Swiss Too-Big-To-Fail Approach and the Feasibility of Resolution

Daniel K. Tarullo*
28 August 2023

The decision of Swiss authorities not to place Credit Suisse into a formal resolution proceeding has understandably raised questions as to whether, and how, resolution planning and the resolution process might be improved. It makes eminent sense to pursue this project. In particular, more exacting demands on the three domestic systemically important banks (D-SIBs) for credible resolution plans could substantially increase the prospect of an orderly resolution should one of those institutions fail. However, even with greater attention to resolution planning, there is a very good chance that the authorities would decline to place UBS into resolution in the event that bank faced serious challenges. Accordingly, I would recommend that the Swiss authorities place as much, or greater, emphasis on enhancing resiliency measures and recovery planning for UBS.

This memo begins with an explanation of my view that placing UBS into resolution, while of course a possibility, is far from the most likely outcome in the event that the bank encounters serious difficulties. Then the memo discusses the implications of this view for resiliency and recovery policies, including some policy recommendations that Swiss authorities may wish to consider. The memo ends with some observations and recommendations on the role resolution planning should play in the regulation of UBS.

Why it May be Unrealistic to Expect a Resolution of UBS

Despite the enormous amount of work on resolution planning at both national and international levels, there remains substantial doubt that any distressed global systemically important bank (G-SIB) would be placed into a resolution proceeding. Many G-SIBs, operating under legal resolution planning frameworks, have produced plans that appear credible. Resolution authorities in both home and major host jurisdictions of G-SIBS have carefully built out their resolution processes.

For all this work, however, regimes for resolving G-SIBs are untested. When a G-SIB actually appears to meet the criteria for being placed into resolution, responsible governmental authorities may well hesitate, especially if the bank's distress occurs in the context of generalized financial system stress.[1] Even a modest chance that contagion arising from the failure of the bank would set off a full-blown financial crisis may seem too big a risk to take. Indeed, this seems to have

* Currently Nomura Professor of International Financial Regulatory Practice, Harvard Law School, Cambridge, MA, USA. From 2009-2017, Member of the Board of Governors of the Federal Reserve System, and oversight Governor for Supervision & Regulation, member of the Financial Stability Board (including four years as Chair of the FSB Standing Committee on Supervisory and Regulatory Cooperation).

[1] While an essentially idiosyncratic failure of a G-SIB is conceivable, it seems much more likely in a period of systemic stress.

been precisely the ultimate view of Swiss authorities as Credit Suisse's condition deteriorated rapidly in March.[2]

Even the increased prospect of a resolution may trigger a flight of customers and counterparties from the firm, which could create disorder in financial markets. Resolution plans that contemplate drawing on liquidity buffers and pushing capital from the holding company or parent level into operating facilities can look credible in an arithmetic sense. That is, the plan seems to include (a) enough stockpiled liquidity to meet deposit withdrawals and the unwillingness of short-term funders to roll over their investments, and (b) sufficient debt write-offs or equity conversions to recapitalize the bank's depository institution, broker-dealer, and other key subsidiaries. However, the inevitable high degree of uncertainty about the bank's condition and prospects, both in resolution and beyond, could nonetheless lead customers and counterparties to terminate their relationships with the bank. Once confidence in the bank has been sufficiently shaken, its business can vanish at an alarming rate. Revenues can drop quickly, and fire sales of assets become necessary even where the bank's balance sheet indicates it remains solvent. If this happens, the downward spiral of the bank will become essentially irreversible. Even if the bank retains some valuable assets (e.g., sovereign debt instruments, highly creditworthy loans), its business model will have collapsed.

Hypothesizing a situation in which UBS is in distress, it seems probable that these arguments against a resolution would weigh even more heavily now because of the characteristics of the Swiss banking system following the failure of Credit Suisse. UBS is the dominant institution in the Swiss financial system, and the only Swiss bank with a substantial global presence outside of private banking services. Even with expected reductions in the balance sheet acquired from Credit Suisse, UBS will likely have the highest ratio of assets to home country GDP of any bank headquartered in an OECD country. And, of course, with Credit Suisse now having been absorbed by UBS, there is no longer the back-up possibility of a merger of the two global banks as a means of rescuing the one in distress. While a merger with a foreign institution is theoretically possible, that option might well face both domestic political resistance and foreign hurdles. The former could arise from the prospect of Switzerland being left with no globally active banks outside of private banking. The latter could arise because the home authorities of the acquiring bank would need to approve the acquisition. (On this point, recall that U.K. authorities refused to approve Barclays' proposed acquisition of Lehman in the fall of 2008).

The echoes of 2008, as amplified by the repercussions from the possibility of official sector support of the UBS-Credit Suisse merger, would obviously make an official sector rescue package a politically unappealing one. However, with no immediately viable merger possibilities, on the one hand, and the potential for market disorder and a dramatic diminution in

---

[2] As summarized by the Swiss National Bank:

> According to the Federal Council's dispatch, client confidence in Credit Suisse had been eroded to such an extent that it was uncertain whether the resolution measures would have restored market confidence. Furthermore, in the authorities' view, the resolution of a G-SIB and a bail-in would likely have created massive turmoil in the market environment from March 2023. This could not only have jeopardised a successful resolution of Credit Suisse, but it would have increased the risk of contagion for other banks, thereby endangering financial stability in Switzerland and worldwide.

Swiss National Bank, Financial Stability Report 2023, p. 37

Switzerland's role as an international banking center, on the other, Swiss authorities might find it the least bad of an unattractive set of options.

Enhancing UBS Resiliency

If the option of placing UBS into resolution is a measure that will, in a period of stress, appear to lie somewhere between risky and reckless, then further enhancement of the bank's resiliency becomes imperative. With the absorption of Credit Suisse into UBS, there will effectively be a distinct regulatory regime for a single firm. To be effective, this regime should include not only a strengthening of quantitative requirements, which FINMA has already indicated are forthcoming. It should also include robust supervisory oversight.

Increased Capital Requirements a Necessary, But Not Sufficient, Measure

The acquisition of Credit Suisse assets and liabilities will, in a mechanical fashion, increase the G-SIB score of UBS under the Basel Committee on Banking Supervision's formula. Depending on the amount of increase, UBS may fall into a higher surcharge "bucket,"[3] Similarly, as announced by FINMA, requirements for UBS will rise under the progressive Swiss TBTF regime for minimum capital levels, though with a lengthy transition period that could last until 2030.[4] **Swiss authorities may wish to consider moving up the date by which UBS should complete this transition, either by starting it sooner than the end of 2025 or shortening the period once it begins.** Much can happen in seven years. Moreover, a less distant end date would incentivize UBS to sustain its stated aim of reducing the risks of the Credit Suisse investment bank and, perhaps, to take addition measures to reduce its balance sheet as one method of meeting higher capital requirements.

Yet even if the application of these formulas produces a material, timely increase in capital requirements, there are two reasons why additional resiliency measures will be necessary.

First – focusing specifically on minimum required capital levels – the existing Basel Committee and Swiss capital regimes are not based on the assumption of a single dominant bank in a jurisdiction. The Basel G-SIB approach is based on the negative externalities the failure of a G-SIB would have on the global financial system.[5] The Swiss TBTF requirements were developed when there two Swiss G-SIBs. But, as explained earlier, the failure of UBS, as the sole surviving Swiss G-SIB, would likely have negative externalities greater than those that would have ensued from the failure of a similarly large bank that continued to co-exist with another, smaller G-SIB.[6]

---

[3] The Basel Committee G-SIB surcharge system does not take a continuous function approach to setting the surcharge based on G-SIB score. Instead, G-SIBs falling within a range of scores are assigned to a single surcharge "bucket," (e.g., 1%, 1.5%). When a G-SIB score goes higher than that range, the surcharge increases by a full 50 basis points.

[4] FINMA Press Release, 12 June 2023.

[5] Basel Committee on Banking Supervision, The Basel Framework, SCO40, Global Systemically Important Banks, at 18 (effective as of 9 November 2021), *available at* https://www.bis.org/basel_framework/index.htm?m=2697.

[6] This point can be illustrated by reference to one of the methodologies relied on by the Basel Committee in setting its G-SIB score formula. The "expected impact" approach sets a G-SIB capital surcharge at the level needed to equalize the impact of that bank's failure on the financial system, discounted by the probability of failure, with the

Second, capital measures, and thus reported capital ratios, are by their very nature backward-looking. Quite apart from the problematic lag between reported capital requirements and the real-time condition of a bank,[7] capital levels reflect only losses that have already been sustained and income that has already been received. If, as appears to have been the case with Credit Suisse, customers and counterparties are abandoning a bank because of skepticism about the sustainability of its business model, its future income stream will be reduced, with consequent anticipated effects on future capital levels. As the prospects of the bank deteriorate, remaining customers and counterparties will recognize the looming decline in capital levels. As more withdraw, the bank's business model can be further eroded and its long-term viability threatened, even if it has not yet sustained significant asset losses.

Supervisory Measures

It is possible to address this problem through considerably higher quantitative standards As suggested a moment ago, some additional increase in those standards for UBS may indeed be appropriate. But to rely solely on capital and liquidity buffers to guard against all risks to the bank – financial, strategic, operational, and reputational – would be very costly. At some point, regulatory requirements become so high that UBS would not be competitive with other banks, including the non-Swiss G-SIBs with which UBS competes internationally. The alternative is to complement high quantitative standards with supervisory oversight that (a) can identify nascent or chronic problems at the firm before they mature into major challenges or become irreversible, and (b) is backed by the legal authority allowing FINMA to require action to mitigate these problems. But to fill this role, the supervisory regime must be robust and sustained.

An effective supervisory regime for UBS would be well-resourced, forward-looking, and self-critical. Achieving such a regime would require some significant changes in the current FINMA approach to supervision.[8] Among the changes that Swiss authorities may wish to consider are the following:

1. **Decreased reliance on the use of external supervisory audits and a concomitant significant increase in the size of a FIMA team of supervisors dedicated to oversight of UBS.** The outsourcing of supervisory oversight to external auditors can be a useful way to augment FINMA's own resources. However, it does not seem well-advised to delegate the core of supervisory monitoring to auditors employed by the bank. Conscientious auditing is a different function from scrupulous supervision. Auditing

---

impact of the failure of a large, non-GIB bank. Basel Committee on Banking Supervision, Consultative Document: Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement, July 2011, at 23-24, *available at* https://www.bis.org/publ/bcbs201.pdf. The impact of the failure of the now-combined UBS and Credit Suisse on the Swiss financial system and economy would be much greater than the failure of one of the two previously separate banks, as occurred earlier this year.

[7] The lag results in reported capital levels being higher – in a period of bank-specific or systemic stress, perhaps considerably higher – than real-time, actual capital levels. The lag problem is compounded when banks are slow to mark down assets that do not have readily ascertainable market values.

[8] The IMF's most recent Financial Sector Assessment for Switzerland provided a useful analysis and set of recommendations that Swiss authorities may wish to revisit in light of the Credit Suisse failure and increased importance for financial stability of the supervision of UBS. IMF Country Report 19/184, Switzerland: Financial Sector Assessment Program, Technical Note – Selected Issues on Banking Supervision (June 2019), https://www.imf.org/en/Publications/CR/Issues/2019/06/26/Switzerland-Financial-Sector-Assessment-Program-Technical-Note-Selected-Issues-on-Banking-47046.

generally looks to see if a firm is in compliance with existing rules and specified guidance. Bank supervision, while including the compliance function, should also be looking for latent vulnerabilities and for potential issues that have not been anticipated in rules and guidance. So, for example, while an external audit may be able to validate a risk model used by a bank (assuming the auditor has adequate technical expertise), it is less likely to identify circumstances in which the bank's risk management system is failing to adapt both quantitative and qualitative risk assessment to new conditions. Good supervision continually asks what could go wrong in the future, as well as what problems have already emerged at a bank. This perspective on supervision argues for a sizeable FINMA team of supervisors – perhaps around thirty in number – assigned solely to UBS. This team should include specialists with the technical expertise to assess significant UBS practices and activities that could affect the stability of the bank.

2. **Clarification of legal authority to require remediation of safety and soundness issues.** In its 2019 Financial Sector Assessment of Switzerland, the International Monetary Fund observed that the authority of FINMA to require remediation of material qualitative supervisory concerns is unclear.[9] For supervisory oversight to be an effective complement to capital, liquidity, and other quantitative requirements, it must include tools to ensure that a bank remediate significant shortcomings in risk management, corporate governance, and other aspects of the bank's operations. Thus it may be appropriate to amend existing legislation to clarify that this authority exists. Of course, these powers should include administrative and/or judicial safeguards consistent with Swiss legal principles, so long as those safeguards do not unreasonably delay appropriate remedial measures.

   With an eye to the protracted decline of Credit Suisse, Swiss authorities may also want to consider granting additional legal authority for use in unusual circumstances: Where a bank has chronically failed to remediate previously identified significant problems, the authorities could be empowered to impose more far-reaching measures, such as changes in management or targeted divestitures. This authority may be understood as a kind of intermediate step between standard resiliency measures (e.g., capital requirements, bank risk management standards) and recovery measures such as those discussed in the next section. As with my recommendation to place greater emphasis on recovery planning, this recommendation rests on the supposition that the closer UBS gets to serious difficulties, the harder it will be for Swiss authorities to manage the situation. The threshold for exercising this authority would be significantly higher than for the enforcement power suggested in the preceding paragraph, but lower than for placing the bank into resolution. It might also usefully involve government actors in addition to FINMA. Doing so would, first, broaden the range of government officials who could initiate discussion of its potential invocation and, second, assure that responsibility for the decision to take (or not take) action was more broadly shared.

---

[9] . IMF Country Report 19/191, Switzerland: Financial Sector Assessment Program, Technical Note – Financial Safety Net and Crisis Management Arrangements (June 2019), at pp. 11-12, https://www.imf.org/en/Publications/CR/Issues/2019/06/26/Switzerland-Financial-Sector-Assessment-Program-Technical-Note-Financial-Safety-Net-and-47055.

3. **Create mechanisms to assure self-critical supervisory oversight.** Even the most conscientious supervisory team can, over time, lose perspective on the overall condition of a bank or miss some of its problems and shortcomings. In the wake of the Global Financial Crisis, a number of jurisdictions around the world have established or strengthened committees to supplement the analysis of primary banking supervisors. These committees most often have an explicitly macroprudential mandate. In the case of Switzerland, however, the prominence of UBS further obscures the always fuzzy line between microprudential and macroprudential oversight. Thus it may be wise to create mechanisms to augment FINMA's oversight of UBS. Some possibilities include

   First, establish market-based triggers whose breach would require an inquiry and report by FINMA. Proposals to establish market-based triggers for mandatory supervisory action have run up against the problem that there can be a lot of noise in metrics such as traded equity prices or credit default swaps. General swings in market sentiment, for example, can affect a bank's equity price for reasons only tenuously related to its viability. But while the problem of statistical noise is a reason not to make such metrics a basis for mandatory *action*, there is a strong case for making those metrics a basis for a mandatory *inquiry and report* by FINMA supervisors. Market sentiment, especially if sustained (e.g., subpar performance of a bank's equity price over time), may reflect issues that supervisors have tended to downplay or overlook. Requiring an inquiry and report would compel supervisors to explain the market movements and, where there were no convincing exogenous reasons for those movements, create a presumption for supervisory action.

   Second, establish a formal group for reviewing the conditions of UBS that would involve SNB and the Finance Department, as well as FINMA. This group, which might meet on a quarterly basis, would be the appropriate recipient of any reports required by the breach of market triggers. More broadly, it would allow for informed discussion among multiple agencies of the financial and business circumstances of UBS. Again, the aim is to enhance the capacity for self-critical supervision of UBS by bringing different perspectives to bear. SNB, for example, would bring a data-driven perspective that complements the on-the-ground observations of supervisors.

   Third, the Committees on Economy and Taxation of the Federal Assembly might consider establishing a regular oversight process for bank regulation and supervision. This process, perhaps on an annual basis, need not be limited to oversight of UBS. And, of course, there will be confidential supervisory information that would not be appropriate for inclusion in public meetings or reports. But a legislative process can have the advantages of (a) soliciting non-governmental perspectives on the state of the Swiss financial system, and (b) assuring that the interest of Swiss citizens in the stability of Swiss banks are explicitly considered by their elected representatives.

Bolstering Recovery Capacity

There is, of course, no bright line dividing measures promoting resiliency from those boosting recovery capacity. Still, there is a set of tools specifically aimed at enhancing prospects for a

bank to recover when it has suffered some combination of financial, business, and reputational losses that have at least begun to call its viability into question. In the work of both international standard setters and domestic regulators, recovery tools and planning have received less attention than either resiliency or resolution measures. But if my supposition that authorities may ultimately decline to invoke resolution procedures for a G-SIB has merit, then it is vital that there be a greater investment in recovery planning. For the reasons noted earlier, this is especially the case for Switzerland, given the size and dominance of UBS. There are four elements of an enhanced recovery strategy that Swiss authorities may wish to pursue.

1. **The most difficult, issue is whether AT1 bonds can – as a practical matter – be used on a going concern basis to reinforce the capital position of a troubled (but not imminently failing) bank.** As the Credit Suisse episode itself illustrates, whatever the original cause(s) of serious bank problems, a capital increase will almost always be necessary if the bank is to maintain its medium-term viability. In fact, while Swiss authorities are much better positioned than I am to draw conclusions, it appears from the outside that an important catalyst for the bank's demise was the public statement of a major shareholder that it would not inject additional capital under any circumstances.

   Presumably, the very purpose of having Additional Tier ***One*** capital instruments was to provide an internal source of additional equity that would reassure customers and counterparties that the capital position of the bank had been adequately reinforced, and thus the bank remained viable. Yet when FINMA instructed Credit Suisse to write down its AT1 bonds in response to the "Viability Event" of extraordinary government support, it did so as part of the plan to merge Credit Suisse into UBS.[10] Even if this action was in form a going-concern write down, in substance it was more a gone-concern measure.

   The Credit Suisse incident has revived academic and policy discussions of the thorny issues associated with the inclusion of contingent convertible bonds (CoCos) in bank regulatory capital structures: triggers for conversion or write-off that are automatic versus those that are subject to supervisory discretion; to the degree that automatic triggers are used, regulatory metrics such as capital ratios versus market metrics such as equity prices or credit default spreads; appropriate rates for converting the bonds into equity, such that there will not be inappropriate incentives for bank management to trigger (or avoid triggering) conversion or for market actors to trigger conversion through short selling or other strategies; and the impact of the answers to the preceding issues on the attractiveness of AT1 to investors (e.g., difficulty of modelling risk where conversion can be triggered at the discretion of supervisors; legal or other inhibitions on certain institutional investors' appetite for convertible bonds; pricing effect if investors conclude from the Credit Suisse case that total write-off, rather than a conversion to equity status, is the likely outcome of a triggering event).[11]

---

[10] FINMA Press Release, 23 March 2023.

[11] I would note that the difficulties of resolving these issues – especially those around the triggering standards – led U.S. regulators (of whom I was one) to omit CoCos from the package of capital requirement reforms they implemented following the Global Financial Crisis. The official results of the U.S. Government study of CoCos mandated by Congress were provided in a report by the Financial Stability Financial Council in 2012. Financial Stability Oversight Council, Report to Congress on Study of a Contingent Capital Requirement for Certain Nonbank Financial Companies and Bank Holding Companies (July 2012),

Arguably the most crucial of these issues is how to ensure that the conversion of the AT1 bonds to equity is triggered in a timely manner. Waiting until the case for conversion is overwhelming will very probably mean that it is too late to save the bank as a viable going concern. Obviously, though, conversion should not be triggered in circumstances where the bank could significantly improve its capital position through other measures – including suspension of capital distributions and raising new equity.

Assuming Swiss authorities conclude they can deal with all these issues so as to make the timely conversion of the AT1 bonds of UBS a realistic prospect, they should be as transparent as possible with markets as to how conversion will proceed. That transparency should include clear information on whether and, if so, when holders of AT1 bonds would be treated less favorably than existing shareholders.

To sum up : In view of the fact that UBS is the now sole Swiss G-SIB and consequently, as argued earlier, unlikely to be resolved in accordance with resolution plans and processes, the issue is whether that bank's significant amount of AT1 could be converted to equity in a timely and effective fashion, so as to promote that bank's recovery from a possible future troubled condition. If so, then the viability of a recovery strategy is substantially increased. If not, then Swiss authorities may need to consider even higher Tier 1 Common Equity requirements for UBS. That is, the lesser utility of recovery measures would need to be offset by the bank's greater resiliency.

While the practicability of timely AT1 conversions may be the most important consideration in determining the weight Swiss authorities can reasonably place on a recovery strategy for UBS, the remaining measures should be useful in any case. Engrafted onto a viable AT1 scheme, they would round out a fairly robust recovery strategy. Standing alone, they would of course be less effective. But would still be helpful.

2. **Regular exercises within the Swiss government to plan for circumstances in which UBS was facing significant challenges that might, if left unaddressed, develop into a threat to the firm's viability.** These exercises– which should include at least FINMA, SNB, and the Department of Finance – would be a form of what is sometimes called "wargaming." Government officials would consider different potential scenarios in which UBS would be under stress. By playing out those scenarios in detail, the officials would gain more insight into the problems they might face and be able to assess whether they possess policy tools necessary for restoring the bank to a more stable position. Where appropriate tools are already available, officials would hopefully begin to converge around a common understanding of when and how they should be deployed (e.g,, liquidity support from SNB). Where analysis revealed that appropriate tools were not available, they could either develop those tools (or make requests for them to the Federal Council) or buttress resiliency measures to mitigate the particular problem identified in the exercise.

---

https://home.treasury.gov/system/files/261/Report%20to%20Congress%20on%20Study%20of%20a%20Contingent%20Capital%20Requirement%20for%20Certain%20Nonbank%20Financial%20Companies%20and%20Bank%20Holding%20Companies%20-%20July%2C%202012.pdf.

In any exercise of this sort, it would be important to involve people with extensive financial markets experience who would have special insight into how markets will likely react both to the hypothesized difficulties of UBS and to the policy steps with which Swiss authorities might respond to those difficulties.

3. **On basis of what officials learned during these exercises, FINMA could require UBS to revise its recovery plan to address specific problems identified in the recovery exercises that would most efficiently be mitigated by changes in the bank's practices**.

4. **As the recovery "playbook" for Swiss authorities evolved, they should consult with major host jurisdictions of UBS foreign operations.** These consultations would serve a dual purpose. By convincing host authorities before a crisis began to develop that Swiss authorities had a viable recovery strategy, these consultations would improve chances that foreign supervisors would forbear from actions (e.g., ring-fencing liquidity) that might complicate the recovery measures taken by Swiss authorities. In addition, the feedback and concerns offered by host supervisors might suggest additions or modifications to the strategies being devised by Swiss authorities.

These consultations could be conducted through existing international supervisory channels, such as those that have been established for cross-border resolution planning.

Resolution Planning

The core argument of this memo has been that authorities will be hesitant *ex post* to risk exacerbating financial turmoil by placing a G-SIB into resolution and, accordingly, they would be well-advised *ex ante* to emphasize resiliency and recovery measures. This argument applies with particular force in the case of UBS, given its new status as the dominant Swiss bank and only G-SIB. However, this position does not imply that resolution planning for UBS should be neglected.

For one thing, my argument is a probabilistic one – I believe there is a significant chance that authorities will, as in the Credi Suisse case, decline to put UBS into resolution. But there is surely a chance that they will. Good resolution planning increases this chance – at least marginally, and perhaps more.

Second, many of the same vulnerabilities that would prevent an orderly resolution would impede the recovery of a G-SIB at an earlier stage of stress. A rigorous resolution planning process can uncover these vulnerabilities and ensure they are addressed, thereby advancing both a credible resolution plan and a realistic recovery strategy.

There is one caveat, however, While recovery and resolution planning will generally be compatible, there may be some areas in which there may be tension between the aims of the two processes. One example is liquidity management. Resolution planning can lean toward requiring banks to maintain pools of liquidity in various subsidiaries and/or jurisdictions in which the bank operates. These pools of liquidity help assure that, in resolution, the operations of the various parts of the bank are able to continue or be wound down relatively smoothly. However, when a bank is under stress but still viable, it may be necessary to deploy liquidity to

the parts of the bank that are most acutely experiencing the stress. In this context, resolution planning requirements for trapping liquidity in particular subsidiaries or operating units might impede an effective recovery.

There is no simple answer to this potential conflict between resolution and recovery planning. It is just something to bear in mind. Since FINMA is both regulator and resolution authority, its officials will be able to make an informed judgment how best to accommodate both sets of policies.