Factsheet: Capital backing of foreign subsidiaries by the Swiss parent company (Measure 15)

Capital adequacy requirements stipulate the minimum level of capital a bank needs in order to cover its business activities. They also limit the use of client deposits and lender for the bank's external financing (debts). Capital adequacy requirements are intended to ensure that a bank remains solvent even after making substantial losses.

There are two approaches to capital adequacy requirements, whereby the more restrictive of the two always determines the minimum required level of capital:
- on a risk basis, as a required percentage of the risk-weighted assets (**RWA**)
- as a percentage of the entire volume of business, not weighted according to risk, to protect against excessive financial debt. This is known as the **leverage ratio** (**LR**).

In Switzerland, both approaches to capital adequacy requirements apply increased capital requirements to systemically important banks (SIBs) compared to the non-systemically important banks. These increased requirements are divided into:
- higher **going-concern** capital for cushioning losses in the ordinary course of business, compared to non-systemically important banks and
- additional loss-absorbing capital (**gone-concern** capital) for the event of resolution.

Together these form the total loss-absorbing funds (total loss absorbing capacity, TLAC).

Compliance with these requirements is also subject to conditions:
- Going-concern requirements must predominantly be met using **Common Equity Tier 1** (**CET1**) capital. This will primarily consist of paid-up share capital, reserves and other retained profits.
- **Additional Tier 1** (AT1) capital may also be included for fulfilling the going-concern requirements. This refers to special bonds which only convert into CET1 and become loss-bearing if an agreed capital ratio is not achieved, at the point of non-viability, or if state support is provided.
- **Bail-in bonds** that only become loss-bearing in the case of resolution may be issued for gone-concern requirements.

1. Background

Foreign subsidiaries of Swiss banks which offer financial services are supervised by foreign financial authorities as independent financial institutions, and are required to meet foreign capital adequacy requirements. These requirements are set and monitored by the appropriate foreign authorities.

The participation in these subsidiaries (i.e. their shares) is held by a Swiss bank. In the case of UBS, this is effectively the parent bank, which carries out its own banking operations while also holding subsidiaries. As such, the parent must be able to carry losses incurred by its own business as well as losses in value of its subsidiaries.

Swiss regulations stipulate how much capital the parent bank must hold in order to back its participations in subsidiaries. Under the current regulations, such participations do not have to be fully backed by capital, which means that the parent bankcan partially finance participations in subsidiaries with debt. Because only CET1 capital directly absorbs losses, the parent bank's CET1 ratio[1] comes under pressure if the subsidiaries suffer a loss of value. As a consequence, the risks arising from the parent bank's own operating business are no longer sufficiently covered by its capital. In the Credit Suisse crisis, this meant that important crisis management measures, such as divestment of foreign business operations, could not be carried out because the Swiss parent no longer fulfilled the capital adequacy requirements.

2. The issue and its relevance from the Swiss perspective

Participations in foreign subsidiaries which are not fully capital-backed carry risks for the client deposits and creditors of the parents of Swiss banks, and ultimately also for Swiss taxpayers[2]. Using UBS as an example and based on the publicly available data for the end of 2024 and the target vision communicated by UBS[3], the following chart shows how much capital would remain available for covering its own operational business risks and for covering risks arising from the subsidiaries under various hypothetical scenarios involving valuation losses on the Swiss parent bank's (UBS AG) foreign subsidiaries. With the current capital backing of the foreign subsidiaries, the parent bank's CET1 ratio would fall below the expected future regulatory CET1 requirement[4] of 11.3% under these scenarios – and not just under those involving a full loss of value. In a crisis, this could impede crisis management measures. If the management buffer[5] – held on top of the capital adequacy requirements – had already been diminished due to other reasons, which is to be expected in a crisis, the effects of such a loss in value would be more pronounced. Depending on UBS's growth abroad, the importance of the foreign subsidiaries, in particular in the USA, could also grow, which would increase the risks to the parent bank from such valuation losses in the future. On the other hand, if the foreign subsidiaries are fully deducted from the CET1 capital (participation deduction), the CET1 ratio would remain unchanged, at the initial rate of 12.5%, following a valuation loss on foreign subsidiaries.

1 CET1 capital in relation to risk-weighted assets

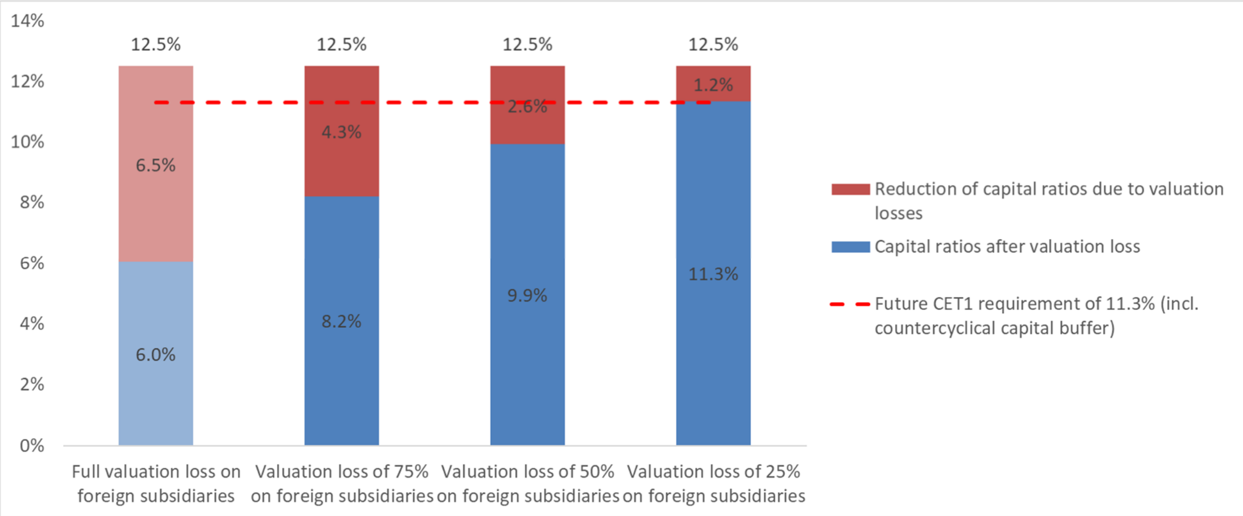
2 Residual risks for taxpayers could arise during a crisis, or the resolution of a systemically important bank, if state-backed liquidity assistance is granted

3 UBS announced in its Earnings Call of 4 February 2025 that it will close its UK subsidiary and repatriate its capital. It was also announced at the same time that it will use distributions to reduce the parent company's CET1 ratio from 13.5% in Q4 2024 to no higher than 12.5% "in the near future"

4 This is the estimated requirement under the current regime which UBS will provisionally have to achieve by the end of 2030 at the latest, based on its size and market share

5 A management buffer is an additional capital buffer above the capital requirement required by regulation, which is held on a voluntary basis by banks in order to maintain room for manoeuvre for unexpected losses or fluctuations and to always remain above the minimum requirements

Impact on the CET1 ratio of UBS's Swiss parent bank of various scenarios involving valuation losses on foreign subsidiaries[6]



Source: own calculations, UBS AG (parent) group financial statement p.18 and UBS disclosure statement Q4 2024, p.109.

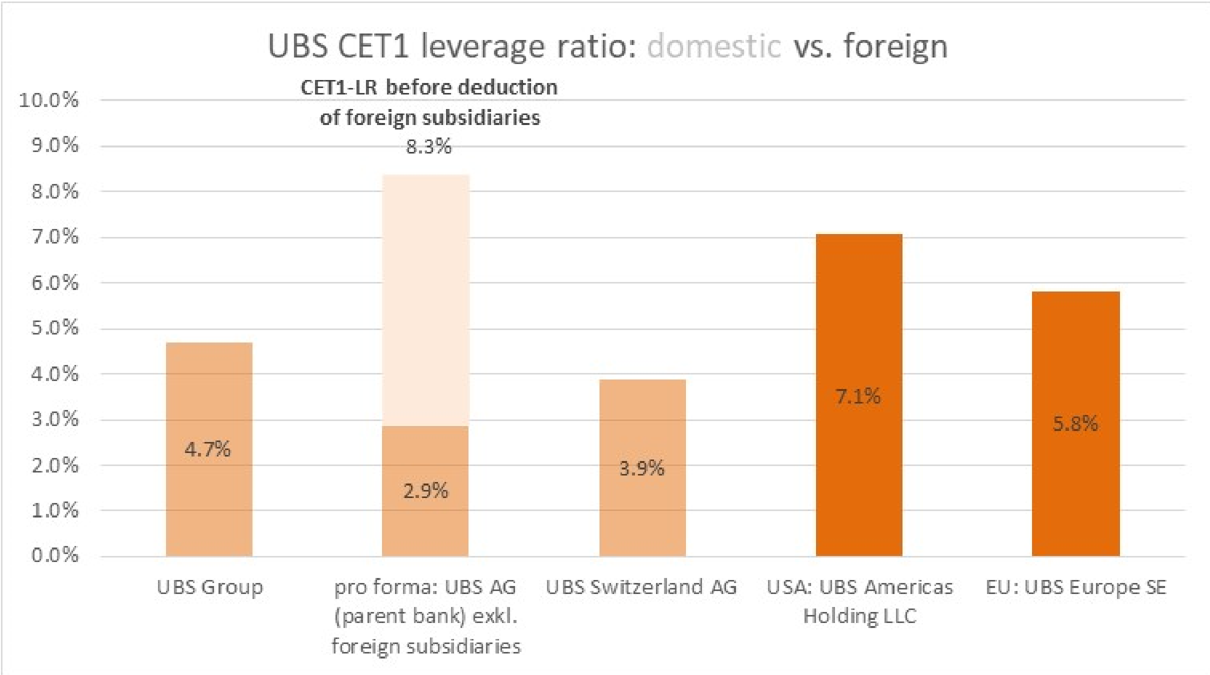
The distribution of capital within the UBS Group is also of relevance to the creditors and customers of the Swiss parent bank, and also to any risks being carried by the Swiss taxpayers. UBS is currently reporting significantly higher capital ratios abroad than domestically. This applies to the risk-weighted as well as the unweighted capital ratios. Given that there are certain differences amongst the jurisdictions in the methods used for risk-weighting the balance sheet items, the following chart[7] shows the unweighted capital ratio (leverage ratio). Reasons for the uneven distribution of capital could be higher requirements set by foreign regulators, or higher voluntary buffers abroad. Consequently, during a crisis, there would be more capital located abroad, in relation to the respective business volumes, than there would be domestically. Foreign authorities could therefore use *ringfencing*[8] to improve protection for the customers and creditors of the foreign subsidiary, to the detriment of those of the Swiss parent bank. The proposed full capital backing of participations in foreign subsidiaries will also increase the protection of the parent's creditors and customers against losses.

[6] Using a risk-weighting of 400%, which will be in force at the end of 2028 in accordance with the current regulations

[7] When comparing, it is important to note that, for example, the American subsidiary can count dividend reserves as CET1 capital, whereas these must be deducted from the CET1 capital in Switzerland. However, including the dividend reserves would not substantially alter the picture

[8] *Ringfencing* occurs when foreign supervisory authorities impose higher regulatory requirements on legal entities of G-SIBs located in their country (e.g. due to doubts over the stability of the bank), or restrict transferability of capital and liquidity

Current distribution of capital within the UBS Group AG for covering the group's own business[9]



Source: UBS disclosure statement Q4 2024, own calculations.

3. The options examined and the proposed solution of a full deduction of participations from CET1 capital

The Credit Suisse crisis made it clear that the Swiss parent bank's capital base was insufficient. Therefore, the capital backing for foreign subsidiaries (participations) of SIB parent banks needs to be increased: instead of the current system of partially backing the participations, in future the SIBs will have to fully deduct the carrying value of foreign subsidiaries from the Swiss parent's CET1 capital (known as the participation deduction), which equates to full backing with CET1 capital. Theoretically, this measure affects all systemically important banks, but in practice only UBS has accordingly large foreign subsidiaries, e.g. in the USA and Europe.

The Federal Council reviewed various alternative options and rejected them, including in particular the following:

- Full deduction of the subsidiary's carrying value from going-concern capital (i.e. partially from AT1 bonds) or from total loss-absorbing capital (i.e. also partially from bail-in bonds);
- Higher, but still only partial, capital backing of foreign subsidiaries with CET1 capital (e.g. at 80%);
- Ensuring lower and more stable valuation of foreign subsidiaries by stipulating a conservative valuation method in the regulations;

---

[9] The current system of partial capital backing for foreign subsidiaries means that the parent bank's disclosed CET1 leverage ratio (8.3% as at the end of 2024) grossly overestimates its resilience in the face of risks arising from its own business. Participations need to be deducted from capital in order for the leverage ratio to be meaningful for the parent bank. When the foreign participations are deducted, the parent bank's CET1 leverage ratio drops to 2.9%

- Different capital requirements for wealth management and investment banking activities.

The alternatives would also improve – to varying degrees – the background situation as outlined above, and would strengthen the parent bank. However, the problem of a valuation loss on a foreign subsidiary leading to capital losses at the Swiss parent bank can only be solved systematically by fully deducting these participations from CET1 capital. The Swiss National Bank (SNB) and the Swiss Financial Market Supervisory Authority (FINMA) came to the same conclusion. Some of the alternatives, such as different treatment of wealth management and investment banking, were also rejected because they were overly complex or because of difficulties implementing them.

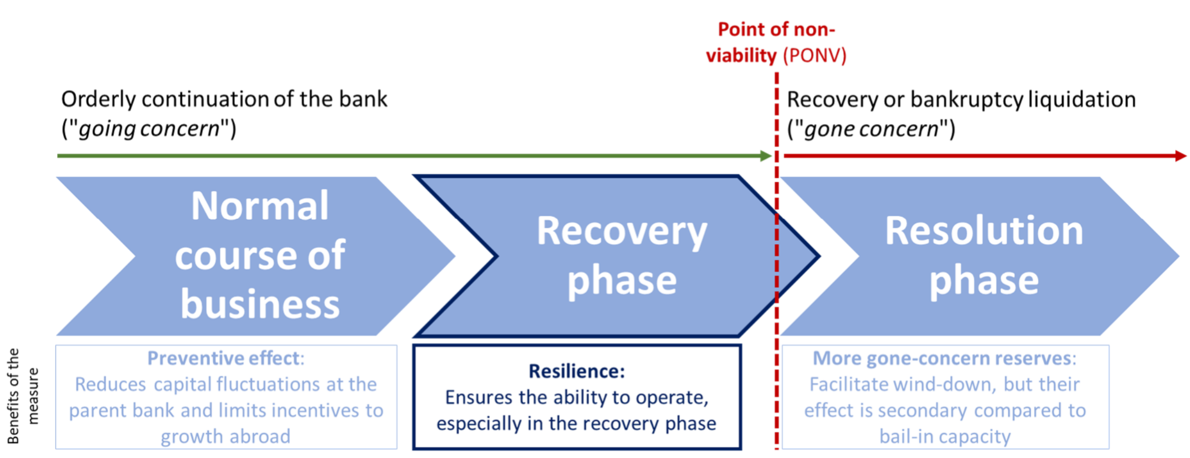
4. The impact of stricter capital requirements

As well as addressing the capital backing of foreign subsidiaries by the Swiss parent bank, the Federal Council's package of measures on capital adequacy also includes stricter capital requirements for assets which did not prove to be sufficiently recoverable during the Credit Suisse crisis (see the consultation bill on the ordinance amendment).

4.1 The benefit and effects of stricter capital backing of foreign subsidiaries by the parent bank

Stricter capital backing of participations in foreign subsidiaries by the Swiss parent has a positive impact in all phases – in the going concern, in the recovery phase and in the resolution phase. In the going concern, it reduces fluctuations in the parent bank's equity caused by losses incurred by foreign subsidiaries. However, the main advantage comes in the recovery phase. In this critical phase, in which a bank can still act independently, it should be able to dispose of foreign subsidiaries either in part or in their entirety, without this negatively impacting the capitalisation of the parent bank. This should avoid the bank being wound down, which always remains the last resort.

Where does the measure have an impact? Importance of the individual entity's resilience in the recovery phase



A fall in the carrying value, or the sale of subsidiaries below carrying value will lead to a loss of CET1 capital for the Swiss parent bank on a like-for-like basis. Participations in foreign subsidiaries are currently backed at around 60% with going-concern capital (CET1 and AT1), with the rest being financed with debt. If we consider CET1 capital alone, then foreign participations are only backed at around 45%. Going-concern losses are primarily absorbed by CET1 capital. So, for example, a valuation loss of USD 10 billion on foreign subsidiaries leads to a fall in the Swiss parent bank's available CET1 capital of around USD 5.5 billion.[10] This is then insufficient to cover the risks from the parent's operational business.

As such, the measure greatly improves the situation and the room for manoeuvre in the going concern and in particular in the recovery phase, even if the foreign subsidiary has only a partial loss in value rather than 100%. It strengthens the resilience of internationally active systemically important banks and improves their chances of independently carrying out new strategic repositioning in the recovery phase of a crisis without endangering its Swiss parent's mandatory capital adequacy requirements. Since the new regulation will obligate the Swiss parent bank to hold more capital than previously, this will enable creditor and investor confidence levels to rise. It can also help to gain security-conscious wealth management customers. The new regulations also play a strong role in reducing the likelihood of loss of confidence, and continue to safeguard solvency, which is imperative for obtaining liquidity assistance from the SNB. Finally, the measure drives UBS's Swiss parent's capitalisation relative to the volume of business closer to the comparatively high capitalisation relative to the volume of business abroad.

4.2 The impact on capital needs and costs

The main impact on costs involves the effects of stricter capital adequacy requirements for the banks affected, i.e. specifically for UBS. Because of the large degree of public interest, and since the Federal Council will have to publish a regulatory impact assessment in any case, estimates of the impact on capital will be provided below, based exclusively on publicly available data. However, it must be noted that these estimates are not certain and caution should be applied accordingly when interpreting them. In particular, the impact will depend on various factors which are presently unknown, such as the future size and structure of UBS, the future extent of its foreign business and the future value of its participations in foreign subsidiaries, various management decisions to be made by UBS, the USD-CHF exchange rate, and last but not least, the details of the final requirements adopted by Parliament and the Federal Council.

With regard to the additional capital needs, it is possible to distinguish between the degree to which the regulatory requirements will rise compared to the current situation, and the degree to which additional capital needs to be built up compared to today (i.e. the effective capital shortfall). All the new capital adequacy measures combined increase the going-concern requirement (CET1 and AT1 together) of the UBS parent bank (UBS AG) by up to USD 18 billion. The measures also strengthen capital quality at the same time. This means that the rise in the going-concern requirement needs to be met with up to USD 26 billion of CET1 capital, to allow the AT1 bond holdings to be reduced[11] by around USD 8 billion.[12]

[10] The parent loses USD 10 billion of CET1 capital, but the CET1 requirements only reduce by USD 4.5 billion. This means that the available CET1 capital held by the Swiss parent is reduced by around USD 5.5 billion

[11] The reduction of the AT1 requirement is a result of the RWA being reduced by the deduction of the foreign participations. It corresponds to 4.3% of the deducted RWA

[12] As at the end of 2024, the parent bank was reporting foreign participations of around USD 51 billion. This figure will presumably drop to around USD 46 billion with the repatriation of funds from the UK subsidiary, as announced by UBS. With a CET1 requirement of 11.3% (incl. the countercyclical capital buffer) and a risk weighting of 400%, under the current regulations these participations require a CET1 backing of 45% (400% x 11.3%). With UBS's CET1 target of 12.5%, they will require a backing of 50% (400% x 12.5%). As such, the difference between this and full backing corresponds to around USD 23 billion. On top of this, the measures from the draft ordinance also give rise to a probable additional parent-level CET1 requirement – based on current estimates – of around USD 3 billion. Thus, the CET1 requirements rise in total by around USD 26 billion. These figures only apply retrospectively to 2024, i.e. assuming there are no changes, including to the size of the balance sheet and the RWA, no valuation adjustments to participations, no adjustments to the management buffer, no further repatriations or structural adjustments, no change to the relevant exchange rates and no other adjustments to the regulatory requirements

However, the effective capital shortfall is significantly lower. There are various options for financing additional capital requirements.[13]

This means the required build-up of capital can ideally be achieved without raising capital, without excessively restricting organic growth and without excessive reduction in distributions. From the authorities' perspective, and from the vantage point of the present, this aim is achievable with a sufficiently long transition period, e.g. of a minimum of 6 to 8 years from the new regulation coming into force.

4.3 An international comparison of CET1 ratios

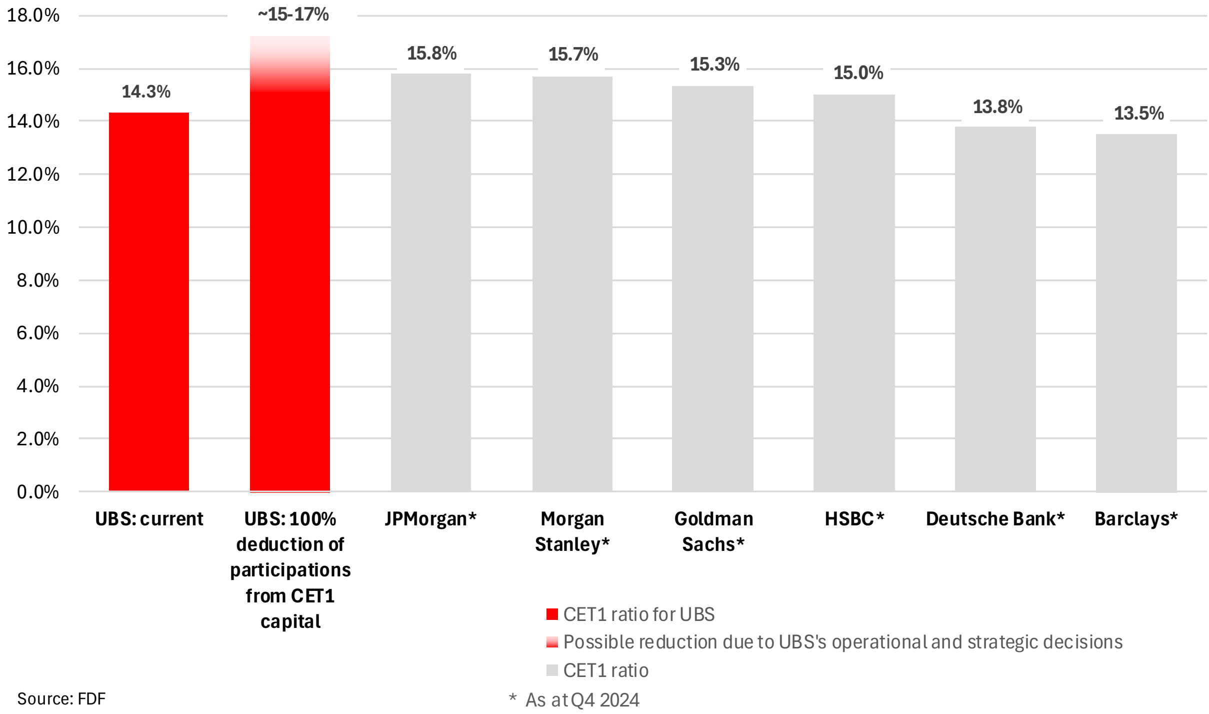
The chart below compares the UBS Group's current and possible future CET1 ratio (after implementing all of the measures) with the CET1 ratios of other G-SIBs as at Q4 2024. With the full deduction of participations in foreign subsidiaries from the Swiss parent bank's CET1 capital as proposed by the Federal Council, combined with the measures at ordinance level, the CET1 ratio would rise to around 17%. The authorities assume that UBS can reduce this to under 15% through management decisions.

Based on current estimates, the UBS group-level CET1 ratio would lie above its current ratio and probably also slightly above those of its international peers following implementation of the planned measures. The actual group-level CET1 ratio will also depend in particular on the size, complexity, business model and capital needs of the foreign subsidiary. The chart differs from the chart in the expert opinion which was commissioned externally by the FDF and carried out by Alvarez & Marsal, because the expert opinion only takes into account the effects of the capital backing for foreign subsidiaries. However, the chart below considers the effects of both the proposed regulations and the capital backing for foreign subsidiaries. The lower estimated CET1 ratio is the result of the proposed regulations reducing both eligible CET1 capital and risk-weighted assets (RWA) at group level.

[13] For instance, any capital repatriation from subsidiaries, capital freed up during the restructuring and integration of Credit Suisse entities, and existing capital reserves can be used to cover the higher regulatory requirements. In principle, such freely available capital can be used for distributions of for capital build-up

CET1 ratios in an international comparison

According to current estimates, if all the measures announced by the Federal Council were to be implemented, UBS's CET1 ratio would be slightly above that of other internationally active big banks. To a certain extent, this ratio can also be influenced by management decisions.



4.4 Increase in total financing costs

Stricter capital adequacy requirements on an unchanged total asset figure mean that a bank can reduce borrowed capital. Since the forecast shareholder return will be a higher burden on equity than the interest paid on debt, the annual total financing costs, i.e. the overall financing costs of debt and equity, will rise overall. However, the expected rise in total financing costs will be cushioned by various mitigating effects. Firstly, the additional equity is replacing debt, specifically including particularly expensive AT1 bonds, and consequently no longer incurs interest. This reduces borrowing costs.[14] Secondly, the risks to both shareholders and lenders are also reduced with the increase in capital, which can then have a positive impact on the total financing costs.

Two independent expert opinions were commissioned by the FDF (one by Prof. Dr. Heinz Zimmermann and one by Alvarez & Marsal) to estimate the costs of the measure. Zimmermann estimates the influence of higher capitalisation on the average weighted capital costs irrespective of their cause. Alvarez & Marsal specifically assess the full deduction of foreign participations (without the additional amendments in the current proposed regulations) and try to estimate the possible effects (the required build-up of capital and the costs thereof) for UBS based on publicly available data and using various approaches.

For example, according to the expert report by Prof. Dr. Heinz Zimmermann, USD 20 billion of additional CET1 capital raises the annual average total financing costs by around an estimated USD 640 million (whereby the costs in relation to the need for

[14] Tax effects weaken the positive effect slightly, because the bank is able to deduct less of the costs of capital borrowing from taxes

equity capital are scalable on a linear basis). The expert report by Alvarez & Marsal estimates the annual total financing costs of the additional CET1 capital (USD 14.7-23.3 billion) required for the capital backing of foreign subsidiaries at USD 0.8-1.3 billion. The report gives ranges for the impacts and shows, amongst other things, that under strict capital requirements, total financing costs can be influenced to a large degree by management decisions. One of the reasons for the difference in the estimates is Zimmermann assuming that higher capitalisation reduces the risks for shareholders and lenders and thereby also reduces the expected returns. He refers to empirical studies of the Swiss capital market. Alvarez & Marsal, on the other hand, assume constant expected returns on equity and debt in their estimate.[15] If the bank also reduces the capital needs of foreign subsidiaries through strategic and operative adjustments, the additional annual total financing costs would further reduce.

In its December 2024 report, the Parliamentary Investigation Committee "Management by the authorities – CS emergency merger" (PinC) made it clear that the additional costs for SIBs must be weighed up against the possible costs of state support. The proposed measure makes some headway in this regard, in that it goes further to guarantee that risks will be borne internally or by the shareholders.

4.5 The impact on customers, shareholders and growth

The question of who bears the financing costs of increased capital depends on many factors, and not least on decisions made by the affected bank. If they are not transferred to the investors by way of lower returns, then the costs are to be compensated through the operational business. In the case of capital backing for participations in foreign subsidiaries, the higher costs are caused by the business carried out by these foreign subsidiaries. It therefore follows in cause-related costing – as in common in banking – that the increased financing costs should also be absorbed by the business carried out with the foreign subsidiaries. However, given that nothing in the capital requirements is changing for the Swiss business activities, it does not follow that the cost of borrowing would increase for the lending business in Switzerland. Cross-subsidising the business of the foreign subsidiaries with income from domestic lending business would also contradict the assumption of an efficient, competitive Swiss financial market and could lead to movements in the market share.

The impact on shareholders also heavily depends on many factors including decisions made by UBS. Dividend payments and organic growth should still be possible with appropriate transitional periods and if the generated profits are in line with the authorities' estimates. However, for the shareholders, the measure could mean that UBS carries out fewer share buy-backs, if only temporarily, and reports a somewhat lower return on equity, along with lower risks. This reduction will be partially compensated by the lower lending costs caused by substituting debt with equity.[16] After building up the capital with retained profits, the net value of the shares increases and the risk of capital dilution from increased share capital if losses are reported decreases. To gain a comprehensive picture of a bank's long-term prospects, other business ratios need to be considered alongside return on

[15] With regard to the cost of borrowing, Alvarez & Marsal argue the case of a strong UBS credit rating, that can be partially attributed to the market perception of an implicit state guarantee. Under this assumption, the lenders would have already priced in the added security that higher capital would give them because they had already assumed an implicit state guarantee. However, this assumption would also imply that, hitherto, part of the risk was being covered by the state rather than the lender

[16] Lower borrowing costs raise profits and thereby the numerator in the return on equity business ratio. At the same time, the measure also increases the capitalisation (denominator)

equity. Profit in relation to total assets (*return on assets, RoA*), or the ratio of costs to net earnings (cost-income ratio) should improve considering the lower financing costs for debt.

Growth through foreign subsidiaries or by taking over foreign business remains possible for systemically important banks, but in the future will have to be fully financed through the Swiss parent's CET1 capital. If a Swiss bank wishes to expand its overseas business or invest additional capital in foreign subsidiaries in the future, the Swiss parent will have to hold the required CET1 capital to fully cover the resulting increase in value of its participation in foreign subsidiaries. The measure can therefore make growth abroad through subsidiaries expensive and thereby extends in a targeted manner those capital requirements which gradually increase with growth to the entire banking group.

5. Next steps

Initiation of the consultation on the legislative proposal on parent bank capital requirements for foreign subsidiaries is planned for autumn 2025. Appropriate, i.e. sufficiently long transition periods are envisaged for this amendment to the capital requirements. From the present vantage point, a minimum transition period of 6 to 8 years from the entry into force would seem appropriate for meeting a requirement of full deduction of participations in foreign subsidiaries from CET1 capital.

A consultation will be carried out with interested parties on the measures at ordinance level until 29 September 2025.