Thomas J Jordan: Approaching the finishing line – the too big to fail project in Switzerland

Speech by Mr Thomas J Jordan, Vice Chairman of the Governing Board of the Swiss National Bank, at the International Center for Monetary and Banking Studies, Geneva, 17 May 2011.

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Introduction

Eighteen months ago, we here in Switzerland tackled a major challenge: the search for a solution to what is known as the "too big to fail" problem in the current financial system. "Too big to fail" means that the state has no choice but to rescue a company because its demise would seriously affect the entire economy. In good Swiss tradition, a broad-based committee of experts[1] presented the Federal Council with a proposal supported by all involved parties and the implementation of which would significantly alleviate the "too big to fail" problem. This proposal was, in essence, approved by the Federal Council and has been put before Parliament in the form of a draft law.

At this point, I should like to deliver an important message. The package of TBTF – too big to fail – measures is not intended to hurt the big banks or the banking sector in Switzerland. Rather, it aims to protect state and taxpayer from incurring an unwanted and unacceptable risk, while also creating the necessary framework conditions for the banking sector to be able to develop sustainably and successfully over the long term.

The decision is now up to the politicians. In the coming weeks and months, Parliament will decide whether the proposed measures will actually be implemented. The final, decisive phase of the project is thus underway – we are approaching the finish line!

In the Swiss system of direct democracy, the electorate essentially also has the final word in the legislative process. It is therefore important to ensure that the public clearly understands such a complex topic as the regulation of systemically important financial institutions. The SNB has the statutory mandate to contribute to the stability of the financial system. It thus played a significant role in drafting the solution put before the Federal Council. Allow me to explain the considerations behind the proposed legislation.

The cost of financial crises

The latest crisis highlighted the fact that big, globally interconnected financial institutions present a particularly large risk to an economy. If they fail, systemically important functions vital to the smooth running of the economy – such as the lending business or executing payment systems – can no longer be carried out. It is for this reason that an economy cannot afford to allow such an institution to fail. In a crisis, the state – in other words the taxpayer – has no choice but to rescue the bank. Big banks of this kind therefore possess an implicit state guarantee and benefit from artificially low borrowing costs. From an economic point of view, this equates to a state subsidy. This is not in line with the basic principles of a free market economy. (cf. chart 1)

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[1] The commission of experts was composed of members of the Federal Department of Finance, the SNB, FINMA, representatives of the private sector and academics.

This problem is particularly acute in our country, with its two very big banks. Although they have reduced their balance sheets significantly since 2008, the balance sheet totals of both big banks still amount to around four times the gross domestic product. Even though this is only a rough yardstick, it nevertheless gives an indication of the risk to an economy. As the crisis has demonstrated to us, this risk can have dramatic consequences if it turns into reality. The cost to the state of rescuing a TBTF bank may be enormous. In extreme cases, the state may even need to ask for international help, which can would greatly jeopardise a country's independence. (cf. charts 2 and 3)

In order to massively reduce the likelihood of this nightmare scenario suddenly coming true, we must put our financial system back on a more stable footing. There is no doubt that this is in the interest of Switzerland as a whole. Indeed, having enough capital and hence being considered robust is – undoubtedly – also in the interest of the banks themselves. Although we dealt with the crisis competently – here, I am referring to the successful bail-out of UBS in autumn 2008 – there is unfortunately no guarantee that our country will come off so lightly in future crises.

The Swiss TBTF proposal

As the above remarks make clear: big, interconnected financial institutions can destabilise the financial system and an entire economy, with dramatic consequences. How can they be made more secure? And how can the problem of the implicit state guarantee be reduced?

The package put together by the Federal Council in Switzerland is precisely targeted at these two questions.[2]

A central component of the Swiss approach is that systemically important banks should markedly improve their capital base and liquidity positions, both qualitatively and quantitatively, and reduce their risk exposure to other banks.[3] This will make systemically important banks more stable in future and reduce the likelihood of them running into difficulties. Furthermore, organisational measures aim to ensure that systemically important functions can continue to be performed during a crisis, while simultaneously liquidating the big bank in an orderly manner. This reduces the need for state intervention.

These measures may have different starting points and goals, but they all harmonise with each other. If the provisions for improving stability do not suffice and a crisis occurs anyway, the mechanisms that guarantee the continuation of systemically important functions will kick in.[4] In their entirety, these measures help to ensure that the banks are again able to bear more of their risks themselves.

What are the objections to the package of measures?

So why are there still objections to the Swiss package of measures from various quarters, if the advantages are so obvious? Do these measures have any harmful consequences?

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[2] The proposal of the committee of experts and the message of the Federal Council can be downloaded at www.efd.admin.ch.

[3] The new capital adequacy regulations for systemically important banks are to apply to risk-weighted capital and to the leverage ratio. Furthermore, they are designed to be progressive. In other words, the bigger the bank, the higher the requirement. Given the current size of Switzerland's two big banks, the requirement would be 19% total capital of the risk-weighted assets, of which 9% can be held in convertible capital (cocos) and 10% must be held in common equity.

[4] If common equity falls below the threshold of 5%, the cocos will be converted and the emergency planning for separating the systemically important functions from the rest of the bank will be initiated.

Objections and doubts before the introduction of new regulations or laws are part and parcel of a thriving democracy. Before implementation, we can never know with absolute certainty how our economy or society will react to changed framework conditions – there is therefore always an element of doubt. For instance, one objection to the package of measures is that the cost of taking such drastic action to achieve the transition to a more stable system would be too high. In addition, doubts have also been expressed concerning the rapid pace and the impact of the proposed reforms. Although we can understand such criticisms, the SNB believes them to be exaggerated and largely unfounded. Allow me to explain.

I would like to begin by making three general preliminary observations. Firstly, regulation is never free of charge for every participant. However, analysis of the possible costs of regulation must always differentiate between the *private* and the *social* costs: in practice, regulation is bound to lead to additional costs for those regulated. This is part of the plan and makes economic sense provided that these additional costs are smaller than the benefits that regulation brings to the entire economy. If regulation leads to the elimination or reduction of market distortions – such as subsidies, for example – then an economically more efficient result is obtained.

Secondly, regulation can be formulated in a more or less cost-efficient manner. Particular attention was paid to this element in Switzerland. For instance, the additional capital required here by systemically important banks can largely be held in the form of more cost-efficient convertible capital. Other, far more drastic measures, such as a strict ban on certain business activities or the introduction of a bank tax – as discussed in other countries – were firmly rejected, partly for cost reasons.

Thirdly, the proposed measures are by no means excessive in scope – on the contrary: the increase in capital would reduce the big banks' ratio of debt, which currently stands at approximately 98%, by only three percentage points: around 95% of the balance sheet total could continue to be financed by borrowed capital! Besides, the Federal Council's proposal merely implies a return to a level of capital that the big banks exceeded up until 1996 (cf. chart 4).

Ladies and gentlemen, let us now take a closer look at the potential negative consequences of the proposed regulation of the big banks.

Will stricter regulations push up borrowing costs within Switzerland?

Firstly, there are fears that stricter capital adequacy requirements could lead to higher financing costs for the banks. It is argued that this would above all lead to more expensive credit for companies and households. Lending would then decline, acting as a brake on Swiss economic growth.

According to economic theory, the one does not necessarily lead to the other, since an increase in capital should not have any effect on a bank's overall financing costs.[5] Owing in part to the preferential tax treatment of borrowed funds, the Modigliani-Miller theorem referred to here, cannot be applied directly in practice, which means that overall financing costs would rise if capital increases. However, this is exactly what the proposed measures on convertible capital take into account. They create better conditions, so that capital structure will have less influence on a bank's financing costs.

Independently of this finding, it is argued that the reduction of the state subsidy – which is one aim of the new regulation – will lead to an increase in lending rates for clients. There are various arguments against this. On the one hand, structural factors within Switzerland's banking sector limit the big banks' scope for setting prices even today: There is a sufficient

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[5] Cf. Modigliani, F. and Miller, M. H., 1958. *The Cost of Capital, Corporation Finance and the Theory of Investment.*

number of domestic lending providers in the market, which keeps margins relatively low. On the other hand, the reduction in the subsidy will tend to lead to even more competition. The current disadvantage suffered by other banks active in the domestic market is lessened – the package of measures thus levels the playing field in the Swiss customer business segment. In this environment, an increase in lending rates by the big banks would lead to a loss of market share. A reduction in the subsidy is therefore more likely to manifest itself in lower returns on equity or lower compensation for the bank management than in higher lending rates.

Empirically, there is no connection between the capital ratio and the credit volume, either. In the phase of debt-financed balance sheet ballooning seen between 1995 and 2007, the amount of credit available did not rise accordingly, nor did it decline in the following period when debts were being cleared. This observation is even more striking, given that, in autumn 2008, the regulatory authorities stated that as of 2013 both big banks will have to have twice as much capital as the Basel II minimum international standard specifies: According to current findings, the capital adequacy rules did not have a negative impact on lending levels nor did they increase lending rates (cf. charts 5 and 6).[6]

With a view to other possible economic repercussions of tighter regulation of the big banks, the question also arises as to whether and to what extent employment and value creation *in Switzerland* are at all affected. A glance at the statistics covering the period when UBS and CS saw their balance sheets expanding between 1995 and 2007 shows, among other things, that there is no clear-cut positive connection between the size of a balance sheet, on the one hand, and jobs and contribution to value creation at these banks in Switzerland, on the other. This implies that reducing the balance sheet as a result of stricter regulation would not necessarily have negative consequences in these respects (cf. chart 7).

To conclude, it appears that there are no theoretical or empirical grounds to indicate that the Swiss economy will be adversely affected by the proposed regulation. Even though, in the short term, the transitional phase would generate some costs for those regulated, this is clearly outweighed by the long-term advantages.

Is international competitiveness being weakened?

The second concern expressed is that tougher banking regulation would have negative repercussions for the Swiss financial centre if it is stricter or too strict compared with other countries *in relative terms.* Critics say that this would be a disadvantage in international competition, with far-reaching consequences such as a weakening – or even redimensioning – of the Swiss financial centre. They claim that customer assets and international companies would move abroad, since the Swiss financial centre would no longer offer a comprehensive range of banking services. Switzerland would therefore lose jobs and create less added value, they believe.

Key factors for international competitiveness

One significant aspect of the discussion about the repercussions of regulatory differences is that other factors are at least as decisive for the international competitiveness of the Swiss banks. These include favourable tax conditions, political and economic stability, a high degree of legal certainty, excellent asset management expertise and high standards in the banking business generally. Overall, this “Swissness” represents a crucial success factor for the banks when it comes to competing internationally with other financial centres.

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[6] Nor is there a connection, empirically speaking, with passing on the banks’ financing costs to customers: during the phase when the banks were constantly reducing their capital ratios, the spread between the borrowing rate and the lending rate did not narrow (Cf. Kugler, 2011. Presentation in Vienna).

Secondly, we should bear in mind that a country-specific difference in banking regulation is nothing new. Even before the financial crisis began in 2007, both the Swiss big banks were subject to stricter regulations in terms of capital requirements than their competitors in many other countries. As already mentioned, FINMA ruled, in autumn 2008, that as of 2013, both big banks will have to hold double the amount of capital specified in international minimum standards. The current "Swiss finish" therefore calls for an extra 100%!

However, these regulatory differences do not seem to have harmed the Swiss financial centre in the past. On the contrary, Switzerland's banks have always had a tradition of a "Swiss finish". Stability is one of the Swiss financial centre's clear competitive advantages and has made a significant contribution to attracting customer assets and companies to Switzerland.

A consideration of regulatory differences in their entirety

Let us now take a closer look at the possible regulatory differences in connection with current trends in Switzerland and other countries. How significant are these differences?

First of all: the thrust of international capital regulation is the same everywhere – more capital, stricter risk weighting and systemic importance to be taken into account when deciding how rigorous the regulation should be. The Basel Committee on Banking Supervision and the Financial Stability Board have stipulated that banks of international systemic importance should hold a substantial capital surcharge in relation to risk-weighted assets, which is *over and above* the Basel III standards.[7] However, this additional amount does not take national systemic importance into account. Each country, therefore, must henceforth decide individually on an appropriate additional amount based on the risk. For example, even if the international capital surcharge was set at a low level of 1%, the "Swiss finish" would result in only 25% more common equity (cf. chart 8).[8]

Unlike in the case of risk-weighted capital regulation, however, Switzerland does not play a pioneering role as regards the absolute indebtedness (leverage ratio) of banks. The United States and Canada, for example, both introduced a leverage ratio some time ago. These countries are therefore stricter than Switzerland regarding leverage ratio.

Furthermore, one thing is often overlooked in the current debate: banking regulation is by no means restricted to capital adequacy requirements. On an international comparison, it is the overall package of measures proposed for the regulation of (systemically important) banks that is decisive. In the US, for example, the Dodd-Frank Act[9] severely restricts proprietary trading by banks that accept deposits. Sweden, for example, introduced a tax on systemically important banks. A variety of other proposals, such as the establishment of a permanent bail-out fund or new regulations on the organisational structures of banks, are being planned in the EU (cf. chart 9).[10]

When comparing regulatory packages at international level, it is therefore important not to look at capital adequacy requirements in isolation. Additional measures with far-reaching effects on economic freedom can have grave unintended consequences. They therefore end

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[7] In the form of minimum common equity.

[8] 10% common equity (Swiss proposal) vs. 7% common equity plus 1% systemic capital surcharge (Basel III).

[9] The financial market regulation reform package was passed in the US in summer 2010.

[10] The European Commission proposes that a permanent European bank bail-out fund should be set up starting in 2013. Furthermore, the EU have called for size restrictions on banks in receipt of state aid (ING and Commerzbank) and divestitures (ING had to sell ING Direct USA). Lloyds Banking Group and Royal Bank of Scotland are also expected to shrink their balance sheets. In the United Kingdom, the Independent Banking Commission (the equivalent of the Swiss TBTF commission of experts) proposed high capital requirements alongside structural changes. Universal banks therefore have to separate out their UK retail business (no subsidiarity as in Federal Council proposal).

up costing considerably more than measures that create targeted incentives to allow market discipline to operate again.

To sum up, an analysis of international differences in regulation shows that, in the past, stricter capital regulation was in fact a competitive advantage rather than a disadvantage for Swiss banks. Furthermore, a look at the various regulatory packages in their *entirety* shows that the future requirements for internationally active, systemically important financial institutions will be designed differently at global level. Ultimately, however, they will differ in rigour only as far as the respective national regulators deem necessary in response to country-specific risks.

Is the Swiss package of measures being introduced too quickly?

A third objection concerns the pace of the regulatory reforms. Compared with other countries, the implementation of the Swiss package of measures is regarded as too hasty in some quarters. One concern is that significant aspects have not been properly considered when drafting the package, with the ultimate consequence that the TBTF problem is not tackled effectively.

First of all, it is important to remember that the latest crisis reached its peak some three years ago. It is therefore entirely inappropriate to refer to the Federal Council's proposal as hasty.

On the contrary, the committee of experts worked intensively on drawing up a proposal supported by all groups involved. The administration conducted a thorough analysis and carried out an extensive consultative process. The Federal Council has thus been able to put forward a sophisticated package of measures. This method of proceeding is in keeping with the Swiss tradition of taking the necessary action while avoiding snap decisions. However, actually implementing these rules will take some time. Because of the pressing need for reform in Switzerland, it is not practicable to wait for the international bodies to complete their work in this area. It would make much more sense to implement the best possible measures within a suitable time frame, in order to achieve a significant reduction in the risk to our country as early as possible.

I consider that the best possible measures are those which take account of the specific characteristics and risks inherent in our banking structure and have a high impact without incurring too high a cost. The package now before Parliament fulfils these criteria. On the one hand, the proposed measures are rigorously based on tried-and-tested approaches and instruments[11] which have been in existence in all developed countries for decades and whose effectiveness cannot be doubted. On the other hand, measures with great potential for unintended consequences have been decisively rejected by the committee of experts and the Federal Council, and not included in the package.

Conclusion

I am now drawing to the end of my remarks.

The failure of a big bank would have enormous and incalculable negative implications for Switzerland – not least because a state bail-out would be unavoidable. This risk is no longer acceptable. That is why strenuous efforts have been made over the past eighteen months to find a solution to the "too big to fail" problem. The Federal Council has recently presented a carefully thought out, balanced package of measures for Parliament's consideration.

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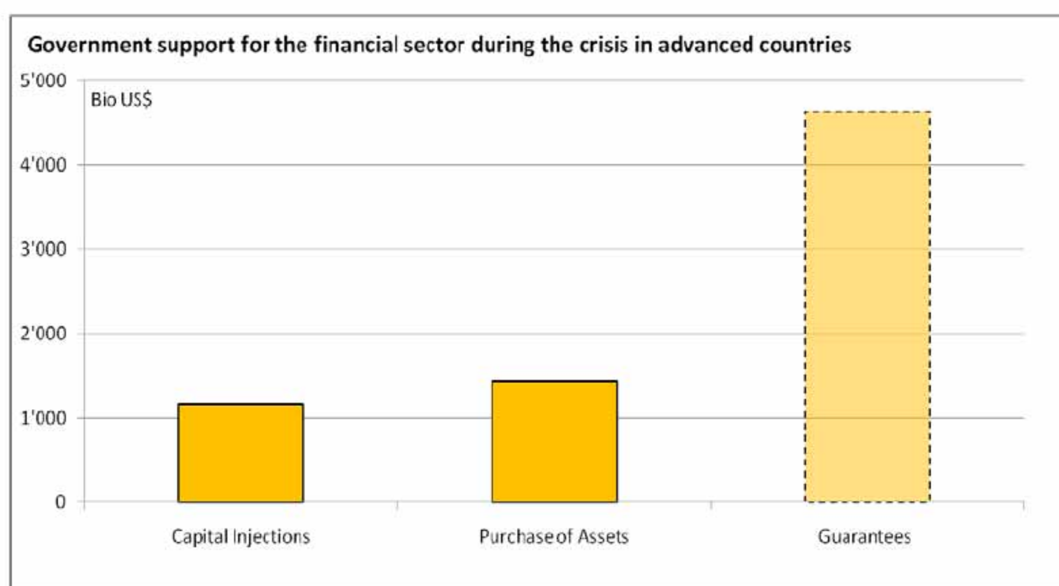
[11] Regulations on capital, liquidity and risk concentration.

Implementing these measures in full will make an effective contribution to significantly reducing the problem in Switzerland. This package considerably lessens the probability of a big bank crisis and the ensuing need for state support in such a crisis – which would create an intolerable strain in terms of regulatory and fiscal policy – and at the same time restores market discipline.

We need to be aware that regulation is never implemented without some cost to those regulated. However, fears about the extent of the potential repercussions are in my view unfounded, not least because consideration has been given to the costs involved during the drafting of the new rules. In particular, the newly introduced convertible capital will contribute to limiting the costs of stricter capital adequacy requirements. What is more, the organisational measures do not constitute excessive interference with the freedom of scope and responsibility enjoyed by a bank's management. Measures of this kind can only be subsidiary in nature. This means that the regulatory objective is not exceeded.

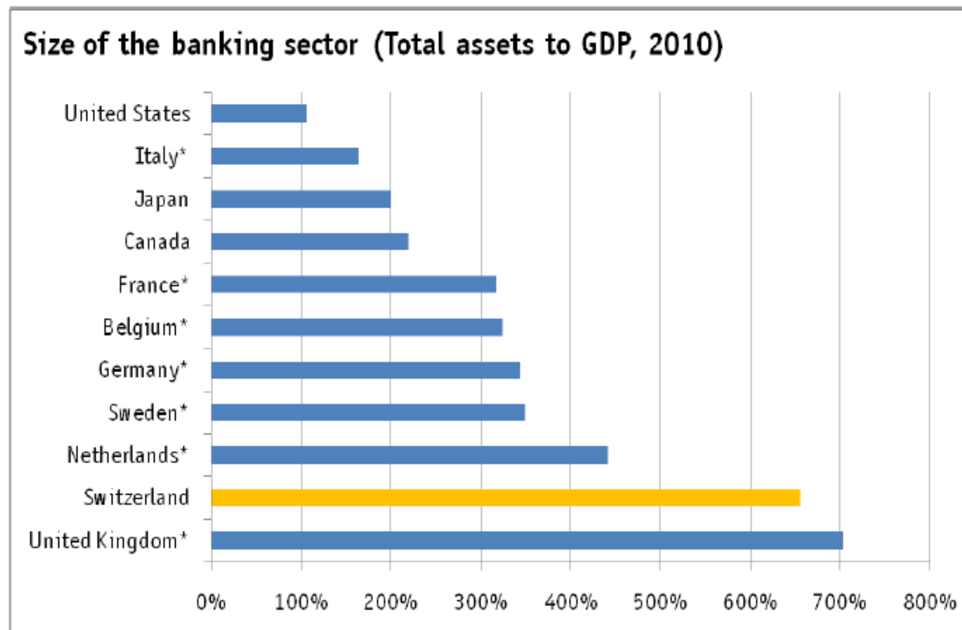
The increased stability brought about by this package will help not only Switzerland but also our entire financial centre to emerge from the latest crisis significantly stronger than before. What happened to UBS may not happen again. The proposed amendments to the regulations will also soon create legal certainty for the banks and allow them to plan concretely, while at the same time promoting the reasonable, long-term development of the financial centre. There is no doubt about the positive long-term consequences for the entire Swiss economy in terms of income and employment.

Chart 1



Source: IMF 2009

Chart 2



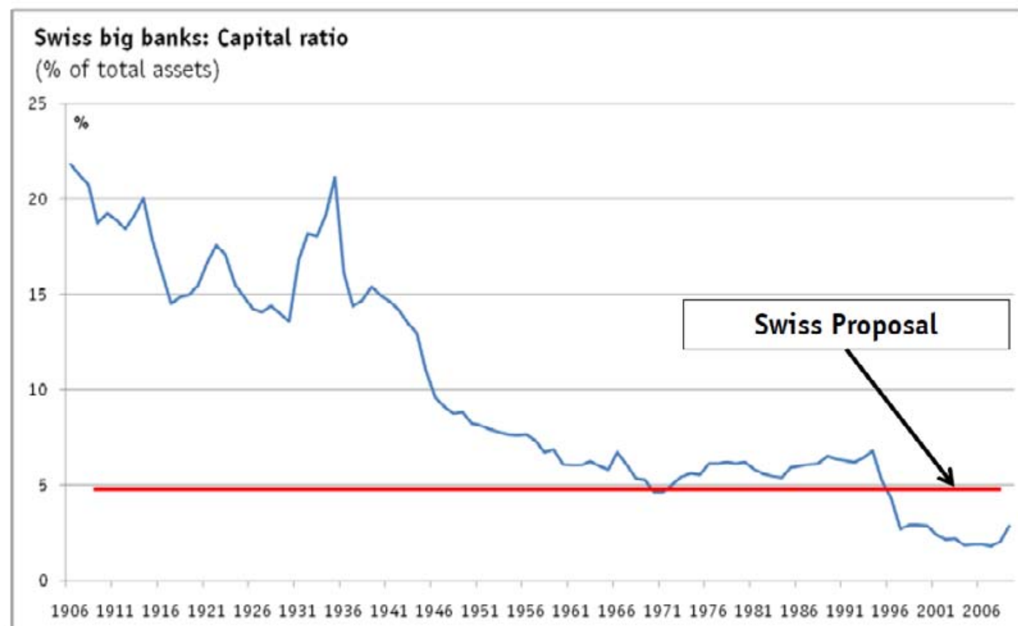
* As of June 2010; Sources: Bank of Canada, Bank of Japan, Bankscope, EZB, FFIEC, FINMA, Japanese Bankers Association, OECD, SNB

Chart 3

	Size of the banking sector (ratio of total assets to GDP, 2010)	Size of the two largest banks (ratio of total assets to GDP, 2010)
Belgium*	3.2	2.6
Germany*	3.4	1.1
France*	3.2	1.9
Italy*	1.6	1.0
Japan	2.0	0.6
Canada	2.2	0.8
Netherlands*	4.4	3.3
Sweden*	3.5	2.2
Switzerland	6.6	4.3
United States	1.1	0.3
United Kingdom*	7.0	2.5

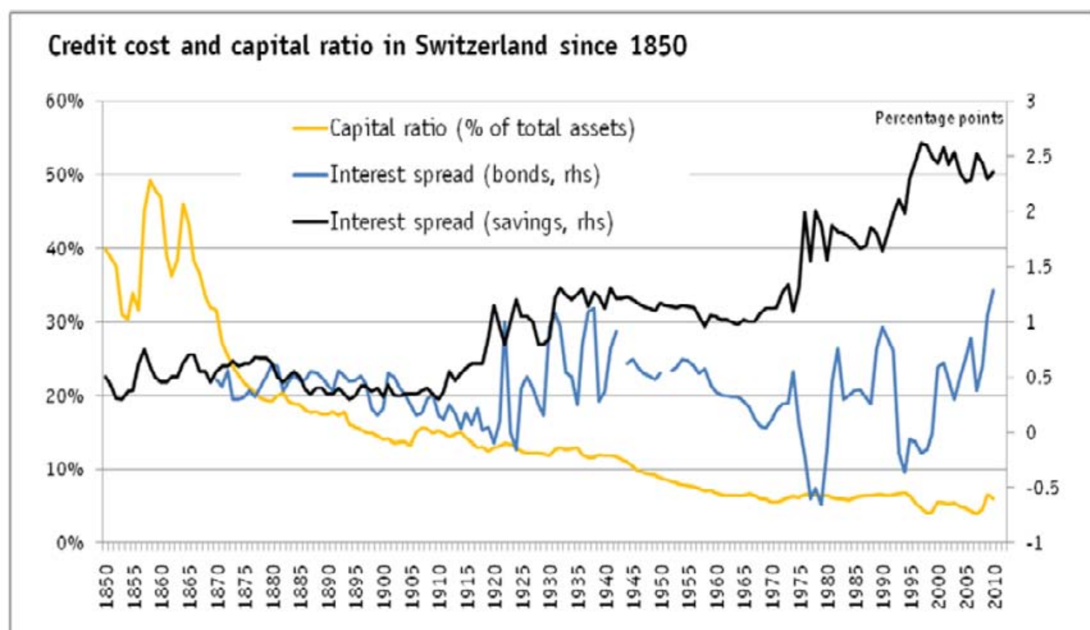
* As of June 2010; Sources: Bank of Canada, Bank of Japan, Bankscope, EZB, FFIEC, FINMA, Japanese Bankers Association, OECD, SNB

Chart 4



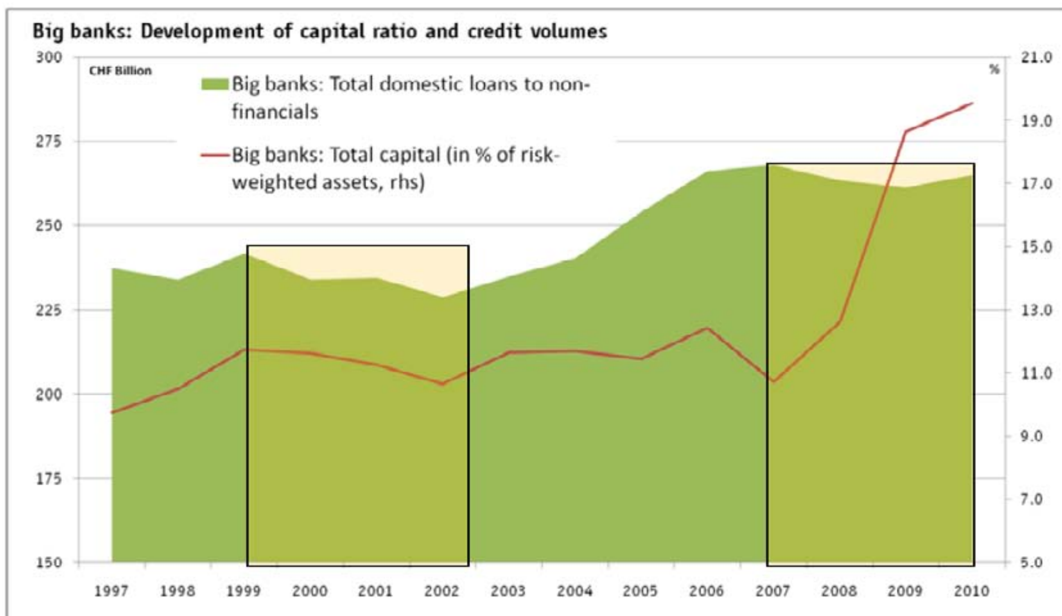
Source: SNB

Chart 5



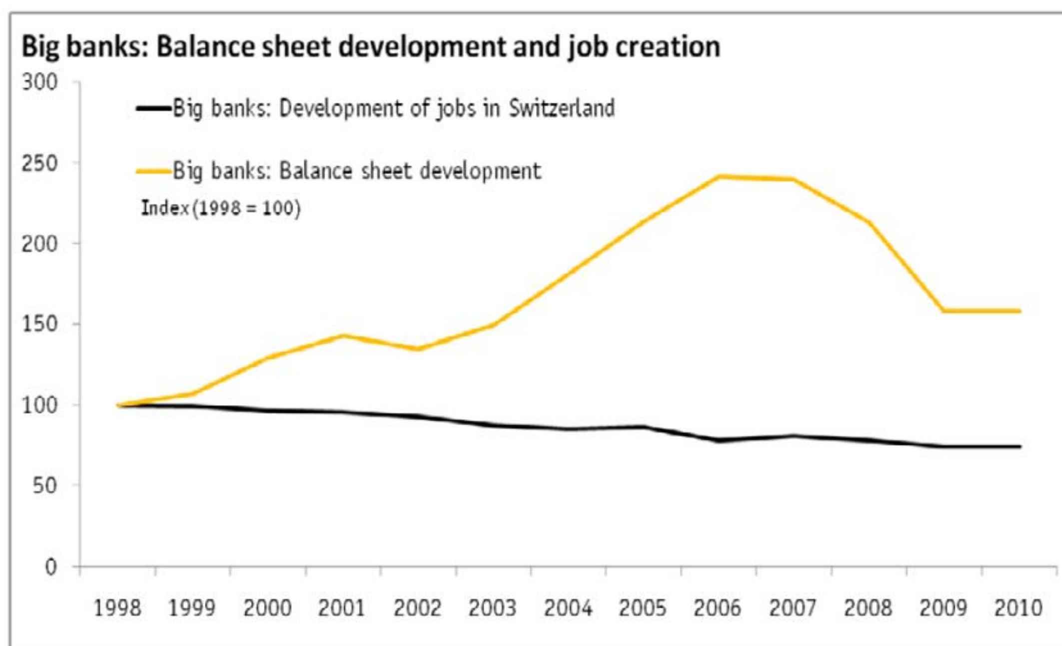
Source: Kugler 2011

Chart 6



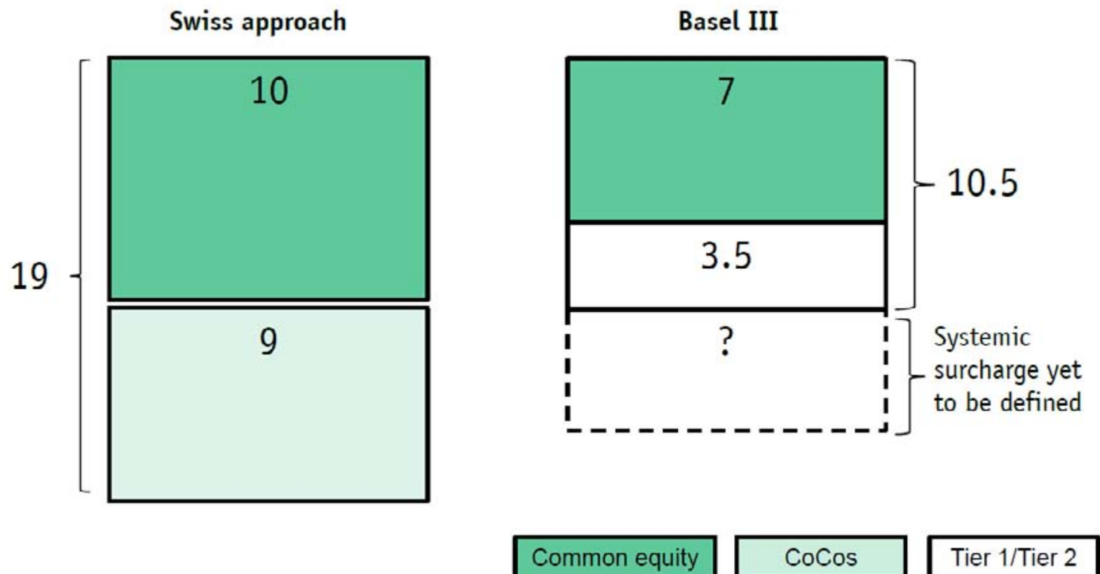
Source: SNB

Chart 7



Source: SNB

Chart 8



Source: SNB

Chart 9

Banking regulation - more than just capital requirements

Proposed regulation	CH	US	EU	Germany	UK
Bank levy	-	-	+	+	+
Capital requirements	++	+	+	+	+
Organisational measures	+	+	+	++	++
Narrow banking	-	+	-	-	-
Proprietary trading restrictions	-	+	-	-	-
Liquidity and risk diversification	+	+	+	+	+

++ Tougher than international trend
+ According ro international trend
- Not proposed

Source: SNB