

We got everything under control! Basel III and the Post-Crisis Regulation of the Financial Sector

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National Report of Switzerland

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The implementation of the Basel III guidelines

1. Is there a basic intent in your country to implement the Basel III guidelines? If yes: Why does your country intend to implement the Basel III guidelines?

Parallel to the numerous injections of liquidity by the public sector in the USA and most European countries in 2008, the Swiss public sector was forced to stabilize the Swiss financial system and its interdependencies abroad. Among the highlights were the issuance by UBS of a contingent convertible bond in the amount of CHF 6 bn subscribed by the Swiss Confederation and the acquisition by the SNB of illiquid assets of UBS in the amount of USD 38.7 bn².

Although the Confederation could sell the subscribed bonds making a profit of CHF 1.2 bn in 2009, public funds had been placed at risk and the intervention was thus strongly criticized by Swiss taxpayers. Further, the size of both “big banks”, Credit Suisse and UBS, in proportion to the Swiss GDP started to be seen as a threat to the Swiss financial system³. The Confederation would not let them fail and without any further measures, moral hazard would be favored and competition disrupted.

In November 2009, the Federal Council created the experts commission “Too big to fail (TBTF)” for the issuance of a report on the limitation of macroeconomic risks by big companies in general. The main objective was the systemic stability of the financial system and the avoidance of repeated support by public funds⁴.

2. In which stage of the implementation of the Basel III guidelines is your country currently? When will the rules be enacted?

Since 2010, Switzerland has revised and enacted several laws and regulations in order to give shape to the new capital requirements and follow Basel III as a minimum standard. The Federal Banking Act (FBA), the Federal Banking Ordinance (FBO), the Capital Adequacy Ordinance (CAO) and the Liquidity Ordinance (LO) have been revised /newly enacted, respectively. Further, a large number of Circulars have been issued by FINMA to detail the new capital requirements.

3. Is there a delay in the implementation of the Basel III guidelines? If yes, what is the main cause for it?

Basel III is being implemented in Switzerland following very similar transitory provisions as provided by Basel III itself. The amendments resulting from the

² Explanatory message of the Federal Council relating to the provisions of TBTF 11.028, of April 20, 2011 (Botschaft FBA), 4726.

³ Between 2003 and 2007, the average proportion of UBS assets to the Swiss GDP was of 280%. For Credit Suisse, the proportion was of 100%.

⁴ See final report of September 30, 2010 under www.sif.admin.ch.

TBTF bloc related to a) particular requirements for systemically relevant banks⁵; and b) new instruments accountable as eligible capital⁶ entered into force on March 1, 2012. The new CAO containing the more detailed provisions entered into force on January 1, 2013, with transitory provisions until 2018 at the latest.

The capital conservation buffer, will start to be applied in 2016⁷. The ratio of 2.5% coverage of risk weighted assets with common equity will be implemented progressively with increasing values from 2016 to 2018⁸.

The main new provisions in connection with reinforced insolvency measures for banks was implemented between September 2011 and January 2013⁹.

4. Does the national implementation of Basel III guidelines meet, exceed or undercut the stated minimum standards concerning the below mentioned issues?

Swiss capital requirements mainly meet and exceed the Basel III framework¹⁰. Most of the requirements are already implemented. As mentioned above, a transition period has been established in connection with individual features such as the creation of the capital buffer and the calculation method of risk weighted assets (RWA).

4.1 Eligible capital

Eligible capital consists of Common Equity Tier 1 (**CET1 and AT1**) capital for going concern capital and Common Equity Tier 2 (**CET2**) capital for gone concern capital, which are calculated as follows:

- **CET1: Common capital**, which is the sum of (i) paid-in capital (common shares¹¹), (ii) open reserves (including share premiums resulting from the issue of shares), (iii) reserves for general banking risks (iv) retained earnings and (v) interim profit or loss (after deduction of dividends to be distributed)¹²; and
- **AT1: Additional capital**, consisting of instruments that do not qualify as common capital but absorb losses at a contractually specified trigger, following the same principle as Basel III. Such trigger must be - at the latest -

⁵ Article 7 ss. FBA.

⁶ Article 11 ss. FBA.

⁷ Article 43 FBA.

⁸ See progressive values in article 144 CAO.

⁹ The articles 28 ss. FBA entered into force in September 2011. The Federal Ordinance on Insolvency of Banks entered into force in November 2012 and detailed provisions were inserted in articles 21 ss. FBO in January 2013.

¹⁰ Botschaft FBA, 4728.

¹¹ Preference shares only can be accounted as common capital subject to particular requirements, amongst other that they are junior to all other liabilities together with the rest of common shares.

¹² Article 21 CAO.

the falling of CET1 below the threshold of 5.125% of risk weighted assets (RWA)¹³.

Instruments qualifying as additional capital can be preference shares or debt instruments and must be perpetual. Among debt instruments, two main mechanisms can apply to generate the loss absorption: (i) a partial¹⁴ or total write-off (*Forderungsverzicht*) or (ii) a conversion in common equity (*Wandlungskapital*). Their conditions of issuance are subject to FINMA's approval.

Besides the trigger mentioned above, the write-off or conversion have to be executed prior to any granting of a public capital injection and in any case upon order from FINMA to prevent the institution from bankruptcy (so called point of non-viability, PONV)¹⁵. This provides FINMA with a relatively broad frame of judgment in this respect.

Under the instruments which can be accounted for as AT1 the contingent convertible bonds or so called "CoCos" enjoy particular acceptance in the capital market. Already in February 2011, Credit Suisse issued CHF 2 bn CoCos called Buffer Capital Notes. From a corporate perspective, the issuance is facilitated by the law as the general assembly can, by means of an amendment of the by-laws, allow the board of directors of a bank to make future capital increases up to a particular amount. Where it would be required for the benefit of a swift and smooth placement of shares or share certificates, the board is allowed to cancel the right of preferential subscription of shareholders on a particular placement¹⁶, which facilitates the issuance of CoCos¹⁷. Further, CoCos enjoy a beneficial tax treatment¹⁸.

- **T2 (CET2)** instruments are similar to AT1 bonds as they also must provide a complete conversion into capital or write off in case of reaching PONV. CET2 enjoy less stricter rules, as for instance they can have a limited maturity of 5 years¹⁹.

¹³ Article 27 para. 3 CAO.

¹⁴ Only to be accounted as CET1 for the part which can be written-off.

¹⁵ Article 29 CAO.

¹⁶ Article 12 FBA.

¹⁷ See "Contingent Convertible Bonds – CoCos, Umsetzung in der Schweiz", René Bösch and Benjamin Leisinger, SWZ/RSDA 1/2012.

¹⁸ See Amendment to Federal Law on Withholding Taxes for the Activation of the Swiss Capital Market of January 2013.

¹⁹ Article 30 CAO.

The above requirements are in line with the Basel III definitions of eligible capital. Equal to Basel III, also reductions apply to the eligible capital for the elements which are not capable to absorb losses²⁰.

4.2 Required capital

Required Capital for non-systemically relevant banks is the sum of the following concepts:

- **Minimum capital requirements**²¹:
 - CET1 = 4.5% of RWA (3.5% in 2013 and 4% in 2014)
 - CET1 + AT1 = 6% of RWA (4.5% in 2013 and 5.5% in 2014)
 - CET1 + AT1 + T2 = 8% of RWA

RWA are calculated by assigning the asset to a type of position and applying the corresponding risk weighting factor²². The CAO allows risk weighting of assets according to the following systems:

- SA-BIZ which allows the utilization of ratings published by rating agencies; or
- IRB (simple or advanced), which requires prior authorization of FINMA. FINMA is required to follow Basel minimal standards.

Until the end of 2018, banks are allowed to use the Swiss standard approach (SA-CH).

- **Capital buffer** amounting to additional 2.5% of RWA to be covered with CET1. There is a transitional period and the capital buffer will enter into force from January 2016²³. Progressive factors apply from 2016 to 2018²⁴.
- **Countercyclical buffer** is currently structured in a way that the SNB is empowered to request the Federal Council to oblige banks to hold an amount of additional CET1 up to 2.5% of RWA, in order to increase resilience

²⁰ Article 31 ss. CAO.

²¹ Article 42 CAO.

²² Basler Kommentar FBA, Helbling, 2. Edition, Philippe Bingert, Bernhard Hinemann (BSK), N 61.

²³ Article 43 CAO.

²⁴ Article 144 CAO.

against an excessive growth of credits²⁵. On January 2014, the SNB requested an increase from 1% to 2% of RWA secured by Swiss mortgages²⁶.

- **Additional capital:** Further to the above, FINMA may require add-ons depending on the size of the bank²⁷.

4.3 Leverage ratio:

Following the Basel III framework, FINMA has been empowered by the FBA to set a leverage ratio within the observation period provided within Basel III, which goes from January 1, 2011 to January 1, 2017. The disclosure duty of leverage ratio by banks in 2015 provided within Basel III is expected to be implemented by an amendment of FINMA Circular 2008/22. The leverage ratio shall be transposed by a modification of CAO by the end of the observation period²⁸.

5. How many systemically relevant financial institutions are located in your jurisdiction?

The SNB designates by means of a regulation and after consultation of FINMA, which banks are considered systemically relevant banks and which their systemically relevant functions are²⁹. Currently, the Swiss banks designated by the SNB as systemically relevant are UBS, Credit Suisse and Zurich Cantonal Bank.

6. How does your country regulate the capital requirements for systemically relevant financial institutions?

Systemically relevant banks must fulfill particular additional capital requirements. Such requirements have to observe the principle of proportionality and therefore take into account both, the level of systemically relevance and the particular impact of implementation for the bank in terms of competition³⁰.

The requirements for systemically relevant banks are as follows³¹:

- Capital requirements shall allow a higher loss absorbency, allow the continuity of systemically relevant functions, limit the level of systemic

²⁵ Article 44 CAO.

²⁶ Communication from SNB of January 23, 2014.

²⁷ Proposed New Capital Adequacy Rules Remodel Swiss Regulatory Capital Framework, René Bösch/Jonas Oggier, CAPLAW 2012/2.

²⁸ FINMA Communication (25) 2011.

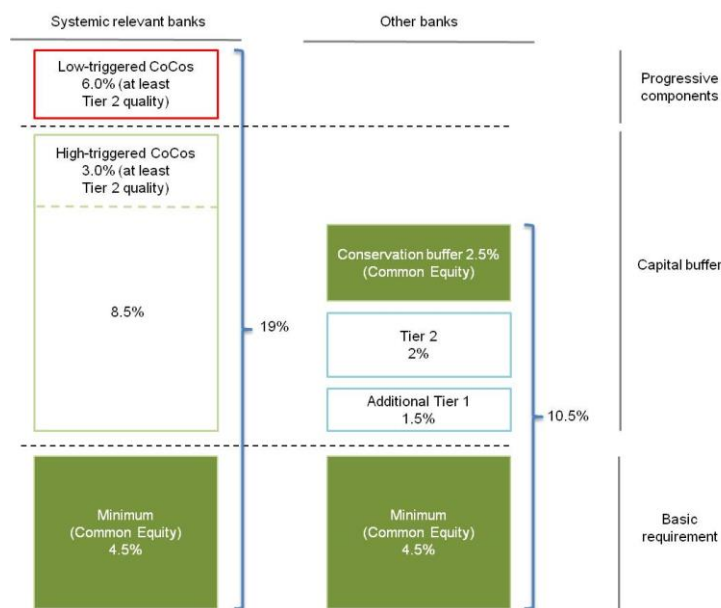
²⁹ Article 8.3 FBA.

³⁰ Article 9.1 FBA.

³¹ Article 9.2 FBA.

relevance and be measurable based on risk weighted assets and out of balance transactions. The particular requirements are as follows³²:

- CET1 = 4.5% RWA
 - Capital buffer = 8.5% RWA, to be covered with a minimum of 5.5% CET1 and a maximum of 3% of CoCos with trigger at 7% of RWA.
 - Variable progressive component depending on degree of systemic relevance : to be covered with CoCos with a trigger at 5.5% of RWA³³.
 - Countercyclical buffer of up to 2.5%³⁴
- Liquidity requirements shall absorb liquidity shortfalls;
 - Counterparty and cluster risk limitation requirements;
 - An emergency plan shall allow continuity of functioning of systemically relevant functions in case of imminent insolvency with independency of other functions.



7. Do you think that many banks in your country will struggle to meet the requirements of Basel III? Why do you think so?

Swiss banks are implementing the Swiss enactments as applicable according to the transitory provisions referred to above. The aim is to fully comply with the

³² Transitory provisions also apply to systemically relevant banks.

³³ Such variable component provides with some flexibility which allows the Swiss system to adapt to international developments. According to the TBTF report, the maximum capital requirement shall in total not exceed 19%.

³⁴ Recently increased by SNB to 2% RWA.

final provisions in 2019. Evidently, the measures put pressure on profitability margins and reduce return on equity and thus earn criticism from the banking sector now and then. On the other hand, the market for bondholders of CoCos has been very positively established, and the strict Swiss regime of the Basel III is sometimes even seen as a competitive advantage of the Swiss financial sector.

Regulatory Framework for Managers of Alternative Investment Funds

8. Is there any legislation in your jurisdiction concerning Managers of Alternative Investment Funds?

The Swiss Federal Collective Investment Schemes Act (**CISA**) establishes the basic framework for the regulation of managers of collective investment funds in Switzerland. Further, the Federal Regulation on Collective Investment Funds (**CISO**) and the FINMA Ordinance on Collective Investment Funds (**CISO-FINMA**) contain more detailed provisions in this field.

9. Is your jurisdiction member of the EU or the EEA and therefore legally obligated to implement the AIFM Directive 2011/61/EU? If yes: is the implementation of the AIFM Directive 2011/61/EU already successfully completed?

Switzerland is not a member of the EU or the EEA and is therefore not obliged to transpose the AIFM Directive. The AIFM Directive contains however third country provisions considering equivalency of regulations. It is therefore in the interest of Switzerland as a third country to develop equivalent regulations which enable Swiss based investment schemes to be present in the EU market.

10. At which point in time was the legislation concerning AIFM enacted?

CISA and CISO have recently been revised with the aim of making them compliant with the provisions of the AIFM Directive regarding the status as third country. The new provisions have entered into force in March 2013. The main amendments of the revised CISA are as follows:

- (a) all kind of AIFMs are subject to authorization and supervision³⁵ – until recently, only the AIFMs of Swiss based AIFs were supervised by FINMA - ;
- (b) the provisions on custody are aligned to international standards, increasing responsibilities of custodian banks; and
- (c) the distribution to qualified investors in Switzerland is now regulated³⁶.

³⁵ Certain de-minimis exceptions apply.

³⁶ The revised CISA aims to be compliant with the AIFM Directive requirements, and harmonizes such requirement for all AIFMs notwithstanding whether they will be subject to EU regulations or not.

11. What is the name of the competent supervisory authority for Alternative Investment Funds in your country?

The principal supervisory authority is the Swiss Financial Market Supervisory Authority FINMA³⁷, which is in charge of granting licenses and supervising collective investment funds. In addition, a dualistic supervision concept applies according to which auditors exercise supervision “as if they were the extended arms of FINMA”. AIFMs are required to instruct an auditor with the audit of the assets managed and the management of the AIF³⁸.

12. Which minimum-capital does an AIFM require in order to obtain a license or authorization?

Depending on the activity performed by the collective investment fund manager, different capital requirements apply as follows³⁹:

- If it conducts funding business for foreign collective investment funds, the minimum capital required for the manager is of CHF 500'000;
- If it administrates individual portfolios, provides investment advice, distributes the fund or represents foreign investment funds, the minimum capital required amounts to CHF 200'000.

In case of partnerships, a bank guarantee covering the respective amounts can be provided.

13. How long is the duration of authorization process to obtain an AIFM-license?

According to data published by FINMA, the average duration of authorizations of Swiss based collective investment schemes in the first quarter of 2013 amounted to 75 days⁴⁰. For AIFs which are already supervised by a foreign regulator, FINMA may establish a simplified and accelerated authorization procedure in individual cases⁴¹.

14. What are the key elements of the authorization process?

Both foreign and Swiss based managers and distributors of collective investment funds which operate in Switzerland are subject to CISA⁴². Such managers and distributors are required to obtain a license from FINMA in order to operate⁴³. The

³⁷ Article 1 Swiss Financial Market Supervision Act (FINMAG).

³⁸ Article 128 ss. CISA.

³⁹ Article 19 CISO.

⁴⁰ FINMA Communication of August 14, 2013 by Products and Distribution on Markets, p. 12.

⁴¹ Article 17 CISA and 120 CISA.

⁴² Article 1 c) CISA.

⁴³ Article 13 CISA.

Federal Council can release managers who are subject to an equivalent supervision in a third country from the licensing requirement⁴⁴.

The requirements to obtain a license are detailed in CISA. The following key elements can be highlighted: (a) the manager has to enjoy a good reputation, be able to safeguard a proper management and hold the required professional qualifications; (b) the persons holding a qualifying holding must enjoy a good reputation as well ; (c) the fulfillment of the obligations of CISA have to be ensured by the internal operational organization; (d) sufficient collateral must be provided.

Further to the authorization requirements above, the corporate documents of the collective investment scheme are subject to authorization by FINMA⁴⁵.

15. Is it mandatory for AIFM to have a local residence in your jurisdiction?

It is not mandatory that a manager of collective investment funds has local residence in Switzerland in order to be able to distribute or manage AIFs in or from Switzerland. However, if the funds is mainly managed in Switzerland or the fund's assets are exclusively transacted in Switzerland, the manager is required to be incorporated in Switzerland and comply with the applicable provisions for Swiss based managers⁴⁶.

Further, distribution of a non-Swiss based AIF in Switzerland requires the appointment of a representative who protects the interest of investors in Switzerland.

16. Does the legislation distinguish between different types of AIFM? What are the key differences between them?

Managers of collective investment funds with qualified investors (as defined in Question 23 below) which comply with one of the following conditions are exempt from regulation⁴⁷: (i) assets under management amount to a maximum of CHF 100 million; (ii) assets under management amounting to a maximum of CHF 500 million consisting of not leveraged collective investment funds with a redemption of at least five years; or (iii) the investors are exclusively group companies of the manager.

17. Are there any legislative restrictions regarding legal structures of AIFM?

CISA allows the following legal forms of managers⁴⁸:

⁴⁴ Article 13 para. 3 CISA.

⁴⁵ Article 15 CISA.

⁴⁶ Article 29a para. 2 CISO.

⁴⁷ Article 2 para. 2 lit. h CISA.

⁴⁸ Article 18 CISA.

- (a) legal entity in the form of a corporation (*Aktiengesellschaft*), association limited by shares (*Kommanditaktiengesellschaft*), or a limited partnership (*GmbH*);
- (b) a partnership limited by shares (*Kollektiv- und Kommanditgesellschaft*);
- (c) a Swiss branch of a foreign manager of collective investment funds, if it is subject to adequate supervision, sufficiently organized and there is a cooperation agreement for exchange of information between FINMA and the corresponding regulatory authority.

Further, foreign managers of collective investment who conduct distribution activities in Switzerland can have the form of a legal entity organized under the laws of their home country if they have obtained a corresponding license in such country and use the term “manager of collective investment funds” either in their trade name or business documentation.⁴⁹

18. If you are a member of the EU or EEA, can a AIFM in your country obtain an EEA/EU-passport which enables to distribute AIFs to professional investors?

Even though Switzerland is not a member of the EU, the regulation for non-EU AIFMs of the AIFM Directive becomes relevant when a Swiss based AIFM is active in a relevant part of the EU or actively markets the fund in the EU to a professional investor⁵⁰. According to the AIFM Directive, after a transition period of two years (i.e. at the earliest in 2015), a harmonized passport regime for third countries becomes applicable. At this point, a non-EU AIFM should be able to request an EU-pass. This only will be possible if the non-EU AIFM is fully compliant with the AIFM Directive.

19. Do AIFs themselves require to be licensed or authorized by a competent supervisory authority?

The collective investment fund, in whichever form it has been constituted, is required to obtain an authorization from FINMA. Both Swiss based collective investment funds and foreign collective investment funds which are distributed in Switzerland are subject to supervision by FINMA⁵¹.

Also the documentation of the fund is subject to FINMA’s approval, with the exception mentioned below.

⁴⁹ Article 29a CISO.

⁵⁰ Except in cases where the de-minimis thresholds defined by the Directive would not be reached or certain transitory provisions would apply.

⁵¹ Article 2 para. 1 CISA.

20. How are AIFs categorized and what is the authorization or license requirement for each category?

Mainly, the following persons or entities require a license of FINMA: (i) fund management companies⁵²; (ii) SICAVs⁵³; (iii) limited partnership for collective investments⁵⁴; (iv) SICAFs⁵⁵; custodian banks⁵⁶; managers of collective investment funds⁵⁷; distributors⁵⁸; representatives of foreign collective investment funds⁵⁹. The license is granted if both the general and the institution-specific conditions are fulfilled.

The distribution of foreign investment funds to qualified investors in Switzerland does not require an authorization⁶⁰.

21. How long does the process or authorization or licensing of AIFs take?

For such funds which require the authorization of FINMA, the same answer applies as in Question 13 above.

22. Are there certain legal structures for AIFs? Please name them.

There are mainly two categories of collective investment funds:

- a) Open-ended investment funds, where investors have either a direct or indirect legal entitlement to redeem their units at the net asset value. They can be in the form of:
 - (i) a contractual fund; or
 - (ii) an investment company with variable capital.
- b) Close-ended investment funds, where investors have no entitlement at the expense of the collective assets to the redemption of their units at the net asset value. They can be in the form of:
 - (i) a limited partnership for collective investment; or
 - (ii) an investment company with fix capital.

⁵² Article 28 ss. CISA.

⁵³ Article 36 ss. CISA.

⁵⁴ Article 98 ss CISA.

⁵⁵ Article 110 ss. CISA.

⁵⁶ Article 72 ss. CISA.

⁵⁷ Article 18 ss. CISA.

⁵⁸ Article 19 CISA.

⁵⁹ Article 119 ss. CISA.

⁶⁰ Article 120 CISA.

23. What are the key differences with reference to the authorization and marketing of AIFs that are distributed to retail investors and those only distributed to professional investors?

Distributors of collective investment funds which are exclusively distributed to qualified investors are excluded from the field of application of CISA⁶¹. As specified in Question 16, managers of funds which are solely distributed to qualified investors and comply with certain requirements are not subject to CISA. Both the documentation of the collective investment funds which are distributed to retail and to professional investors need to be approved by FINMA. Only regarding foreign investment funds which are solely distributed to professional investors, the fund documentation does not require FINMA's approval⁶².

Qualified investors are defined as follows: (i) supervised financial intermediaries such as banks, securities dealers and managers of collective investment schemes; (ii) supervised insurance institutions; (iii) companies with professional treasury. High net-worth individuals are entitled to request to be treated as qualified investor in written. A private person is considered a qualified investor if one of the following conditions are fulfilled:

- (i) the investor proves that based on the education and professional experience, he or she has acquired sufficient knowledge in order to assess the risks related to the investment and has personal means of at least CHF 500'000; or
- (ii) the investor confirms in written that he has personal means of CHF 5 million.
- (iii) Further, investors who have signed a written asset management agreement are considered as qualified investors if they do not declare the opposite.

24. Are there any special requirements for leveraged AIFs?

As mentioned in Question 16, one of the exceptions for which the managers of investment schemes are not subject to an authorization of FINMA apply solely to not leveraged investment funds.

25. Are there any special regulations with regard to private investors or semi-professional investors?

As mentioned in Question 23, high net-worth individuals are entitled to request to be treated as qualified investors.

⁶¹ Article 2 para. 1 lit. e) CISA.

⁶² Article 15 para. 1 lit. e) CISA.