup>52</sup> Nonetheless, the actions taken by the Swiss Government did succeed in resolving the difficult financial situation of UBS within a relatively short period of time. Undoubtedly this was helped by the extraordinary measures taken elsewhere by other Governments to shore up their banking systems and to stabilise the world economy and financial system, including the huge amounts of liquidity that were injected into the markets by central banks.

## *B Regulatory Amendments*

The resolution of UBS's troubles was remarkably effective and efficient, particularly when compared to the huge losses incurred by other European Governments in supporting their banking sectors. Nonetheless, the Swiss Government immediately appointed a Commission of Experts to develop a

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<sup>48</sup> Federal Council of Switzerland, BBl 2008 8945, above n 47, 8946.

<sup>49</sup> Swiss National Bank, '105<sup>th</sup> Annual Report' (Report, Swiss National Bank, 2012), 84 <[http://www.snb.ch/en/mmr/reference/annrep\\_2012\\_komplett/source](http://www.snb.ch/en/mmr/reference/annrep_2012_komplett/source)>.

<sup>50</sup> Ibid and see <[http://www.snb.ch/en/mmr/reference/pre\\_20130816/source/pre\\_20130816.en.pdf](http://www.snb.ch/en/mmr/reference/pre_20130816/source/pre_20130816.en.pdf)>.

<sup>51</sup> At the time of writing, early October, 2013, the UBS share price was CHF18.55.

<sup>52</sup> Federal Council of Switzerland, BBl 2011 4714, above n 47, 4718.

regulatory regime which would prevent similar situations arising in the future. The scope of the Expert Commission's mandate included:

- (i) Defining the term 'too-big-to-fail';
- (ii) Analysing how large companies contribute to the overall economy and how the failure of such companies would affect the economy;
- (iii) Indicating how these risks could be minimized; and
- (iv) Presenting possible measures in response.<sup>53</sup>

According to its preliminary report, the Commission found that only the two big banks, UBS and Credit Suisse, are systemically significant for the Swiss economy. The large insurance companies in contrast were held to not be systemically significant.<sup>54</sup>

In September 2010 the Commission of Experts presented its final report with a large number of recommendations.<sup>55</sup> The Commission proposed a policy mix in four core areas: (i) capital components; (ii) liquidity requirements; (iii) improvement of risk diversification; and (iv) organisational measures with respect to the resolvability or resolution of a SIFI. This policy mix largely mirrors the Basel III framework and is compatible with it and with the proposals of the FSB for the reduction of systemic risk in a financial system.<sup>56</sup>

Based on that report, the Federal Council dispatched a White Paper to the Parliament on 20 April 2011 ('the Draft Bill') that proposed a series of measures to address and hopefully avoid any future requirement for massive state intervention to rescue a banking institution that is systemically important.<sup>57</sup> The Draft Bill was in essence a partial revision of the Federal Banking Act of 1934.<sup>58</sup>

The new legal provisions were adopted by the Swiss Parliament on 30 September 2011,<sup>59</sup> and came into force on 1 March 2012. The supervisory authority, the Financial Market Authority (FINMA), is requiring banks, in particular the two Swiss G-SIFIs, UBS and Credit Suisse, to implement preventive measures based on the new legal provisions. The FINMA has published a new circular on eligible capital (effective from 1 January 2013) and revised its circulars concerning capital planning, credit

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<sup>53</sup> "Too big to fail" Commission of Experts, 'Final Report of the Commission of Experts for Limiting the Economic Risks Posed by Large Companies' (Final Report, Commission of Experts, 30 September 2010), 3 <<http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en>> ('Final Report of the Commission of Experts').

<sup>54</sup> "Too big to fail" Commission of Experts, 'Preliminary Report' (Report, Commission of Experts, 22 April 2010) <<http://www.sif.admin.ch/dokumentation/00514/00519/00592/>>; Federal Council of Switzerland, 'Botschaft über die Planung von Massnahmen zur Begrenzung volkswirtschaftlicher Risiken durch Grossunternehmen' [Message of the Federal Council, limiting economic risk caused by large companies], (Report BBl 2010 3367, Federal Council, 12 May 2012), 3368 [author's trans] <<http://www.admin.ch/ch/d/ff/2010/3367.pdf>>.

<sup>55</sup> Final Report of the Commission of Experts, above n 53.

<sup>56</sup> Ibid 5.

<sup>57</sup> Federal Council, 'Federal Council adopts dispatch on strengthening financial sector stability' (Media Release, 20 April 2011) <<http://www.efd.admin.ch/00468/index.html?lang=en&msg-id=38721>>.

<sup>58</sup> See references above n 47.

<sup>59</sup> Federal Convention, 'Bundesgesetz über die Banken und Sparkassen (Stärkung der Stabilität im Finanzsektor: *too big to fail*)' [Strengthening the Stability in the Financial Sector: *too big to fail*] (Report AS 2012 811, Federal Convention, 30 September 2011) <<http://www.admin.ch/ch/d/as/2012/811.pdf>>.

and market risk, disclosure and risk diversification.<sup>60</sup> The implementation of the legal amendments is proceeding apace while the absence of any further crises mean the new provisions remain untested.

## C Capital and Liquidity — Loss Absorbency Instruments

As the Expert Commission has pointed out, it is vital that legal measures succeed in reducing the probability of a failure of a SIFI so that SIFIs are able to survive a crisis without the support of the Government. The Swiss law in line with Basel III pursues this goal by addressing two key factors: *capital and liquidity*.<sup>61</sup>

The Swiss capital adequacy framework, based on the Banking Law, the Capital Adequacy Ordinance (CAO) and FINMA Circulars, is aimed at implementing the recommendations of the FSB and the BCBS, particularly with respect to minimum capital requirements, the capital conservation buffer and the counter-cyclical buffer. In addition to implementing these international standards, FINMA has added specific Swiss capital buffers depending on the size of the bank. These have been termed the ‘Swiss Finish’.<sup>62</sup>

From a corporate law perspective, two new ‘baskets’ – based on established corporate law traditions – of capital issuing authorisations are available to cover the needs of a SIB, which aim to strengthen the capital base and reduce the likelihood of financial distress. These are: reserve capital (‘Vorratskapital’) and conversion capital (‘Wandlungskapital’). Reserve capital allows the board of directors of a SIB to issue new shares without seeking prior approval of the shareholders’ meeting. This is designed to serve as a “rescue tool” by facilitating the raising of equity capital in times of financial distress.<sup>63</sup> Conversion capital – convertible contingency bonds (‘CoCos’) - addresses the same topic another way: CoCos are created by the issuance of debt which automatically converts into equity if core capital falls below a pre-defined level of risk-weighted assets (‘RWA’). This is designated as the trigger event.<sup>64</sup>

According to Swiss corporate law, authorised capital is quantitatively limited: authorised reserve capital may not exceed 50% of issued capital; this rule (Art. 651 (2) CO) has been derogated by Art. 651 (5) CO and Art. 12 (3) a of the Banking Act. Only the nominal amount is to be included in the company statute (Art. 12 (1) Banking Act).<sup>65</sup> Therefore, reserve capital may be raised by private placements at a discount if there is a corporate benefit from a smooth and fully subscribed placement of shares.<sup>66</sup> The Supervisory board has to state the basics of determining the issue price

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<sup>60</sup> FINMA, ‘FINMA publishes circulars on implementing Basel III and TBTF requirements’ (Press Release, 18 July 2012) <<http://www.finma.ch/e/aktuell/pages/mm-rs-umsetzung-b2-tbtf-20120718.aspx>>.

<sup>61</sup> FINMA, ‘Addressing “Too Big to Fail”: The Swiss SIFI Policy’ (Report, FINMA, 23 June 2011), 7 <<http://www.finma.ch/e/finma/publikationen/Documents/be-swiss-SIFI-policy-june-2011-summary-20110624-e.pdf>>.

<sup>62</sup> See also René Bösch & Jonas Oggier, *Proposed New Capital Adequacy Rules Remodel Swiss Regulatory Capital Framework* (2012) CapLaw, <<https://caplaw.swisslex.ch/JournalPortal.mvc/AssetDetail?assetGuid=758f7c32-8373-4e5e-9826-17845aa1dcc6>>.

<sup>63</sup> See also Thomas U Reutter, *Capital Raising in Light of Too Big to Fail: the Swiss Government’s View* (2011) CapLaw <<https://caplaw.swisslex.ch/JournalPortal.mvc/AssetDetail?assetGuid=77014270-99a3-417c-9e41-37de787a42a5>>.

<sup>64</sup> Bösch & Oggier, above n 62.

<sup>65</sup> Reutter, above n 63.

<sup>66</sup> Ibid.

of the new shares and the generic circumstances under which pre-emptive rights may be excluded (Art. 12 (2) Banking Act).<sup>67</sup>

According to Basel III and the Swiss CAO, total regulatory capital is composed of Common Equity Tier 1 capital (going-concern capital) and Common Equity Tier 2 capital (gone-concern capital). Tier 1 capital is further divided into Common Equity Tier 1 and additional Tier 1 capital. Tier 2 capital is no longer subdivided into upper and lower Tier 2 capital, and the previously existing Tier 3 capital is no longer eligible to serve as regulatory capital.<sup>68</sup>

All non-SIFI Swiss banks are obliged to hold a total capital ratio representing 8% of risk-weighted assets. The 8% RWA ratio is a long-standing one, but the composition of the capital is now significantly changed: Tier 1 capital has to represent 4.5% of RWA and a capital conservation buffer of 2.5% of RWA needs to be added, in conjunction with the introduction of a countercyclical buffer of 2.5% of RWA on an 'as-needed' basis. Consequently, banks must hold total Common Equity Tier 1 capital of 7% of RWA in 'normal' times and 9.5% of RWA in times of rapid credit expansion.<sup>69</sup>

The Swiss SIFIs (UBS, Credit Suisse and also the Cantonal Bank of Zurich which has been designated as 'systemically relevant' by the SNB) are required to comply with substantially stricter capital adequacy rules: the basic capital requirement of 4.5% of RWA has to be complemented by a capital conservation buffer of 8.5% of RWA that must comprise Common Equity Tier 1 capital of at least 5.5% of RWA and may include convertible contingent bonds of up to 3% of RWA. In addition, a variable progressive component depending on the degree of systemic importance of the respective financial institution may also be levied.<sup>70</sup> Furthermore, all Swiss banks have to eventually hold a counter-cyclical buffer of up to 2.5% in times of rapid credit expansion. The Federal Council has activated this by requiring Swiss banks to hold an additional 2% of the 2.5% buffer (i.e. 80% of the maximum possible buffer) on Swiss residential mortgage loans from 1 October 2013.<sup>71</sup>

The convertible contingent bonds are the new loss absorbency instrument introduced by Switzerland as a special part of the capital base. By being converted into equity, and thus liberating the funds set aside for their repayment, these instruments could play a vital role if a Swiss SIFI were to come under severe stress. In February 2011, Credit Suisse started to fulfil those requirements by issuing CoCos (Buffer Capital Notes) in the amounts of CHF 2.5 billion and USD 3.5 billion. So far, UBS has not issued this type of CoCos,<sup>72</sup> but issued two tranches of loss absorbing low-triggering Tier 2 write-off-notes of CHF 2 billion each in 2012.<sup>73</sup>

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<sup>67</sup> Ibid.

<sup>68</sup> Bösch & Oggier above n 62.

<sup>69</sup> Ibid.; 1% minimum and based on CHF 1500 billion adjusted assets and a Swiss market share of 20% rising to 6%.

<sup>70</sup> Ibid.

<sup>71</sup> Swiss Banking, '2013 Banking Barometer: Economic Trends in the Swiss Banking Industry' (Report, Swiss Banking, September 2013), 15. To begin with this was just 1%; since 23.01.2014 it is now 2%; <[http://www.snb.ch/de/mmr/reference/pre\\_20140123/source/pre\\_20140123.de.pdf](http://www.snb.ch/de/mmr/reference/pre_20140123/source/pre_20140123.de.pdf)>.

<sup>72</sup> See further René Bösch, Benjamin Leisinger & Ansgar Schott, *Contingent Convertible Bonds (CoCos) Issued by Credit Suisse* (2011), CapLaw, <<https://caplaw.swisslex.ch/JournalPortal.mvc/AssetDetail?assetGuid=e3f72f27-c8fd-4c71-a76b-96688b3f6130>>.

<sup>73</sup> UBS, Annual Report 2012, p. 30, <[www.ubs.com/global/en/about\\_ubs/investor\\_relations/annualreporting/2012/\\_jcr\\_content/par/teaserbox\\_6c86/t](http://www.ubs.com/global/en/about_ubs/investor_relations/annualreporting/2012/_jcr_content/par/teaserbox_6c86/t)>

Under Basel III, all capital instruments must absorb losses at the point of non-viability — either through conversion into equity or a permanent write-down. The Credit Suisse CoCos convert into equity if the bank's Common Equity Tier 1 ratio falls below 7%. They were well received in the market, in part because they were seen as going-concern capital due to the 'high trigger' for conversion.

The UBS low-triggering Tier 2 notes involve a permanent write-down if the bank's Common Equity Tier 1 ratio falls below 5%. These were less well received in the market, in part because the 'low trigger' meant they were perceived as gone-concern capital. Institutional investors were relatively uninterested in such permanent write-down structures, preferring instruments that convert into equity, leaving UBS to place most of its issuance with private banks and retail investors who were less averse to gone-concern capital instruments.<sup>74</sup>

The specific requirements for the Swiss SIFIs are mainly based on the report of the Commission of Experts upon which UBS and Credit Suisse were represented.<sup>75</sup> The new Liquidity Ordinance (*Verordnung über die Liquidität der Banken*) was adopted on 30 November 2012, and entered into force on 1 January 2013. FINMA also published a new Circular.<sup>76</sup> In addition to general liquidity requirements, the Liquidity Ordinance includes substantial new regulations for SIFIs. The new framework should result in a more accurate rating of liquidity risk because SIFIs are henceforth subject to more stringent reporting obligations. Furthermore, it allows a more appropriate assessment of so called liquidity stress. Moreover, as Switzerland's SIFIs operate globally, the new regulation encompasses requirements on a consolidated level.<sup>77</sup>

#### D Enhancing Resolvability — Resolution Regimes

If a SIFI is no longer viable, a timely and early resolution is necessary, preferably prior to complete insolvency and the implementation of bankruptcy procedures.<sup>78</sup> The main purpose of such a resolution lies in the protection of the vital economic functions of a SIFI and the limitation of economic disruption.<sup>79</sup> Besides the measures concerning capital and liquidity requirements, the second crucial objective of the Swiss SIFI policy therefore concerns business continuity through a focus on: *organization* and *risk diversification*. Should a SIFI fail, this policy aims at reducing the potential systemic fallout of the failure and increasing the resolvability of the institution.

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<sup>74</sup> H Durand, 'UBS' CoCo to be permanent write-down litmus test', *Reuters* (online) 10 February 2012 <<http://www.reuters.com/article/2012/02/10/ubs-contingent-capital-idUSL5E8D9B1T20120210>>.

<sup>75</sup> Bösch & Oggier, above n 62.

<sup>76</sup> FINMA, *Liquidität Banken, Berichterstattung zur kurzfristigen Liquiditätsquote und qualitative Anforderungen an das Liquiditätsrisikomanagement* (Circular 2013/6, FINMA, 6 December 2012) Liquidity Banks, Reporting on the Short-term Liquidity-Ratio and the Qualitative Requirements related to the Liquidity Risk Management, <<http://www.finma.ch/d/regulierung/Documents/finma-rs-13-06-d.pdf>>.

<sup>77</sup> Federal Department of Finance, 'New Liquidity Ordinance for Banks,' (Media Release, 30 November 2012) <<http://www.efd.admin.ch/dokumentation/medieninformationen/00467/index.html?lang=en&msg-id=46938>>; Federal Department of Finance, Erläuterungsbericht zur Liquiditätsverordnung [Explanatory Report Concerning the Liquidity Ordinance] (Report, Federal Department of Finance, 28 August 2012), 19 [author's trans] <<http://www.efd.admin.ch/dokumentation/gesetzgebung/00571/02625/index.html?lang=de>>.

<sup>78</sup> Financial Stability Board, 'Key Attributes for Effective Resolution Regimes,' above n 39, 7; FINMA, 'Addressing "Too Big to Fail,"' above n 61, 7.

<sup>79</sup> Financial Stability Board, 'Reducing the Moral Hazard,' above n 28, 4.

Interim support measures may help a SIFI to overcome financial distress or difficult market conditions. As mentioned, in Switzerland a bank may issue CoCos under certain conditions. These conditions are to be agreed upon between the concerned parties prior to the conversion. During a financial crisis the conversion of the debt capital into equity provides a buffer against financial loss and can therefore help stabilise the SIFI.<sup>80</sup>

However, interim support measures may not prove effective in all cases. Therefore, the Swiss TBTF policy requires organisational measures and arrangements which will enable the SIFI to exit the market in a controlled way where precautionary provisions have failed.<sup>81</sup> The supervisory authorities acquire a predefined role in preparing, and implementing, recovery and resolution plans.<sup>82</sup> The regulatory framework requires that the SIFI: (i) can demonstrate their resolvability with regard to their global business operations as well as to systemically important functions; (ii) has arranged for recovery measures that will stabilize the company in the event of a crisis.

Article 9 II d of the Banking Act, for instance, requires a SIFI to maintain an emergency plan with respect to structure, infrastructure, executive board, control and corporate liquidity and capital flow. In the case of the financial institution becoming distressed or insolvent, this plan must be capable of immediate implementation so as to ensure business continuity of systemically relevant functions. As of 1 November 2012 the new Banking Insolvency Ordinance ('BIO') entered into force.<sup>83</sup> The BIO regulates the restructuring process in detail and provides for a rapid and effective restructuring and bankruptcy process, that takes appropriate account of the individual case and provides legal certainty. The BIO provides the FINMA with extensive powers. The FINMA may direct a company to ensure the continuation of one specific core banking service (instead of restructuring the entire institution), it may order the conversion of debt capital into equity capital and it is entitled to prescribe other corporate actions.<sup>84</sup>

Another aspect that the Swiss legislator bore in mind when designing the new regulatory regime was risk concentration and operational interconnectedness. The Swiss SIFI policy report highlights the danger of a "single point of failure" damaging the business of smaller or mid-sized institutions that may be dependent on the services of one SIFI and hence very vulnerable to contagion.<sup>85</sup> Since restrictions potentially push certain business activities into other markets that are less heavily regulated, the Swiss legislator prefers having banks providing such services in a controlled manner and in observance of appropriate capital requirements.<sup>86</sup>

#### *E Additional Provisions — Leverage Ratio and Supervision*

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<sup>80</sup> See also Federal Council, 'Financial Sector Stability: Allowing the issue of CoCos in Switzerland' (Press Release, 24 August 2011)

<<http://www.efd.admin.ch/dokumentation/medieninformationen/00467/index.html?lang=en&msg-id=40710>>.

<sup>81</sup> FINMA, 'Addressing "Too Big to Fail,"' above n 61, 14.

<sup>82</sup> Ibid 15.

<sup>83</sup> FINMA, 'FINMA's Banking Insolvency Ordinance comes into Force' (Press Release, 22 October 2012)

<<http://www.finma.ch/e/aktuell/pages/mm-inkraftsetzung-bankeninsolvenzverordnung-finma-20121022.aspx>>.

<sup>84</sup> FINMA, 'Addressing "Too Big to Fail,"' above n 61; see also François Rayroux & Christelle Conti, 'New Ordinance of FINMA on the Insolvency of Banks: A Critical Assessment', (2012) 13 *CapLaw* 18, <[http://wp10671066.server-he.de/caplaw/2012/CapLaw\\_03\\_12.pdf](http://wp10671066.server-he.de/caplaw/2012/CapLaw_03_12.pdf)>.

<sup>85</sup> FINMA, 'Addressing "Too Big to Fail,"' above n 61, 18.

<sup>86</sup> Ibid.

Supervisors should have the power to increase the prudential requirements for individual banks and banking groups based on their risk profile and systemic importance.<sup>87</sup> In order to achieve these objectives, the Swiss regulatory agencies, the SNB and the FINMA, signed a Memorandum of Understanding concerning financial stability on 23 February 2010. According to this Memorandum, the SNB has responsibility for monitoring large-scale developments in the banking sector and FINMA has responsibility for monitoring individual financial institutions.<sup>88</sup> These regulatory agencies work together to assess the soundness of the two major SIFIs in Switzerland, coordinating their actions in common areas of supervision, and generally exchanging information and opinions concerning the soundness of a SIFI. The Swiss agencies will also cooperate on an international level with foreign agencies and will work closely with supervisors of such countries where Swiss SIFIs have a substantial market presence.<sup>89</sup>

Based on the Basel III framework, a leverage ratio should serve to reduce or limit the indebtedness of a SIFI.<sup>90</sup> The Swiss assessment of the implementation of this regulation concluded that the Swiss banks should face no problems processing the required data. Based on art 29 of FINMAG the FINMA will collect the information concerning the leverage ratio from the individual Institutions during the period of monitoring. In addition, by 2017 a revised Capital Adequacy Ordinance will implement the new international standards concerning the Leverage Ratio.<sup>91</sup>

Switzerland has therefore responded proactively to the regulatory challenge of managing systemically important financial institutions. Despite, or rather because of, the economic importance of the financial sector to its economy, the Swiss Government and regulatory authorities have not shied away from implementing targeted reforms designed to reduce the economic risks posed by SIFIs. We will now consider the implementation of Basel III in Australia.

## V. IMPLEMENTATION OF BASEL III IN AUSTRALIA

The Australian Prudential Regulatory Authority ('APRA') has taken a broadly similar approach to resolvability issues as has the SNB. APRA has required major Australian banks to prepare detailed resolution plans or 'living wills' that address how the bank could be broken up and sold in the event of a crisis and to identify the sections of the bank likely to be able to be continually operated throughout such an event. APRA expects major Authorised Deposit-taking Institutions ('ADIs') to continue developing their recovery plans and has extended the living will requirement to medium-sized ADIs in 2013.

APRA has not specifically provided for Australian banks to issue convertible contingent bonds. However, its interim requirement that all Additional Tier 1 capital instruments recognised as

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<sup>87</sup> Basel Committee of Banking Supervision, 'Core Principles for Effective Banking Supervision,' above n 36, 21–22.

<sup>88</sup> Swiss Financial Market Supervisory Authority and Swiss National Bank ('SNB'), *Memorandum of Understanding in the field of financial stability between the FINMA and the SNB*, <<http://www.finma.ch/e/aktuell/Documents/mou-snb-finma-e.pdf>>.

<sup>89</sup> FINMA, 'Addressing "Too Big to Fail,"' above n 61, 19.

<sup>90</sup> BCBS, 'A Framework for Dealing with Domestic Systemically Important Banks' above n 33, note 167.

<sup>91</sup> FINMA, 'Implementation of the New Basel Liquidity Regime and the Leverage Ratio in Switzerland' (Newsletter 25, FINMA) 4 <<http://www.finma.ch/e/finma/publikationen/pages/finmamitteilungen.aspx>>.



liabilities for accounting purposes includes a provision under which they convert to shares if the Common Equity Tier 1 ratio of the issuing ADI's consolidated banking group falls below 5.125%. This could in essence be considered a 'vote of confidence' for Australian banks to issue CoCos. Australia's banks have also been issuing hybrid securities for many years. Hybrid securities, which are alternatively called subordinated notes, capital notes and convertible preference shares, have both equity and debt-like characteristics. In response to the new capital regulations, the terms of new issues of hybrid securities have been amended to increase the loss absorption features, making them akin to convertible contingent bonds. Australian banks have issued over AUD\$18 billion of these hybrid securities since November 2011 as part of their capital-raising measures.<sup>92</sup>

As has been outlined above, the principal Swiss response to the post-financial crisis landscape has been to require its systemically important banks to hold much more capital than that required by Basel III. The Swiss SIFIs must now hold capital equivalent to 19% of RWA (excluding the counter-cyclical buffer), including at least 10% of common equity and up to 9% of further common equity or CoCos (high-triggering of up to 3% and low-triggering of up to 6%), depending upon its degree of systemic importance. Moreover, in times of rapid credit expansion, a further amount of capital equivalent to up to 2.5% of RWA must be held as a counter-cyclical buffer. In boom times, therefore, Swiss SIFIs may need to have a capital equivalent of up to 21.5% of total RWA (including the 2.5% counter-cyclical buffer). This is a massive increase over the minimum requirements of Basel III which provides for a highest common equity capital ratio of 12% comprised as to 7% Common Equity Tier 1 capital and the conservation buffer and then up to 2.5% each for a systemic risk buffer and a counter-cyclical buffer.

Under Basel II, APRA required higher quality capital of Australia's banks than the Basel Accord required. APRA insisted that at least 75% of Tier 1 capital under Basel II be comprised of common equity compared with the Accord's requirement that at least 50% of Tier 1 capital be common equity. APRA intends to keep this conservative stance in the implementation of Basel III.

APRA has also elected for an accelerated implementation schedule for Basel III. It considered that since ADIs in Australia already met the minimum requirement of a 4.5% Common Equity Tier 1 Capital ratio, the phase-in requirements allowed by the Basel Committee were not necessary. It thus mandated that the 6% Tier 1 Capital Ratio be implemented from January 2013, as 'a strong demonstration of the capital strength and resilience of the Australian banking system.'<sup>93</sup> APRA also found that ADIs in Australia were already well placed to meet the capital conservation buffer requirements in full from January 2016 and saw no reason to gradually phase the buffer in from 2016-2019, as allowed by the Basel Committee's transition arrangements.

Moreover, the Basel Committee revised its timetable for the implementation of the Basel III liquidity framework, allowing for a minimum Liquidity Coverage Ratio ('LCR') of 60% from January 2015 and increasing by 10% annually until 2019. APRA again considered this phase-in unnecessary for Australian ADIs and proposed to maintain the original timetable of full implementation of the LCR by January 2015.

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<sup>92</sup> Australian Securities and Investments Commission: Hybrid Securities, Report 365, August 2013.

<sup>93</sup> APRA: Response to Submissions: Implementing Basel III Capital Reforms in Australia, APRA, 30<sup>th</sup> March 2012, p.29.

## VI. LESSONS FOR AUSTRALIA

Although the APRA has taken a stringent approach to the timing of the introduction of Basel III in Australia, it has not followed Switzerland's lead in requiring higher levels of capital than the Accord mandates. Given that Australia's banks did not need government-funded capital injections during the global financial crisis, it has perhaps been assumed that they do not require any more than the minimum level set out in Basel III. However, given that there are ongoing risks to the stability of Australia's banking system, as the International Monetary Fund has pointed out,<sup>94</sup> which will impose heavy costs on the public purse and the domestic economy should they materialise, it is worth considering whether the APRA should use the current record level of profitability of Australia's major banks as a welcome opportunity to shore up their capital and increase their resilience.

Although Australia's banks were not at the epicentre of the 2007-9 financial crisis, the crisis revealed how truly unknowable the risks inherent in international finance are, as well as the marked deficiencies of the risk management systems that had been put in place to manage them. This uncertainty, combined with the enormous social and economic costs of a crisis once it materialises, creates a prima facie argument for seeking to enhance the resilience of the Australian financial system as far as is possible, rather than simply imposing the minimum regulatory requirements set out in the Basel Accord.<sup>95</sup>

There are in essence three main tools available to the APRA to enhance the resilience and stability of Australia's banks. These are: (i) to mandate higher capital levels as has Switzerland and many other countries; (ii) to impose a levy on Australia's banks to level the playing field among them and to recapture a portion of the lower funding costs the banks enjoy due to the Government's implicit guarantee of their solvency; and/or (iii) to charge for the deposit insurance that the Government currently provides for free to the banks, and accumulate the proceeds in a fund that would be available should bail-outs be required in the future.

Each of these mechanisms will be considered below.

### A An "Australian Finish" — More Capital for Australia's Banks

The standard arguments against insisting on higher capital for Australia's banks are that: (i) capital is expensive; and (ii) this expense is unnecessary as the banks navigated the GFC very well.<sup>96</sup> The 'capital is expensive' argument, which has been vocally made by the banking sector<sup>97</sup>, has been rejected by the Swiss Government and has been comprehensively refuted in the important new

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<sup>94</sup> IMF: *Australia: Financial Stability Assessment*, above n. 13.

<sup>95</sup> See C. Goodhart: *Ratio controls need reconsideration*, *Journal of Financial Stability*, 2013, 9, pp.445-450 for a discussion of the problems with the Basel's capital ratios.

<sup>96</sup> See Douglas J Elliot, *Higher Bank Capital Requirements would come at a Price*, (20 February 2013) Brookings, <<http://www.brookings.edu/research/papers/2013/02/20-bank-capital-requirements-elliott>>. Kevin Davis, *Higher Bank Capital: What's Wrong With That?* (30 January 2012) Australian Centre for Financial Studies <<http://www.australiancentre.com.au/News/higher-bank-capital-whats-wrong>>; Kevin Davis, *Why Be Afraid of Higher Capital Requirements?* (13 September 2010) Australian Centre for Financial Studies <<http://www.australiancentre.com.au/News/why-be-afraid-higher-bank-capital-requirements>>; Adam Creighton, 'Bloated Business of Banking,' *The Australian* (online) 17 August 2013 <<http://www.theaustralian.com.au/news/features/bloated-business-of-banking/story-e6frg6z6-1226698681657>>.

<sup>97</sup> See for example Institute of International Finance: *The Cumulative Impact on the Global Economy of Changes in the Financial Regulatory Framework*, September 2011.

book, *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*, by Anat Admati and Martin Hellwig.<sup>98</sup> Professors Admati and Hellwig highlight how it is only the banking sector that views capital as expensive, and that the sector currently runs on the lowest level of capital of any corporate sector. Bankers a century ago would never have dreamt of attempting to run a bank on the wafer thin capitalisations of modern banks.<sup>99</sup>

This very thin capitalisation of financial institutions is one of the main reasons why wide-spread insolvency became a very real possibility after the collapse of Lehman Brothers, as financial institutions were simply too leveraged to absorb their losses, and deep systemic interconnections meant that problems at one financial institution invariably and almost immediately became a problem for other financial institutions. In contrast, Apple, one of the largest US companies by market capitalisation, has virtually no debt and operates purely on its own capital.<sup>100</sup> Most industrial companies have debt levels that are, by banking's standards, incredibly low. Higher levels of capital would therefore make a bank's debt and equity safer, with the result that the cost to the bank of both its debt and equity will be lower as both lenders to and investors in, the bank will accept lower returns in exchange for this lower risk. In David Murphy's words:

Basel III and related initiatives such as the G-SIFI charges have dramatically increased the quality and quantity of capital that banks – especially large banks – are required to hold. Clearly a bank with more common equity tier 1 capital can absorb more losses before becoming insolvent, and hence these changes can be seen as enhancing financial stability.<sup>101</sup>

Bank capital may therefore not be as expensive to banks as has been claimed, and it certainly reduces the costs to society of financial instability.

For these and many other reasons, Professors Admati and Hellwig establish that banks could have much higher capital levels without it denting their profitability significantly or requiring the passing on of substantially higher costs to customers. The reliance on such high debt levels, and conversely, low capital levels, by banks is a pursuit to maximise profits in an environment in which the losses can be socialised. Once the social and economic costs of financial crisis are factored in the 'cost of

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<sup>98</sup> Admati & Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to do about it* (Princeton University Press, 2013).

<sup>99</sup> *Ibid.*, 311. See also: Michael Bordo & Barry Eichengreen, 'Is Our Current International Economic Environment Unusually Crisis-Prone?' (Paper presented at the Reserve Bank of Australia Conference on Private Capital Flows, Sydney, 9–10 August 1999); Daniel K Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Peter G Peterson Institute for International Economics, 2008), 29–31; Anil K Kashyap, Jeremy C Stein & Samuel Hanson, 'An Analysis of the Impact of "Substantially Heightened" Capital Requirements on Large Financial Institutions' (Research paper, Clearing House Association, May 2010), 18; 'Strength in Numbers: how much capital did banks opt to hold when they had the choice?' *The Economist* (online) 10 November 2012 <<http://www.economist.com/news/finance-and-economics/21565937-how-much-capital-did-banks-opt-hold-when-they-had-choice-strength>>; Forrest Capie & Geoffrey Wood, 'Do We Need Regulation of Bank Capital? Some Evidence from the UK' (2013) 40 *IEA Current Controversies* 1, 6 <[http://www.lse.ac.uk/fmg/events/financialRegulation/LFR18G\\_Wood.pdf](http://www.lse.ac.uk/fmg/events/financialRegulation/LFR18G_Wood.pdf)>.

<sup>100</sup> Peter Lattman & Peter Eavis, 'To Satisfy Its Investors, Cash-Rich Apple Borrows Money' *New York Times* (online), 30 April 2013 <[http://dealbook.nytimes.com/2013/04/30/apple-raises-17-billion-in-record-debt-sale/?\\_r=0](http://dealbook.nytimes.com/2013/04/30/apple-raises-17-billion-in-record-debt-sale/?_r=0)>.

<sup>101</sup> David Murphy, 'Maintaining Confidence' (Special Paper 216, LSE Financial Markets Group Paper Series, December 2012), 11–12 <<http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP216.pdf>>. Murphy goes on to propose how in a perverse sense more capital may not make banks any safer, a proposition with which we disagree, but which is at least reasoned.

capital' argument diminishes. This is certainly the approach that has been taken in Switzerland. A quantitative study of the costs of the higher capital requirements to the Swiss economy and banking sector found that:

“the long-run social benefits of substantially higher capital requirements are large and are far greater than the social costs. The increase of capital levels as foreseen by Basel III and the Swiss Too Big to Fail (TBTF) regulations will accordingly reduce the probability of systemic crisis by 3.6% and yield an expected permanent annual GDP benefit of 0.64%. Thus, social benefits exceed social costs by a factor of nearly 11. Even if we take into account that the cost-benefit calculations are subject to estimation errors, the sheer difference between social costs and benefits is huge and should be recognized in the debate about the costs and benefits of the new regulations in Switzerland.”<sup>102</sup>

The authors list studies in other countries which have produced similar results.<sup>103</sup> Banks are currently run on such high amounts of leverage and low amounts of capital because it enables them to maximise short-term profits without having to ensure that they have adequate provisioning to cover losses during an economic downturn or market crisis. They know that should they fail, the taxpayers will bail them out – a moral hazard problem which has been made substantially worse by the crisis. Our present capital structures for contemporary banks are a shining example of moral hazard in action.

The second argument commonly made against mandating higher capital levels for Australian banks is their performance during the GFC. This arguably demonstrates a certain degree of complacency about the potential for Australia to be hit by the next financial crisis. The use of the past as a predictor of the future is utterly unreliable as profound uncertainty always lies before us.<sup>104</sup> Indeed, one of the key problems with calibrating the appropriate level of regulatory capital is that modern financial risk management, which underlies the way capital adequacy is assessed, uses risk models and data that rely heavily on events in the past to try to predict the future and so manage risk. This system is well known to work effectively for managing risk in 'normal' market conditions but breaks down precisely when it is needed – i.e. when there is a market crisis. As was evident during the financial crisis, this approach to risk in finance is woefully inadequate for insulating financial institutions from rare events. As the work of a number of thinkers in this field establishes, the most certain thing about the future is that it is likely to surprise us, and using past risk as a guide to future risk is a recipe for disaster.<sup>105</sup> This is a strong argument given the uncertainty inherent in the outputs of risk models for insisting that banks hold higher capital levels so that they are able to absorb unexpected losses without needing a taxpayer-funded bailout. It makes intuitive sense, therefore,

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<sup>102</sup> G. Junge & P. Kugler: Quantifying the impact of higher capital requirements on the Swiss economy, May 2012, p.5, available at: [https://wwz.unibas.ch/fileadmin/wwz/redaktion/makro/Papers/G\\_Junge\\_P\\_Kugler\\_July\\_02\\_2012\\_V3\\_fina.pdf](https://wwz.unibas.ch/fileadmin/wwz/redaktion/makro/Papers/G_Junge_P_Kugler_July_02_2012_V3_fina.pdf) (accessed 18th March 2014).

<sup>103</sup> Ibid., pp. 5-6.

<sup>104</sup> RP Buckley, 'Resilience and global financial governance', in Cork (ed) *Resilience and Transformation: Preparing Australia for Uncertain Futures* (CSIRO Publishing, 2009) 65.

<sup>105</sup> See Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (Random House, 2007); Nicholas Taleb, *Foiled by Randomness: The Hidden Role of Chance in Life and in the Markets* (Penguin, 2007); Ricardo Rebonato, *Plight of the Fortune Tellers: Why We Need to Manage Financial Risk Differently* (Princeton University Press, 2007); Satyajit Das, *Extreme Money: The Masters of the Universe and the Cult of Risk*, (Financial Times, 2011).

that more capital makes banks safer and there is a large body of research which supports the proposition.<sup>106</sup>

There is however, a considerable amount of research<sup>107</sup> and opinion<sup>108</sup> internationally that supports the contrary propositions that either more capital does not make banks safer, or that higher capital levels are intrinsically desirable but now is not an optimum time to introduce them because of the perceived effect they will have on constraining bank lending and the negative impact of this on economic growth.

These latter arguments focus largely on the situation prevailing in economies such as the UK, USA and Europe, where economic conditions have been very different over the last few years to those in Australia. There have been concerns among economists, policymakers, bankers and academics over the economic impact of constraining bank lending and requiring banks to hold more capital at a time when they are already strained and still laden with toxic assets that were hit by the financial crisis. Given that Australia's economy has been strong over the last few years, and has not suffered the deep post-crisis recession that was endured elsewhere, these arguments about the fragility of the economy and the banking sector as a reason not to require higher capital levels are far less relevant than they might appear. For the past three years, Australia's four major banks have been the most profitable banks in developed countries.<sup>109</sup> In 2012, they earned AUD\$33 billion in pre-tax profits. According to the Bank for International Settlements, these pre-tax profits were equal to 1.18 per cent of their total assets, which puts Australia's banks well ahead of those in any other developed

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<sup>106</sup> Martine Hellwig, 'Capital Regulation After the Crisis: Business as Usual?' (Research Paper No 2010/31, Max Planck Institute for Research on Collective Goods, July 2010); Anat D Admati, Peter M DeMarzo, Martin F Hellwig, Paul Pfleiderer, 'Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Expensive' (Research Paper No 2063, Stanford Graduate School of Business, 30 September 2010), 6–8 <[http://www.coll.mpg.de/pdf\\_dat/2010\\_42online.pdf](http://www.coll.mpg.de/pdf_dat/2010_42online.pdf)>; Frank Heid & Ulrich Kruger, 'Do capital buffers mitigate volatility of bank lending? A simulation study' (Discussion Paper No 03/2011, Deutsche Bundesbank, 2011) <<http://econstor.eu/bitstream/10419/44596/1/654088020.pdf>>; Adrian Blundell-Wignall & Paul Atkinson, 'Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity' (2010) 1 *OECD Journal: Financial Market Trends* 9, 24. <<http://www.oecd.org/finance/financial-markets/45314422.pdf>>.

<sup>107</sup> Oxford Economics, 'Analyzing the impact of bank capital and liquidity requirements on US Economic Growth' (Report, The Clearing House, April 2013), ch 3 <<http://www.theclearinghouse.org/index.html?f=074938>>; David Murphy, 'Maintaining Confidence' (Special Paper 216, LSE Financial Markets Group Paper Series, December 2012), 11–12; David Howarth & Lucia Quaglia, 'Banking on Stability: The Political Economy of New Capital Requirements in the European Union' (2013) 35(3) *Journal of European Integration* 333; Anil K Kashyap, Raghuram G Rajan & Jeremy C Stein, 'Rethinking Capital Regulation' (Paper presented at the Federal Reserve Bank of Kansas Symposium on "Maintaining Stability in a Changing Financial System", Wyoming, 21–23 August 200).

<sup>108</sup> Steve H Hanke, 'Basel's Capital Curse' (2013) 7(1) *Globe Asia* <<http://www.cato.org/publications/commentary/basels-capital-curse>> (This is opinion dressed up with graphs that often use wrong data sets as inputs on the x and y axes to make this look like research); Ben Wright, 'More Capital Makes Banks Safer, Except When It Doesn't,' *Financial News* (online) 23 September 2013 <<http://www.efinancialnews.com/story/2013-09-23/more-capital-makes-banks-safer-except-when-it-doesnt-comment>>; Steve Denning, 'Will Higher Capital Requirements Make the Banking System Safe?' *Forbes* (online) 25 June 2013 <<http://www.forbes.com/sites/stevedenning/2013/06/25/will-higher-capital-requirements-make-the-banking-system-safe/>>; 'Base Camp Basel,' *The Economist* (online) 21 January 2010 <<http://www.economist.com/node/15328883>>.

<sup>109</sup> C Yeates, 'Rich pickings for big four,' *The Age* (online) 23 June 2013 <<http://www.theage.com.au/business/rich-pickings-for-big-four-20130623-2oquy.html#ixzz2YQ57nABY>>.

country.<sup>110</sup> Now would therefore be a propitious time for the APRA to mandate that Australia's banks hold higher levels of capital, before the next crisis hits international markets.

In considering the arguments against higher bank capital, it is worth bearing in mind that there is also a certain degree of capture of academics by the finance industry, particularly in business schools. Banks offer enticing consultancies to professors of finance and some professors of law, they participate in or endorse their research grant applications, and/or otherwise confer professional benefits upon them. Government policy setting can unwittingly promote this trend by favouring grant proposals which have industry partners. The quest by Government to ensure research relevance may, unintentionally, skew the perspective from which the work is conducted.

As we have seen, irrespective of these arguments Switzerland has led the way by applying a 'Swiss finish' to its SIFs that requires that they hold up to 21.5% of RWA in boom times. This has been seen as enhancing their international competitiveness by underpinning their stability, and reducing risk to the Swiss economy. Switzerland is not the only country to go beyond the capital levels set out in Basel III. Austria has set a supplementary capital requirement of 3%, Singapore 2%, and Sweden 5% for institutions deemed domestically significant.<sup>111</sup> In fact there has been a marked lack of international consistency in the implementation of Basel III, with various countries choosing to adjust the rules and require higher standards of their banks in various areas. This has led to speculation that a putative 'Basel IV' is already taking shape.<sup>112</sup>

The International Monetary Fund in its report on the Australian financial system explores how much capital would be required to make Australia's major banks safer. As at the end of 2011 a one-year ahead probability of 99.9% of an Australian bank not defaulting on any payment would require the four major banks to hold between 0.2% and 2% of RWA as further Common Equity Tier 1 capital. Increasing this probability of avoiding a default to 99.95% increases the range of extra Common Equity Tier 1 capital the Big Four need to hold over currently required levels is from 1.4% to a very substantial 5.2% of RWA in the case of one bank.<sup>113</sup>

APRA currently requires Australian banks to hold a Common Equity Tier 1 capital ratio of 6% of RWA, made up of 4.5% Common Equity Tier 1 capital,<sup>114</sup> with a further 2.5% capital conservation buffer to be held from January 2016.<sup>115</sup> As we have seen, the International Monetary Fund's technical assessment of Australia's banks recommended that the APRA consider introducing higher capital levels to ensure systemic stability, although in the Fund's words: "how much additional capital may be ultimately required will depend on APRA's risk tolerance."<sup>116</sup> In Australia's case, a requirement of at least further Common Equity Tier 1 capital equal to 2% of RWA would appear appropriate and

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<sup>110</sup> Ibid; Bank for International Settlements, '83<sup>rd</sup> Annual Report' (Report, BIS, 23 June 2013), Table V.1, 54.

<sup>111</sup> International Monetary Fund, 'Australia: Addressing Systemic Risk Through Higher Loss Absorbency — Technical Note' (Country Report No 12/311, IMF, November 2012) 16 ('Technical Note'), p.10 Table 4. The CRD IV package of the European Union is also important for member states.

<sup>112</sup> KPMG: *Basel 4 – Emerging from the mist?*, September 2013, available at: <http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/regulatory-challenges/Documents/emerging-from-the-mist.pdf> (accessed 18th March 2014).

<sup>113</sup> International Monetary Fund, 'Technical Note', Ibid. n. 111.

<sup>114</sup> APRA, *Prudential Standards APS 110: Capital Adequacy* (January 2013), para 22.

<sup>115</sup> Ibid, paras 24–25.

<sup>116</sup> IMF, 'Australia: Financial Stability Assessment,' above n 13, 22.



prudent, and would not unduly burden Australia's banks relative to their international competitors. Given their strong recent profitability, this would not be unduly costly.

The argument in support of this proposition goes beyond arguments of systemic stability, and looks also at the competitive advantage that the implicit taxpayer-guarantee of systemically important banks confers relative to non-systemically important banks. IMF analysis has indicated that the implicit sovereign guarantee of their creditworthiness confers a funding advantage on the Big Four Australian banks (National Australia Bank, Commonwealth Bank, Westpac and ANZ) of approximately 120 basis points, whereas the funding advantage of smaller and regional banks is only 50–70 basis points.<sup>117</sup> The differential results from the fact that it is highly unlikely in the aftermath of the credit crisis that a systemically important institution would be allowed to fail, whereas it is by no means certain that a Government would underwrite the cost of rescuing a non-systemically important financial institution. The financial system should, by definition, be able to absorb the failure of a non-systemically important bank. Accordingly, the implicit guarantee of such institutions is less strong and the funding advantage they enjoy in borrowing in wholesale capital markets is accordingly lower. The IMF has done considerable work on this issue of the value of structural subsidies to financial institutions because of their Government's likelihood of bailing them out. On average, it found that banks in major countries enjoyed a funding cost advantage of roughly 60 basis points at the end of 2007 which rose to some 80 basis points at the end of 2009.<sup>118</sup> The implicit Government guarantee of systemically important banks is therefore seen to undermine the level playing field in banking and reduce competition, which is a further argument in favour of increasing required capital for systemically important institutions in order to reduce this funding advantage. APRA has been reported as considering 'adopting higher capital ratios, but is not necessarily wedded to the idea.'<sup>119</sup> Our preference, for levelling this playing field, however, also involves imposing a levy on the assets of systemically important institutions.

#### *B A Levy on the Balance Sheets of Australia's Big Four Banks*

Imposing higher capital levels on systemically important banks in order to address the structural subsidy they receive through their implicit sovereign guarantee is not primarily using capital for its principal and proper purpose, which is to make those banks safer. A more direct way to level the playing field is to require systemically important banks to make a contribution towards the cost to the taxpayer of affording them an advantage in their funding costs. In the words of the IMF:

"Investors assume that systemic institutions can count on government support, and will therefore accept a lower yield compared with that required for funding non-systemic banks. This cost difference leads to a competitive advantage for systemic institutions ... which provides them with the means and the incentive to become even more systemic. To offset this tendency, one could charge systemic banks a fee to offset this implicit support."<sup>120</sup>

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<sup>117</sup> Ibid 21, Figure 12.

<sup>118</sup> K Ueda and BW Di Mauro, 'Quantifying Structural Subsidy Values for Systemically Important Financial Institutions' (Working Paper WP 12/128, IMF, May 2012) <http://www.imf.org/external/pubs/ft/wp/2012/wp12128.pdf>.

<sup>119</sup> John Kehoe, 'Banks 'Need More Capital' *Australian Financial Review* (online) 17 November 2012 [http://www.afr.com/p/business/financial\\_services/banks\\_need\\_more\\_capital\\_L9516dTwpBfxFReQhaUdLJ](http://www.afr.com/p/business/financial_services/banks_need_more_capital_L9516dTwpBfxFReQhaUdLJ).

<sup>120</sup> IMF, 'Technical Note', above n. 111, p.17.

Australia's big four banks benefit from an implicit taxpayer guarantee of their solvency and so benefit from a cost advantage in wholesale capital markets over other, smaller banks. This is an advantage these banks enjoy which corporations in other sectors do not, and which skews the market mechanism in their favour. If one believes in the allocative efficiency of markets, then the proper role of Government is to ensure that markets work as well as possible. Requiring banks to hold higher amounts of capital does not redress the competitive distortions introduced into the Australian economy by providing an implicit sovereign guarantee of a handful of institutions in one industry. Such distortions will potentially lead to a misallocation of capital in the economy, which may in and of itself creates risks to financial stability. Requiring SIBs to refund a substantial proportion of the benefit that they receive from this subsidy to the Government will help to address this.

Various countries, including the UK, France and Germany, have imposed levies on their banks following the financial crisis. For Australia to do the same would therefore not be inconsistent with measures taken elsewhere. Whereas the objective of these measures elsewhere was to recover some of the costs to the public purse of bailing out the banking sector, the equity arguments for imposing a levy in Australia in order to level the playing field between systemically and non-systemically significant institutions is persuasive. This will enhance competitiveness in the financial services market by recouping some of the cost from the banks of the benefits that they receive to their funding costs through the implicit sovereign guarantee of their solvency.

In the Australian context the Big Four banks are estimated to have enjoyed a wholesale funding cost advantage of about 80 basis points before the global financial crisis, and 120 basis points in 2009, during the crisis. The regional banks enjoyed advantages of between 40 and 60 basis points before the GFC and between 50 and 70 basis points during the GFC.<sup>121</sup>

In the Fund's words:

"Because a funding advantage is relative, charging a fee (or the equivalent higher capital) equal to the difference in funding cost would be unduly severe. Indeed, as the market share of those subject to a fee diminishes, that of the non-systemic institutions rises. In the absence of a detailed study on how market shares would evolve in the Australian context, the analysis uses a parameter of 0.7. This means that 70% of the fee needs to be imposed to offset the market dominance of the 4 large banks. On balance, this exercise yields more uniform results than the previous exercise with similar orders of magnitude of higher loss absorbency requirements. At the end-2011 average level of capitalization (10.1% of RWA), to offset 80 basis points worth of funding advantage, additional capital in the range of 1.2% to 1.6% of RWA is required. This rises to a range of 1.8% to 2.4% to offset 120 basis points."<sup>122</sup>

In response to a request from Senator Christine Milne, Leader of the Greens Party in Australia, of February 5, 2013, the Parliamentary Budget Office of the Australian Federal Parliament has prepared a costing request on 'Banks-Public Support Levy.' The Parliamentary Budget Office inquired into the impact of a 20 basis point levy on bank assets in excess of AUD\$100 billion. The AUD\$100 billion limit

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<sup>121</sup> IMF, 'Technical Note,' above n. 111, 9 & 18.

<sup>122</sup> Ibid 19.



in the Australian context neatly captures the four systemically important institutions. The Budget Office's calculations are that such a levy would result in 'an increase in revenue of \$15.8 billion from the levy and a decrease in company tax receipts of \$4.7 billion over'<sup>123</sup> the next four years for a net revenue gain to Government in that period of some AUD\$11 billion. The Office goes on to note that, 'this costing is considered to be of high reliability. It is based on high quality, up to date information and current growth forecasts.'<sup>124</sup>

Key assumptions made in undertaking these calculations include that the levy is treated as a deductible expense for company tax purposes, and the levy is 20 basis points of the value of total resident assets of each bank in excess of the AUD\$100 billion threshold, and that the cost of the levy is not passed on to bank customers. In the Parliamentary Budget Office's words:

This assumption may be reasonable given that, based on the APRA data, only the 4 major banks would be subject to the levy and that competition from other approved deposit banking institutions would limit their ability to pass the impact through to customers, with the result that the levy would impact on profit and taxable income (as costed). The impact of varying this assumption mainly impacts on the rate at which the levy is assumed to be deducted from assessable incomes. If banks were to pass the levy through to the customers in the form of increased fees or reduced interest, that pass through would increase the assessable income of the banks for tax purposes offsetting the deduction they receive for the levy, but would be matched by reductions in the taxable income of (resident) bank customers.<sup>125</sup>

The assumption that the banks will not pass on a proportion of the added cost represented by the levy is, in our view, naively optimistic. The Big Four among them have considerable pricing power, and a proportion of the levy is likely to be recouped from customers in one way or another. This, however, does not mean that it should not be implemented.

The Budget Office notes that 'a levy would represent a significant impost on affected banks.'<sup>126</sup> Indeed, the net effect of the levy would be higher than the income tax paid by the Big Four banks, and would represent about one-third of the profits of the Big Four, which in 2012, before tax, reached AUD\$33 billion annually.<sup>127</sup> Viewed from another perspective, this is equivalent to saying that the benefit the Big Four Australian banks receive each year from the implicit sovereign guarantee of their solvency amounts to well over a third of their total profits, because the levy only represents some 70% of the benefit they actually receive.<sup>128</sup>

The third option for improving the resilience and stability of Australia's banking sector is to do what virtually all OECD nations do, and charge banks for insuring the deposits of their customers.

### *C Australia's Financial Claims Scheme — Deposit Insurance Down Under*

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<sup>123</sup> Letter from Parliamentary Budget Office to Senator Christine Milne, 13 February 2013, 3  
[http://greensmps.org.au/sites/default/files/pbo\\_costings\\_20130213\\_banks\\_public\\_support\\_levy\\_2.pdf](http://greensmps.org.au/sites/default/files/pbo_costings_20130213_banks_public_support_levy_2.pdf).

<sup>124</sup> Ibid.

<sup>125</sup> Ibid 4.

<sup>126</sup> Ibid 5.

<sup>127</sup> David Richardson, 'The Rise and Rise of the Big Banks' (Technical Brief No 15, The Australia Institute, December 2012), Table 3, 10.

<sup>128</sup> Letter from Parliamentary Budget Office to Senator Christine Milne, above n 123, 3.

The Financial Claims Scheme (FCS) guarantees deposits in ADIs of up to AUD\$250,000 per account-holder per ADI — a significant decrease from the previous cap of AUD\$1 million that was implemented in October 2008 to bolster depositor confidence during the financial crisis.<sup>129</sup> The FCS is activated when APRA makes an application for an ADI to be wound up. The Australian Government pays the relevant sum to the account-holder, which it may then recover in the liquidation process.<sup>130</sup> The FCS is *ex post* funded, backed by a standing budgetary authorization of up to AUD\$20 billion per ADI, and enjoys a priority in claims on liquidation recoveries. An optional levy on the industry provides a mechanism to make up any shortfall in recouping guaranteed depositor payment.

However, *ex post* funding and the levy's optional feature are not consistent with international best practice that seeks to require banks to bear the costs of their own failures and failures within their industry. By definition, if one Australian bank were to fail, it is likely that the solvency of the other three major banks will also be under pressure. The sector is far too interconnected, with the sources of funding for Australian banks and the risks they face far too similar for one major bank to be in trouble and for others to be in good financial shape. In reality therefore, any Government seeking to impose a levy on surviving banks to fund depositor repayments for a failed institution is likely to face the delicate situation where doing so may in fact worsen the solvency situation of the other three, and the exceptional political resistance of institutions struggling for their very survival.

The Federal Treasurer is responsible for making the decision about whether to apply the levy to a particular ADI as the optional levy can be imposed if and when the Government decides to do so. Imposing the levy on one bank, or all banks, will in Australia's particular situation always be a very difficult thing to do politically. Debt levels amongst homeowners in Australia are very high, and there is a risk that banks will pass on the cost of the levy in increased mortgage interest rates, which risks triggering further defaults or bad debts. A deposit guarantee scheme funded *ex post* is also inherently pro-cyclical in that the levies will be imposed on the industry at a time when one of its members has failed or is in serious trouble. It risks therefore contributing further to the stressed financial and economic conditions that are likely to prevail should a major bank fail. There is a strong case to make, therefore, that an *ex post* funded financial claims scheme is inappropriate to the conditions which will prevail should it need to be exercised, and that it should, as matter of urgency, be replaced by an *ex ante* funded scheme. Switzerland, in contrast, does not provide any state deposit insurance, but has rather organised an industry system of protection for accounts up to CHF100,000. This is funded through an association which every financial institution regulated by the Swiss Financial Markets Supervisory Authority has to join, and which maintains funds of CHF6 billion to cover this deposit guarantee. The banking sector itself, therefore, provides a central fund with which to meet the costs of deposit insurance.<sup>131</sup>

An *ex ante* funded deposit insurance scheme is one of several methods available to mitigate moral hazard by having the industry bear its own full costs. We strongly recommend its adoption in Australia, as does the IMF. In the IMF's words,

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<sup>129</sup> APRA, 'Financial Claims Scheme for Authorised Deposit-taking Institutions' (Fact Sheet, APRA, February 2012), 5.

<sup>130</sup> Ibid 4.

<sup>131</sup> Deposit Protection of Swiss Banks and Securities Dealers (esisuisse), see <http://www.einlagensicherung.ch/en/bankkunden-link/home.htm> (accessed 19th March 2014).

“[a]n *ex ante* deposit insurance scheme should have a credible and adequate reserve fund built up from periodic flat-rate assessments on ADIs’ deposits initially but changing to risk-based assessments over time, and the fund’s investment objective should emphasise liquidity and safety over return. An *ex ante* funded deposit guarantee scheme, together with higher loss absorbency requirements ... appear to represent the best option for Australia since the infrastructure is already in place.”<sup>132</sup>

In the Fund’s and our view, these measures are necessary ‘to mitigate moral hazard inherent in a highly concentrated banking sector.’<sup>133</sup>

In October 2012, the Council of Financial Regulators (APRA, the RBA, the Australian Securities and Investments Commission, and Treasury) recommended that the Government consult on the merits of introducing a fee on banks in return for the ongoing taxpayer-funded insurance of deposits. In March 2013, Reserve Bank governor Glenn Stevens wrote to then-treasurer Wayne Swan saying that the Council of Financial Regulators has come ‘to the view that the *ex-ante* funding model for the Financial Claims Scheme should be introduced in Australia.’<sup>134</sup> He said the funding would ‘at least partly compensate the Government for the risks it bears from these guarantees and it would build up a fiscal buffer to assist in meeting any potential future costs of (bank) resolution.’<sup>135</sup>

On August 1, 2013 the then Labor Government announced that it would move to an *ex ante* funded scheme. The insurance levy was to be 0.05% on deposits of up to AUD\$250,000 (ie, those that are insured). It was to be paid by the banks, although the banks immediately said that they would pass the cost on in reduced interest rates on deposits. The levy is scheduled to be introduced in January 2016, and it will be ring-fenced as a financial stability fund to cover any future bailouts, at least until the fund reached AUD\$15 billion. Early modelling suggested the levy will raise about AUD\$500 million a year, so reaching this target amount will take quite some time.

A counter argument to charging the levy is to remove the insurance and return to the pre-crisis model of a banking sector that operates without such insurance. Australia’s financial sector was run without deposit insurance for 107 years, although the tool proved to be a useful stabilization measure in 2008. While superficially persuasive, it fails to take into account the fundamental changes in the banking/financial landscape which have occurred over the post-war period. In the 1960s and 70s, Australia was a financial island, but it has since integrated into global financial markets and is exposed to their vagaries. In 2008, some of the major markets which Australian banks were drawing on for funding simply stopped working and a run on an Australian bank became a realistic possibility, until the Government introduced deposit insurance to reassure savers. It is an effective tool for bank stability in a globalised financial world, but it is also a major taxpayer-funded subsidy to the banking sector and it should not in our view be provided for free to highly profitable banking institutions.

## VII CONCLUSION

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<sup>132</sup> IMF, ‘Australia: Financial Stability Assessment,’ above n 13, 30.

<sup>133</sup> Ibid.

<sup>134</sup> Phillip Coorey & John Kehoe, ‘Banks Slam Deposit “Tax”,’ *Australian Financial Review* (online) 1 August 2013 <[http://www.afr.com/p/national/bank\\_deposits\\_taxed\\_for\\_bailout\\_AKvDLh8Z36mmzu3VQ2lhVJ](http://www.afr.com/p/national/bank_deposits_taxed_for_bailout_AKvDLh8Z36mmzu3VQ2lhVJ)>.

<sup>135</sup> Ibid.

For the past three years, Australia's four major banks have been the most profitable banks in the developed countries.<sup>136</sup> In 2012, they earned some AUD\$33 billion in pre-tax profits. The Bank for International Settlements says the pre-tax profits of the Big Four were equal to 1.18 per cent of their total assets, which puts Australia's banks well ahead of those in any other developed country.<sup>137</sup> As this article has identified, part of the reason for the extraordinary profitability of the major Australian banks is that they are receiving for free (i) an implicit sovereign guarantee of their solvency, which reduces their borrowing costs in wholesale capital markets considerably, and (ii) insurance of deposits with them of up to AUD\$250,000. In addition, by international standards, Australia is not requiring much additional capital from its four major banks so as to minimise the risk of the need for a Government bail-out of any of these systemically important institutions.

One option therefore, is for Australia to follow Switzerland's lead and require the Big Four to each hold considerably more capital. If it were to strictly follow Switzerland's lead, it would demand its major banks hold a further 8.5% of capital, all of which could be held as convertible instruments. However, Australia is not Switzerland and while the two countries share a massive too-big-to-fail problem, the political and economic situations are otherwise very different. An increase in the capital required of Australia's banks would be sensible and prudent, and there will never be an easier time for Australian regulators to insist upon it than in these current halcyon days of super-profitability. APRA and the Financial System Inquiry should act and require more capital of Australia's banks, although in our submission, further capital in the order of 2% of RWA would be appropriate (which is far less than is being required by their Swiss counterparts).

Australia bestows a most generous gift on some of its most profitable entities with its implicit sovereign guarantee of its major banks' solvency. One response to this largesse is to require more capital of its banks. Another response is to impose a levy on the Big Four banks so that they return to the consolidated revenue about 70% of the benefit they receive from it. For reasons of equity across and among industries, equity to the taxpayer for the benefits they are conferring upon banks, and preservation of the market mechanism in Australia as between the banking industry and all other industries, and also as between the Big Four banks and the minor banks which receive far less benefit in their funding costs due to a less certain implicit sovereign guarantee of their solvency, we recommend a levy on Australia's four major banks of about 20 basis points on assets above AUD\$100 billion (which currently would raise about AUD\$11 billion over the coming four years).

The final measure that the Australian Financial System Inquiry should consider implementing at this time is to charge for the deposit insurance that is currently provided for free to its banks. It is time Australia fell into line with international practice on this issue. The accumulation of the proceeds of such a fee in a Financial Stability Fund would do much to ensure the long-term stability of our banks, and obviate the need for Government-funded bailouts, as a Financial Stability Fund can be seen as collective capital available to all of a nation's banks. Furthermore, it is indefensible on equity and fairness grounds for a Government to explicitly guarantee for free a substantial portion of the liabilities of all of Australia's banks when it does not do the same for other Australian industries.

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<sup>136</sup> C Yeates, 'Rich pickings for big four,' Ibid n.109.

<sup>137</sup> Ibid; Bank for International Settlements, '83<sup>rd</sup> Annual Report' (Report, BIS, 23 June 2013), Table V.1, 54.

