Thomas Jordan: Financial stability developments of relevance

Introductory remarks by Mr Thomas Jordan, Vice-Chairman of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Berne, 15 December 2011.

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In my introductory remarks today, I would like to look at the most important developments in the area of financial stability that have taken place since the publication of our most recent *Financial Stability Report* in June of this year. Our latest analysis reaffirms the need for action which we had already identified back then. Firstly, in view of the high level of risk associated with the current global economic environment, the big banks must – to the extent possible – push quickly ahead with the expansion of their loss-absorbing capital base. Secondly, given the medium-term risks in the real estate market, which are particularly affecting domestically focused banks, it is vital that an effective macroprudential policy framework be developed.

International developments of relevance for financial stability

The global economic and financial conditions which affect the stability of the Swiss financial system worsened in the second half of 2011. As my colleague, Philipp Hildebrand, has already mentioned, the outlook for global growth is currently subdued. A major reason for this is the sovereign debt crisis which has been building up in peripheral euro area countries for the last two years or so and is now threatening to spill over into the core countries of the euro area. The European banking sector is particularly affected, as investors fear losses from write-downs on government bonds. The ensuing loss of confidence in the banking system is resulting once again in a sharp fall in activity on the interbank market, which in turn is leading to higher refinancing costs and liquidity bottlenecks. Meanwhile, the European banks themselves are holding back economic activity with their restrictive lending practices. Weak economic activity is further hampering efforts by the affected nations to restructure their budgets. All of these developments have caused a steep rise in credit risk premia in financial markets.

In response to this serious situation, euro area countries have adopted additional measures to strengthen fiscal discipline in a sustainable way and to restore confidence in the European banking sector and the financial markets. The actual implementation of these measures is essential if the financial markets are to be convinced in the long term.

On the whole, we expect that the international environment will probably remain fraught with considerable uncertainty for some time to come; the risks to financial stability will remain correspondingly high.

Situation of Swiss big banks

The deterioration in the global economic environment has not left the Swiss big banks unscathed. In the second half of 2011, their profitability suffered from the volatile financial market situation as well as from low customer activity levels. Against this backdrop and given the enhanced regulatory requirements, UBS and Credit Suisse have announced that they will be significantly reducing their risk exposure for the next few years. In addition to this, they have further expanded their loss-absorbing capital base.

The Swiss National Bank welcomes these measures and sees them as further steps towards achieving a sounder capital situation. Additional efforts are necessary, however, because the loss-absorbing capital of big banks is still low, given their risk profile and the considerable uncertainty in the international environment. In order for them to be better equipped to deal with a possible worsening of current economic conditions, the big banks must further improve their capital situation. They can achieve this by retaining earnings. Another measure would be to issue contingent convertible bonds or contingent capital instruments with write-off features, an essential element of the "too big to fail" regulations. They can also strengthen their capital base by accelerating the announced reduction of their risk exposure. By making use of these options, the big banks could quickly and substantially improve their capital situation.

Situation of domestically focused banks

Allow me now to move on to the situation of banks with a domestic focus. The capitalisation of most domestically focused banks remains good. Profitability – as measured by the ratio of gross profits to assets – dropped slightly, however; not least because of the low interest rate margins. At the same time, domestically focused banks are having to contend with two significant risk factors, namely interest rate risk, which has remained unchanged at a high level, and credit risk, which has risen further.

Interest rate risk measures the potential for loss which results from a mismatch between the term structure of a bank's assets (e.g. mortgages) and that of its liabilities (e.g. customer deposits). While the term structure of assets gets increasingly longer, that of liabilities remains very short.

The rise in credit risk was due, on the one hand, to the deterioration in the outlook for the Swiss economy. A slowdown in economic growth in Switzerland could have a negative impact on domestic credit quality, with the result that banks would face the prospect of write-offs on their assets. On the other hand, the continued strong rise in mortgage loans and real estate prices has also caused credit risk to increase further in the past few months. Furthermore, the results of our mortgage lending surveys suggest a high risk appetite on the part of individual banks.

In this regard, the Federal Department of Finance (FDF) submitted two important measures for consultation which should counter potential imbalances in the real estate and mortgage markets: more risk-sensitive capital requirements for mortgage lending and a countercyclical capital buffer.

With more risk-sensitive capital requirements, incentives for mortgage lending should be structurally improved. The countercyclical buffer is a component of the Basel III framework and represents a variable capital requirement which is only activated in the event of excessive credit growth. As soon as credit growth weakens again, the buffer can be deactivated. It is thus not a permanent instrument for boosting capital, but rather a temporary requirement to be employed in exceptional circumstances.

The countercyclical buffer is an important element in the macroprudential toolkit. I would therefore now like to take a brief look at the progress made in the area of macroprudential policy in Switzerland from the SNB's perspective.

Progress in structuring the macroprudential policy framework

At its news conference one year ago, the SNB drew attention to the absence of an adequate set of instruments in the area of macroprudential policy. This was in response to a request by the Parliament's Control Committees to evaluate our mandate and set of instruments relating to financial stability. So what are the key milestones that have been achieved this year in establishing a framework for macroprudential oversight in Switzerland, in relation both to instruments and to the division of responsibilities?

Firstly, with regard to the above-mentioned countercyclical buffer, the financial stability task force led by the FDF has taken concrete steps towards implementing an important macroprudential instrument. In addition, the proposed structure of this buffer provides for a clear division of responsibilities: After consulting with FINMA, the SNB submits a request to the Federal Council regarding the activation and the level of the buffer. The Federal Council then makes the final decision.

Secondly, in the context of the implementation of the “too big to fail” regulations, the decision-making authority with regard to systemic importance was clearly defined. The proposed legislation gives the SNB the authority to determine which banks and which bank functions are systemically important.

Thirdly, the SNB should be given improved access to information that is necessary for macroprudential analysis. In this context, the Federal Council announced that it would look into ways in which the SNB could gain better access to information from banks in cases where FINMA does not have the requisite data available. To the extent that the existing legal basis does not provide adequately for this, the Federal Council intends to submit a proposal to Parliament in the near future.

The SNB welcomes the progress made in the area of macroprudential policy in Switzerland. What is crucial now is that the appropriate measures are indeed implemented. This is all the more important in view of the fact that the risk of imbalances in the mortgage and real estate markets has increased over this past year. Moreover, owing to its focus on the minimum exchange rate, monetary policy is currently unable to react to potential imbalances in the mortgage market using the traditional instruments. We will therefore continue to work within the relevant committees towards a rapid implementation of an appropriate, streamlined macroprudential policy framework. The decision as to what framework will ultimately apply in Switzerland lies, however, with the policymakers.