

# **Philipp Hildebrand: Review of the international financial system**

Introductory remarks by Mr Philipp Hildebrand, Vice-Chairman of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 10 December 2009.

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## **1. Introduction**

At the news conference in June of this year we spoke of a gradual calming in the general financial market environment, although the outlook remains uncertain. Since then we have seen a majority of banks returning to profitability. The horror stories being reported almost daily just over a year ago have now disappeared. It is very tempting just to go back to business as usual.

However, we must not forget that – just over a year ago now – the international financial system was on the brink of collapse. Support packages of an unprecedented size were being put together for the banks. Exceptional monetary and fiscal measures were required to combat the dramatic plunge in the global economy – measures which have had to be kept in place to the current time. Only by a narrow margin was a complete collapse of the financial system avoided and the danger of a major depression averted.

This experience has clearly shown us all that the principle of sustainability needs to be a much more dominant element in the development of the international financial system than it was previously. This serves the interests of governments and taxpayers; but it is also in the fundamental interests of the financial system itself, since it is not impossible that a future crisis could outstrip the resources of monetary and fiscal policy, thus rendering it impossible to rescue systemically important banks.

## **2. International approach**

Consequently, there is broad international consensus between the relevant authorities on what the objectives of future regulatory measures should be. The Financial Stability Board (FSB), in which Switzerland is an active participant, has clearly formulated these objectives. The financial system must be brought to the point where it contributes to sustained economic growth. Never again must it be allowed to combine such high risks with such minimal safety buffers. Moreover, steps must be taken to avoid profits being privatised while losses are borne by the public at large.

In essence, there are two ways of achieving this goal. The first approach is to adopt preventative measures aimed at reducing the probability of a bank collapse or a systemic crisis. This can be done by increasing safety buffers – for example, by imposing higher capital and liquidity requirements. The second approach is to take steps designed to reduce the costs of a crisis once it has already occurred.

### **2.1 Prevention**

At the international level, the implementation of preventative measures is already well advanced, in that the Basel Committee on Banking Supervision – in coordination with decisions by the G20 and the FSB – has decided on important measures in the fields of capital and liquidity regulation. The consultation package on this matter will be published in early 2010.

The measures designed to strengthen capital include stricter calibration of risk weights to determine the regulatory capital, improvement in the quality of this capital buffer and a direct limitation on the level of debt (leverage ratio). The combined effect of all these measures will

be analysed by the Basel Committee during the course of 2010 in order to calibrate the overall capital requirements.

Liquidity regulation measures are aimed at securing financial institutions' flow of liquidity, particularly during times of crisis. The Basel Committee is proposing a global minimum standard for liquidity regulation. This is to ensure that financial institutions build up a liquidity buffer which allows them to remain liquid in short-term and medium-term stress scenarios.

In line with the decisions of the Basel Committee, we have already implemented stricter risk-weighted capital requirements in Switzerland, supplemented by a leverage ratio. The capital requirements are designed to be anticyclical, i.e. in good times, banks are required to build up a capital buffer in excess of a given minimum level. By contrast, in bad times, the capital buffer is permitted to fall below that level. A new liquidity regulation is currently in the test and calibration phase. This regulation takes into account all balance-sheet and off-balance-sheet items that are of relevance in liquidity considerations, and is based – as far as possible – on internal bank liquidity management principles. It makes the big banks more resilient to disturbances in the interbank market or larger-scale withdrawals of deposits. It promotes longer-term financing as well as higher-rated securities that are capable of generating liquidity even in a stressed market environment. The new regulation is due to come into force in the second quarter of 2010.

These advances and the broad consensus achieved at the international level can certainly be regarded as positive achievements. However, so far they only apply to preventative measures. As mentioned previously, these measures serve to reduce the probability of a crisis, but cannot always prevent its occurrence. Another crisis is inevitable and we must be prepared for it.

### **3. Resolution measures needed; “too big to fail” is biggest challenge**

Consequently, we need tools that will substantially reduce the costs of a crisis. The legacy of the current crisis is a banking system with large international institutions that now enjoy a virtual state guarantee. The fact that systemically important banks enjoy such a guarantee is now openly recognised to be a problem by the banking sector, too. A guarantee of this kind contradicts the basic principle of the market economy and presents us with a situation that cannot be tolerated. It must be possible for any financial institution, even a large one, to fail, without threatening the future of either the financial system or the real economy.

In the last two years, the risks presented by systemically important banks to the stability of the financial system and the economy in general have become only too evident.

First, in principle, systemically important institutions have an incentive to enter into excessive risks (moral hazard). Should these risks materialise, this can lead to losses of unimaginable dimensions, as has indeed occurred. Second, the potential costs of supporting systemically important banks are enormous. Third, the larger the systemically important institutions compared to the size of a country's economy, the greater the likelihood that the costs in question will exceed the capacity of that individual country to bear them (the “too big to rescue” issue).

The leaders of the G20 countries were quick to recognise the significance of these risks and they asked the Financial Stability Board to elaborate proposals before the end of October 2010 on how the “too big to fail” and “too big to rescue” issues could be addressed.

In its interim report on this matter published at the beginning of November 2009, the FSB focuses on three elements. At the same time, it is closely monitoring the development of additional proposals at national and international level.

From the point of view of the FSB, the possibility of conducting an orderly resolution of a failing cross-border financial institution is an important element in finding a solution to the “too big to fail” and “too big to rescue” issues. Effective communication between the relevant

supervisory authorities as well as forward-looking elaboration of emergency procedures are indispensable in this process. Internationally recognised regulations for the dissolution of systemically important institutions that can be enforced under any jurisdiction are no doubt a splendid objective. In the real world, however, different national regulations will continue to exist in this field. From our point of view, reciprocal recognition of national regulations that are mutually compatible, and the associated adjustment of structures and processes, are a more realistic objective.

The second element proposed by the FSB is to supplement the increased capital and liquidity requirements with various measures that address the organisational structures of systemically important financial institutions. Measures of this kind could, for instance, create the possibility of extracting operations that were important for the economy and liquidating the remaining operations.

The third element in the solution envisaged by the FSB is a financial market infrastructure whose design ensures that, as far as possible, it minimises destabilising effects in the event of a bank collapse. Central counterparties can play a special role in this respect. Thus, in markets cleared through a central counterparty, all market participants have just one single counterparty, rather than numerous bilateral business relationships, and the complexity of the financial system is significantly reduced. What is even more important, however, is the fact that, in the event of a bank collapse, a central counterparty guarantees that it will fulfil the commitments it has entered into with respect to the other market participants, thereby eliminating the traditional domino effect. That is why, together with other central banks and supervisory authorities, the SNB is supporting the banks' ongoing efforts to clear a larger part of the enormous over-the-counter derivatives market through central counterparties. These central counterparties come at a cost, since it goes without saying that they must run a very sound risk management system. For even a central counterparty could be threatened with failure. Since the consequences of such an event would be catastrophic, central counterparties need to command sufficient financial resources to ensure that they can withstand the failure of the largest market participant, even in extreme market conditions.

#### **4. Political responsibility**

The SNB is investing substantial resources in actively carrying forward the approaches to solving the "too big to fail" and "too big to rescue" issues that have just been outlined – not just in international bodies like the FSB or the Basel Committee, but also at the national level, in conjunction with FINMA. The reasons for this are obvious. Given the particular importance of the banking sector, with two big banks which hold a key position in the domestic loan and deposit market, the "too big to fail" and "too big to rescue" issues have particular significance for Switzerland.

Consequently, we need to be very conscious of the fact that measures may be needed over and above any international standard. For this reason we are dependent upon political support in order to make our financial system more resistant and more stable with regard to the "too big to fail" and the "too big to rescue" issues. If this succeeds, the competitive position of the Swiss banking sector will be reinforced in the long-term as a result of increased safety, reliability and credibility. The fact that the Swiss Federal Council has appointed a commission of experts on the subject of "too big to fail" is an important step, which we welcome. The willingness of the big banks to participate actively in elaborating solutions to the "too big to fail" and "too big to rescue" issues is also welcome. These latest developments clearly show how urgent the problems are.

Ladies and gentlemen, if we do not manage to fundamentally reform the financial system, it is to be feared that a future crisis of even greater dimensions will trigger such a strong protectionist and regulatory reaction that the damage done will extend even to the market economy to which we owe our prosperity. We owe it to future generations to take action against this danger. Doing nothing is not an option.