Thomas J Jordan: Financial Stability Report – potential risks and actions

Introductory remarks by Mr Thomas J Jordan, Vice Chairman of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Berne, 16 June 2011.

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In my introductory remarks today, I would like to present the most important points from our recently published Financial Stability Report, in which we consider potential risks to financial stability and identify where action may be needed.

General economic and financial conditions for the Swiss banking sector improved further in 2010. Overall, global economic growth was stronger than expected last year, despite the expiry of fiscal stimuli. In Switzerland, too, economic development was robust and growth was high in an international comparison. Against this background, the profitability and capital situation of both big banks improved further, and remained good for banks with a domestic focus.

However, the economic environment remains fragile, and a renewed, sharp deterioration over the next twelve months cannot be ruled out. In the short term, the prevailing uncertainty primarily affects the two big banks, which are still exposed to considerable credit and market risk relative to their loss-absorbing capital. For domestically focused banks, by contrast, the risks are largely of a medium-term nature, and are related to potential adverse developments on the Swiss real estate and mortgage markets.

In view of these risks, all Swiss banks should ensure that they have a broad and high-quality base of loss-absorbing capital. For the big banks, in particular, it is crucial that a sufficient capital base be laid down as soon as possible, so that losses can be fully absorbed. The SNB welcomes the fact that, in 2010, both big banks already took important first steps in this regard, and we would like to encourage them to keep up the pace of their capital expansion.

The capitalisation of most domestically focused banks is good by historical standards. However, a combination of high interest rate risk exposure and strong mortgage lending growth has been reported by a number of banks. In order for these banks to bear the risks in the medium term, it is important to ensure that their capital base is strong enough.

I would now like to take a closer look at the situation of the two big banks, before turning my attention to the situation of the domestically focused banks.

Situation of big banks

Compared to 2009, the two Swiss big banks saw a marked improvement in their profitability and capital situation last year. In 2010, these institutions reported combined net profits of around CHF 13 billion, as opposed to roughly CHF 4 billion in 2009. This positive development was driven by UBS, whose situation improved further over the course of last year. In addition, both UBS and Credit Suisse continued to increase their regulatory capital ratios (ratio of Tier 1 capital to risk-weighted assets), which were already very high by international standards. Moreover, their financial strength ratings also improved. According to rating agency assessments, the big banks' intrinsic financial soundness improved significantly last year.

However, two aspects should be borne in mind when assessing the big banks' situation:

First, their exposure to credit and market risk relative to their capital remains considerable. Although credit quality abroad has improved slightly, it still remains at historically low levels, particularly in the US and Europe. In view of this, lower-than-expected economic growth or a deepening of the debt crisis in Europe could potentially lead to a further deterioration in the creditworthiness of individual countries. Yet, the big banks' exposures to sovereign debt in peripheral euro area countries are only moderate. Should the debt problems in the already vulnerable international banking system or in other sovereigns become amplified, however, these banks could face considerable losses.

Second, the big banks' economic capital situation is less comfortable than their very high regulatory capital ratios under Basel II might suggest. A considerable portion of both institutions' regulatory capital is made up of capital components that proved to be not fully loss-absorbing during the recent crisis. These include, for instance, deferred tax assets, which are only realised if a bank is profitable, or certain hybrid Tier 1 capital instruments, which only become loss-absorbing in the event of bankruptcy. Thus, such capital components will no longer be recognised under Basel III and will be phased out by 2019. The transition period granted to banks gives them sufficient time to meet the new requirements. However, in view of the risk exposures and the prevailing uncertainties in the economic environment, it is crucial that the big banks build up a sufficient base of loss-absorbing capital as swiftly as possible during this transition period.

After adjusting for the not fully loss-absorbing components, the big banks' remaining capital buffers are still thin in light of the aforementioned risks. Despite some improvement, leverage for both UBS and Credit Suisse is still high by international standards. Taking only fully loss-absorbing capital into account, the average capital ratio of both big banks amounted to less than 2% of total assets.

Against this background, both big banks have already made major strides towards expanding their loss-absorbing capital base. To this end, Credit Suisse issued contingent convertible bonds (CoCos), while UBS retained its earnings. These important first steps have already significantly strengthened the big banks' loss-absorbing capital base. They also show that the big banks should be in a good position to build up the necessary, additional capital buffer.

Situation of domestically focused banks

Allow me now to discuss the situation of banks with a domestic focus.

The capitalisation of domestically focused banks was almost unchanged in comparison to 2009. The short but sharp recession in Switzerland in 2009 did not have any noticeable impact last year either. Write-downs and provisions were at a historical low. In a long-term comparison, profits remained at a high level overall. Likewise, the capitalisation of domestically focused banks hardly changed in 2010 and remains good in relation to both risk-weighted assets and total assets.

However, the fact that capitalisation is high overall does not take into account that the regulatory capital requirements do not fully capture certain risks. For example, the interest rate risk and credit risk associated with potentially adverse developments in the real estate and mortgage markets are not taken into account, or only partially accounted for. Yet these risks are especially pronounced in the current environment.

On the one hand, interest rate risk for all domestically focused banks continues to remain at a historically high level. Since there is a maturity mismatch between assets and liabilities, a rise in interest rates would result in losses for the banks. The overall high level of interest rate risk is driven by Raiffeisen and cantonal banks.

On the other hand, credit risk at domestically focused banks continued to increase. This is because the mortgage lending volume, which is closely linked to developments in the real estate market, continued to grow.

The situation in the Swiss real estate market has deteriorated slightly since last year's Financial Stability Report was published. Even though they varied widely, most real estate price indices suggest that prices also rose substantially in 2010. There is still no indication of a general overvaluation based on the current price level, yet several indicators suggest that overheating is already becoming apparent in the owner-occupied apartment and apartment building segments. There are also considerable regional differences, although there are signs that, already now, real estate prices in some regions are no longer justified by fundamentals.

Should real estate prices continue to rise at the current pace and move away from the level justified by fundamentals, a significant price correction is more likely in the medium term. Such a price correction, together with a significant rise in mortgage loan defaults, would pose a threat to financial stability.

Overall, however, there is some uncertainty about banks' risk exposure. Given this uncertainty and signs of potentially adverse developments in the real estate and mortgage markets, there is a need for action in many respects.

Therefore, the SNB and FINMA have already taken the first steps and intensified their monitoring of the mortgage market. For this purpose, at the beginning of 2011, the SNB launched a comprehensive quarterly survey of banks. In this survey, detailed information is collected on key risk indicators such as loan-to-value ratios and affordability criteria in the granting of mortgage loans. The survey results, which are expected from the autumn of this year, should contribute to a better analysis of the vulnerability of the Swiss banking sector and close existing gaps in data.

Moreover, a detailed analysis should be made as to what extent banks with a combination of high interest rate risk exposure and high mortgage lending growth are able to bear those risks. This is mainly a microprudential task, which is performed by FINMA.

Furthermore, a revision of the self-regulation guidelines for mortgage-backed loans by the Swiss Bankers Association might make a substantial contribution to preventing the development of significant imbalances in the real estate and mortgage markets. It might be worth considering the inclusion of quantitative "best practice" standards as a complement to the qualitative guidelines.

Ideally, microprudential supervision and self-regulation will prevent the build-up of systemic risk. Should the growth momentum currently being observed in mortgage lending and real estate prices continue, or even accelerate, further measures would have to be considered. Such measures should be countercyclical, thereby making a preventive contribution to financial stability.

At best, the SNB's monetary policy can only make a minor contribution to financial stability in this respect. First, monetary policy's primary objective is to ensure price stability. Second, monetary policy always affects the economy as a whole. Thus, its effect cannot be directed only at specific areas of the economy.

However, additional macroprudential tools, which would be much better suited to targeted intervention are currently not at the disposal of the Swiss authorities. In the recent past, both the SNB[1] and the International Monetary Fund (IMF)[2] have emphasised that there is a need for action in this area. For this reason, the SNB welcomes the Federal Department of Finance's decision to set up a commission of experts to draw up proposals on macroprudential oversight and to determine the associated institutional responsibilities.

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1 SNB's comment on the recommendations made by the business audit commission of the National Council and the Council of States.

2 IMF Country Report No. 11/115 within the framework of the Article IV Consultation of May 2011.