Preparing for the 1000 year floods – the Swiss approach to the TBTF problem

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11th Annual International Seminar on Policy Challenges for the Financial Sector

Washington
June 2, 2011
The Swiss approach - outline

- **Structural measures** in order to improve the resilience and resolvability of SIFIs
  - Swiss approach combines capital and organisational measures

- **Countercyclical measures** in order to reduce the build-up of systemic risks
  - Add macroprudential instruments to the financial stability framework
Higher capital requirements: Three basic goals

- **Increasing stability** – more equity makes banks more stable and thus *reduces the probability of a crisis*

- **Realigning incentives** – if designed appropriately, a tighter capital framework will strengthen incentives to *reduce excessive risk-taking and hence the systemic risk* stemming from big banks

- **Crisis management** – more equity contributes to crisis management and thus *limits the potential systemic disruptions* caused by a big bank’s failure
Design of the new capital framework for SIFIs in Switzerland

I. Basic requirement
   - 4.5% Common Equity

II. Buffer
   - 5.5% Common Equity
   - 3% Cocos (with high trigger)

III. Progressive component
   - 6% Cocos* (with low trigger)

19% Total Capital*

*Calibration given the current size of the Swiss SIFIs
Why contingent capital?

- Incentives for better risk monitoring by creditors and shareholders
- Automatic conversion provides funding when it is most needed
- Less expensive but similarly loss-absorbing than common equity
Organisational measures: Two fundamental goals

- Ensure the maintenance of systemically important functions at any time
- Make the orderly resolution of a failing financial institution a viable option
Organisational measures: Key elements of the Swiss approach

- Banks are required to **demonstrate** their ability to maintain systemically important functions even in a severe crisis.

- Banks must provide a **feasible emergency plan**
  - Namely: Proof that organisational structure allows for a **timely transfer of systemically important functions** to an independent legal entity.

- Imposing organisational measures follows the **principle of subsidiarity**.
Tight interaction of capital framework and organisational measures

- **In times of serious stress** – e.g. if common equity falls below 5% - the emergency plan kicks in

- At this point of time **sufficient capital must be available** to
  - absorb losses during implementation of the emergency plan
  - capitalise the new legal entity and **assure an orderly resolution** of the remainder of the company
  - ensure equal treatment of all creditors

- To achieve this, **cocos** of the progressive component are **converted** to common equity **at the very same moment**
Wrap-up: Structural measures to mitigate the TBTF problem

- Swiss approach: **Incentive-oriented model** combining capital and organisational measures
- **Increase risk-awareness and enhance accountability** of bank management, investors and creditors
- **Improves overall resolvability** of global SIFIs while reducing the need to apply for taxpayer’s money
Macroprudential instruments to prevent the build-up of cyclical excesses

- **Structural measures** focusing on robustness and resolvability are very important

- In addition: Increasing importance of **countercyclical instruments** in order to further **improve crisis prevention**
Towards a new financial stability framework

Two goals

Strengthening the resilience of the financial system

- A tighter definition of equity
- Improved risk management
- Capital conservation buffers

Preventing the build-up of excesses or imbalances

- A capital surcharge for SIFIs
- Countercyclical capital buffers
- LTV ratios
- New instruments?

Microprudential instruments

Macroprudential instruments

Monetary policy instruments

- Interest rates
Macroprudential framework – next steps

- **Defining** and evaluating effectiveness of **new structural and countercyclical instruments**
- **Understanding the interaction** between microprudential, macroprudential, and monetary policy
- **Clearly define the responsibilities**, duties and rights of different authorities
- However, there are **open issues** - we must always **act prudently** and **assess** any new instrument **thoroughly**