

Too big to fail

8th Annual NBP – SNB Joint Seminar
Zurich, 16 May 2011

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Financial Stability – Systemically Important Banks

Outline

- The 'Too big to fail' (TBTF) issue
- Why is TBTF a problem?
- Special situation in Switzerland
- The proposed TBTF-regulation in Switzerland
- International comparison

'Too big to fail'

- In the current financial crisis the systemic importance of large financial institutions became clear
- Systemically important banks are considered 'too big to fail' (TBTF) because a bankruptcy would lead to a collapse of the financial system and have huge negative effects for the economy
- Worldwide banks have been rescued at enormous costs to taxpayers:
 - ➔ **Large, systemically important banks have an explicit government guarantee**

Why is TBTF a problem?

- No threat of bankruptcy
- TBTF-guarantee has the same effect as an insurance policy
 - ➔ It protects creditors from the consequences of bankruptcy
 - ➔ It creates moral hazard (excessive risk-taking)
- Funding costs are too low (risk premia lower than for banks without TBTF-guarantee)
 - ➔ **TBTF-guarantee is equivalent to a subsidy**

Subsidy arising from TBTF-guarantee

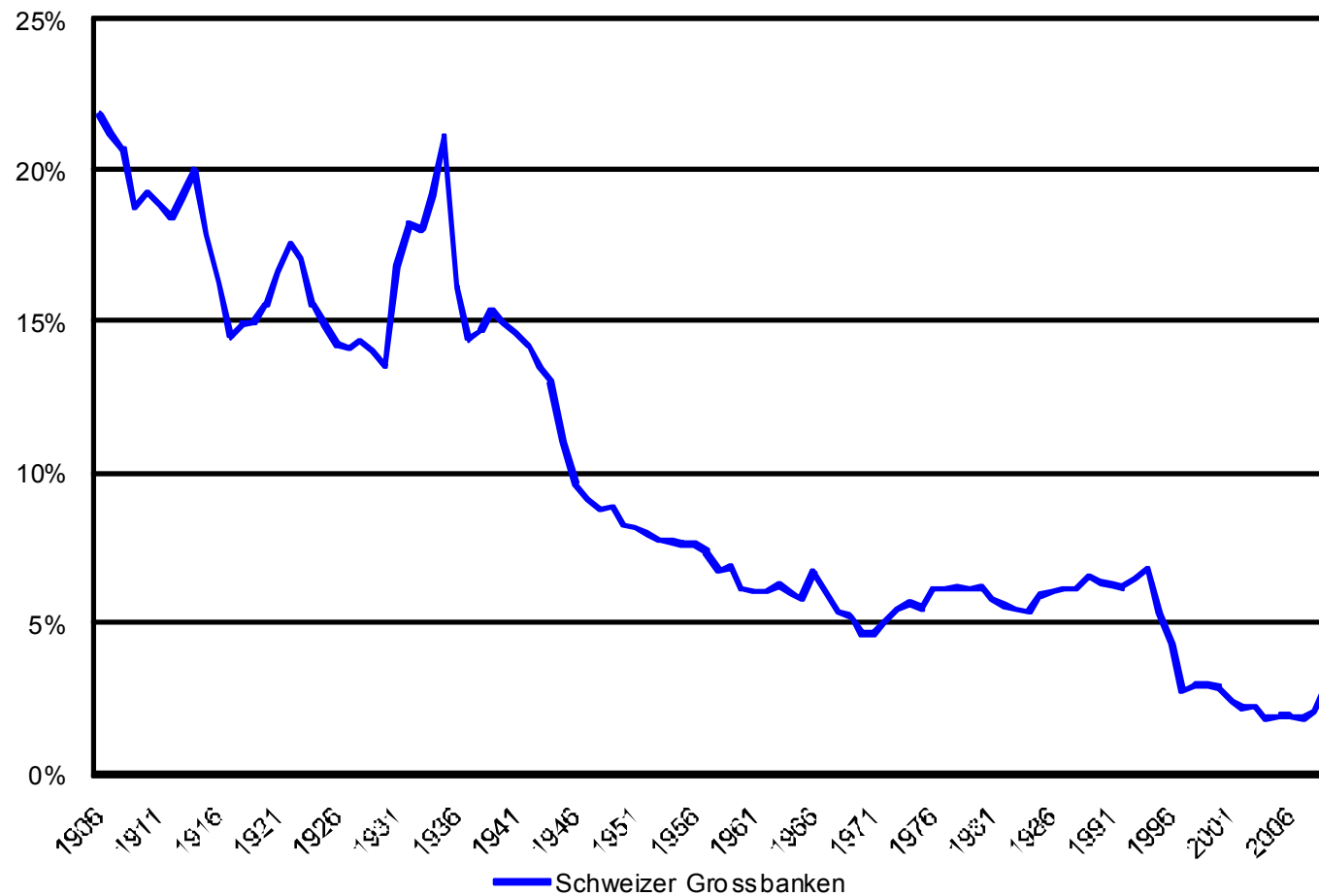
- Rating-bonus: difference between long-term rating and financial strength rating
 - Current difference (Moody's): 2 notches for Credit Suisse, 3 for UBS
 - End of 2009 (Fitch): 3 notches for Credit Suisse, 9 for UBS
- Funding cost differs by ratings
- Bonus is between 40 bp and 100 bp – depending on method used
- For UBS and Credit Suisse the subsidy has a value of between CHF 3 Mrd. and CHF 20 Mrd. – per bank and per year

Further effects of TBTF

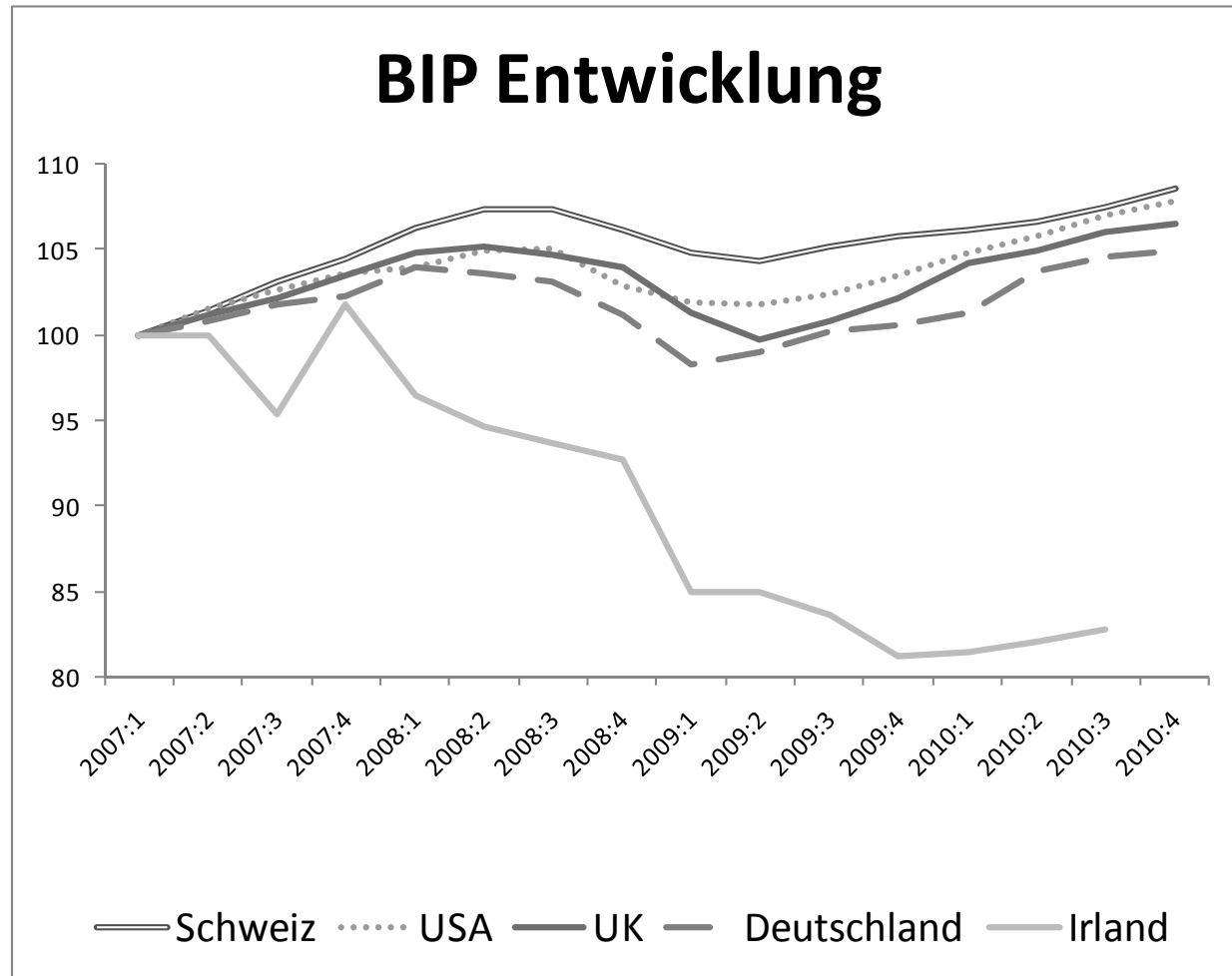
- Because of low funding costs banks have incentive to increase their leverage
- With a high leverage even small losses and value adjustments can lead to serious consequences
- TBTF can lead to huge costs to taxpayers
- The costs of banking sector crisis can have (long-term) negative effects on growth
- TBTF is a contradiction to a free market economy

Leverage

Kernkapital zu Bilanzsumme



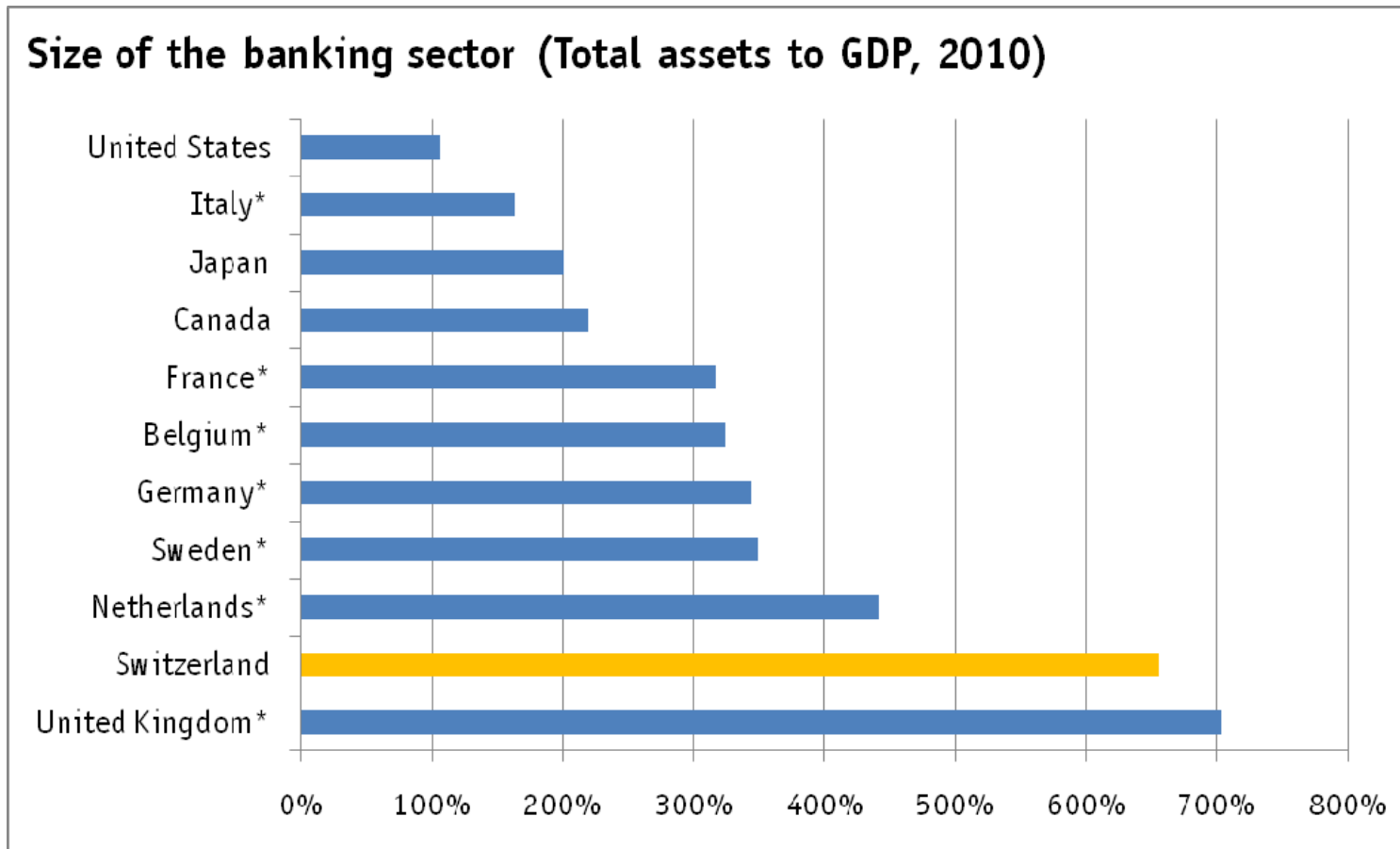
Costs



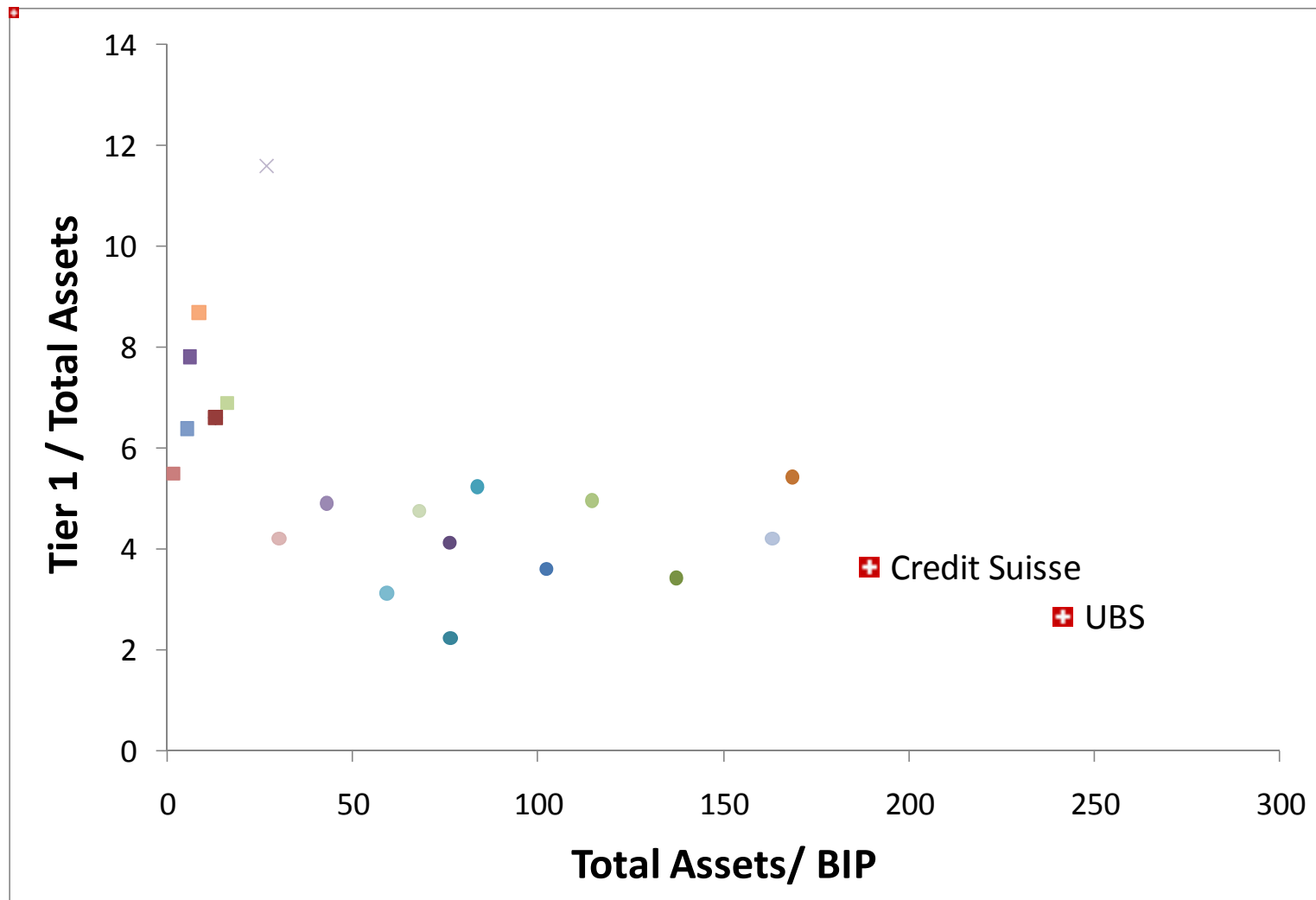
International regulation: Basel III

- Basel III is an important step in the right direction
- Stricter definition of capital and higher buffers for capital and liquidity
- **However**
 - Basel III has no special rules for TBTF banks – this should be decided by the FSB in conjunction with BCBS
 - Basel III is calibrated for the international average not for the special situation in Switzerland

Special situation in Switzerland



Special situation in Switzerland (continued)



Situation in Switzerland

- Switzerland weathered the crisis quite well
- TBTF issue remains unsolved
- If TBTF is not addressed the next crisis could have severe consequences for Switzerland
- Switzerland has a special situation – Switzerland needs a special solution

The Swiss TBTF-Regulation

- Commission of Experts recommends Policy-Mix:
 - Capital
 - Liquidity
 - Organisational measures
 - Risk diversification
- Proposal based on the Experts' report should be discussed in the Swiss Parliament this year
- New Regulation could come into effect as early as 2012

Swiss TBTF-Regulation: Capital requirements

Basic requirement

... for the maintenance of normal business activities

Buffer

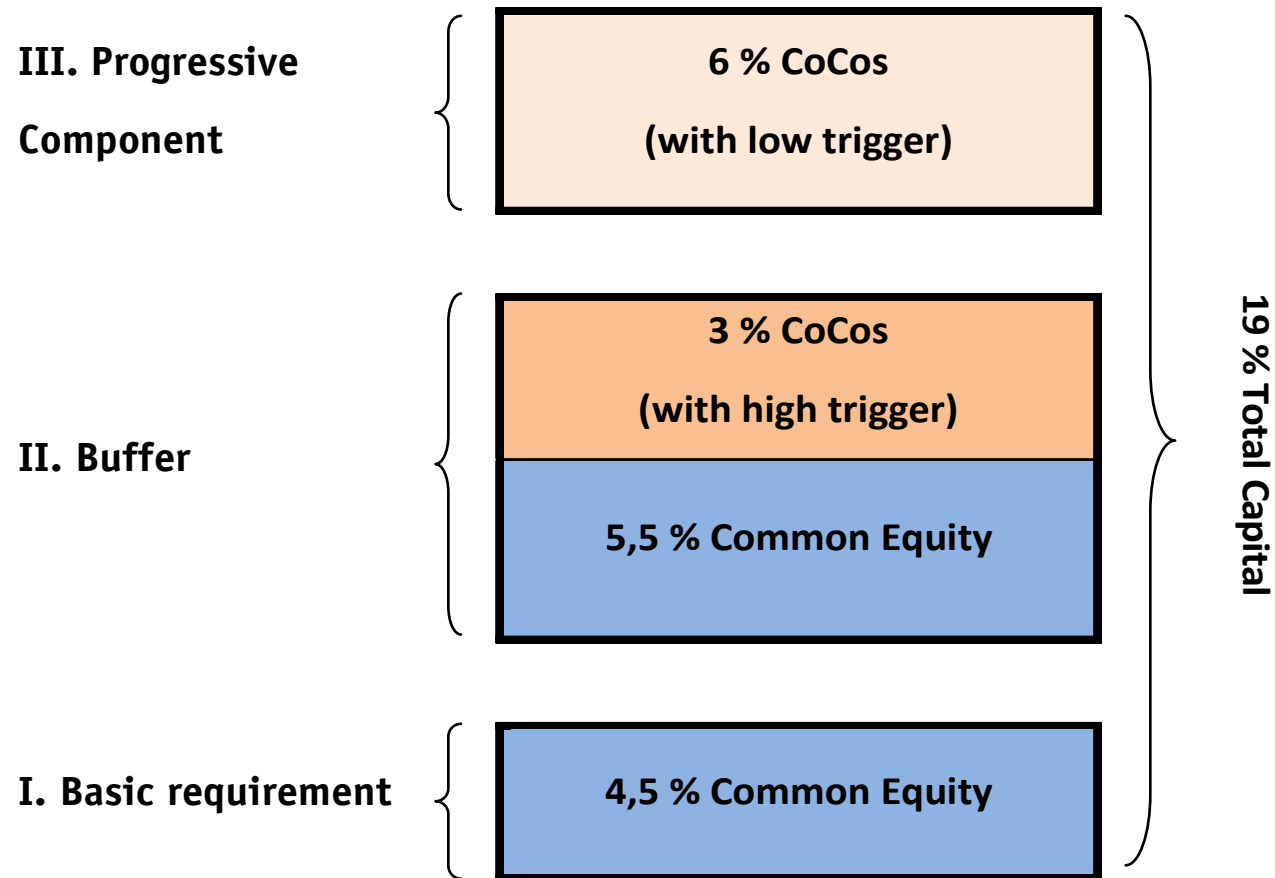
... to absorb losses

Progressive component

... for crisis management and to set incentives

Risk-weighted approach is complemented by a leverage ratio

TBTF - Capital requirements (continued)



New capital instruments

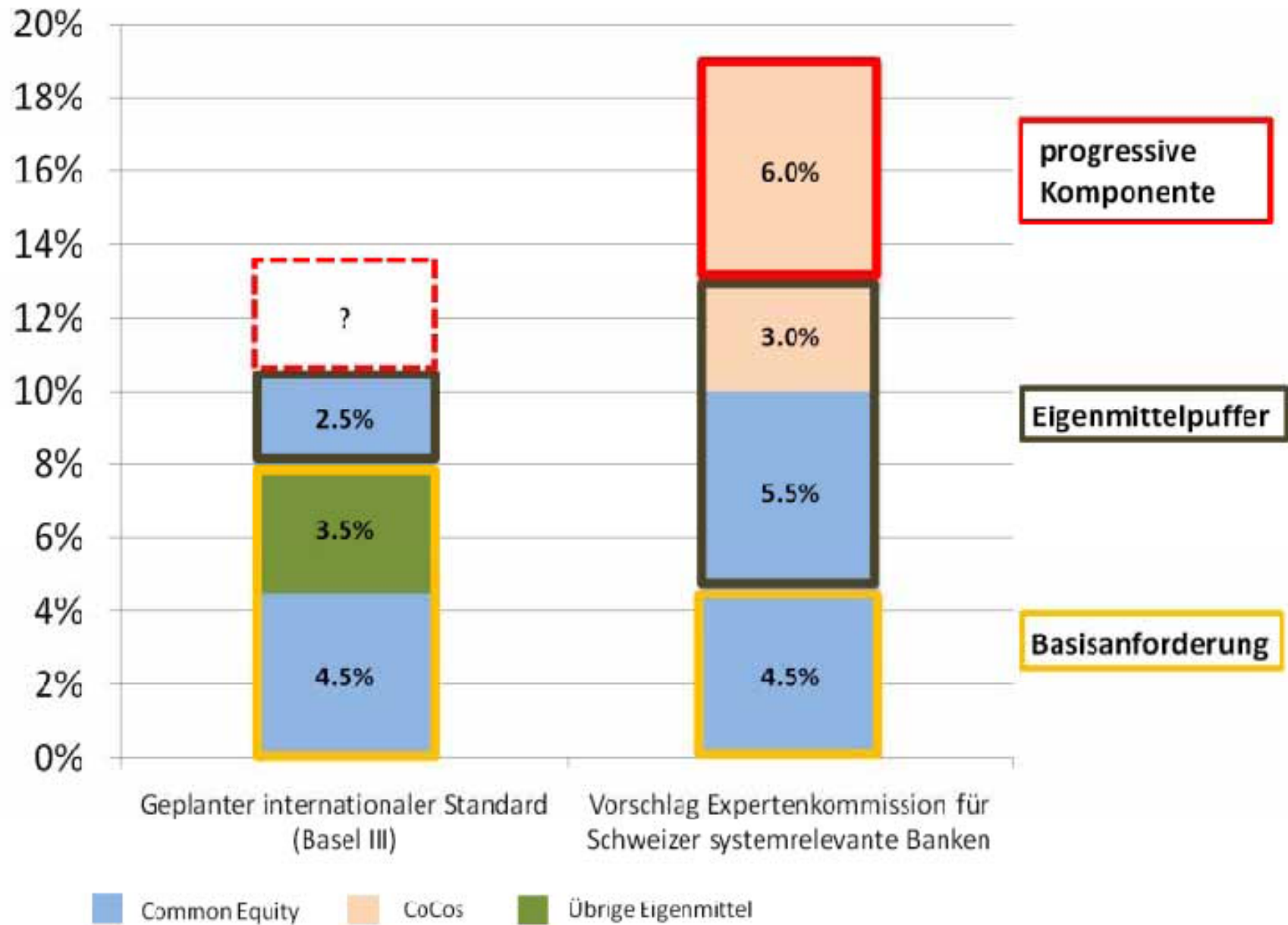
- Contingent convertible Bonds (Coco Bonds) or bonds with write down features
- Bonds that convert to capital (or are written down) when a specified trigger is reached
- Trigger in the Swiss proposal is capital ratio of 7% (high-triggering CoCos) and 5% (low triggering CoCos)

Organisational measures

- Minimal requirement: Banks are required to demonstrate their ability to maintain systemically important functions in a crisis
 - Emergency plan
 - Organisational measure to ensure emergency plan is feasible
- Swiss regulator can prescribe organisational measures only if the banks fail to demonstrate this

Interaction between capital and organisational measures

- Bank's reported capital ratio falls below 5%
 - ⇒ Implementation of emergency plan
 - ⇒ Conversion of contingent capital instruments
- This ensures sufficient capital for the separation of systemically important functions; also ensuring equal treatment of all creditors
- A rebate on the progressive component is possible if banks improve their international resolvability



International comparison

- High capital requirements, **but no**
 - Dismantling of large banks and size limitations
 - Restrictions of business activities
 - Ban on proprietary trading (Volker-Rule)
 - Tax and funds
- ➔ **Comparison of capital requirements alone is inadequate**

Conclusion

- Too big to fail can be seen as one of the causes of the crisis
 - Moral hazard, wrong incentives
 - ➔ High leverage, excessive risk taking
- Switzerland is in a special situation: small country with two large international banks
- The big banks might even be “too big to be rescued”
 - ➔ **Switzerland needs a special solution**
 - ➔ **Swiss proposal should lead to significant reduction of TBTF**