

## Philipp Hildebrand: Global financial system developments and the Swiss banking sector

Introductory remarks by Mr Philipp Hildebrand, Member of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 13 December 2007.

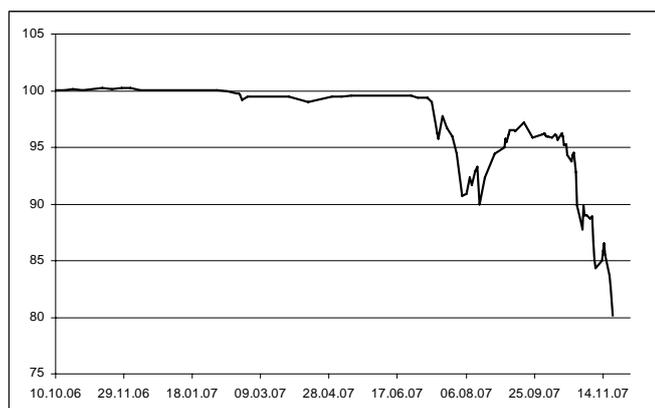
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Six months ago, when our Financial Stability Report was published, I stated that "the global financial system and the Swiss banking sector (...) are moving forward at a pretty fast speed". In view of the credit market turmoil we have experienced since then, I would like to give you a brief updated assessment of the situation. I will then talk about some initial lessons that can be drawn from the latest developments. In particular, I will present some proposals as to how similar situations could be prevented or at least mitigated in future.

### Deterioration of the situation in the banking sector as a result of the credit market crisis

Let me first give you my assessment of the current situation. On the whole, the position of the most important international banks in Switzerland is not as good as it was last June. The deterioration was mainly triggered by the crisis on the US sub-prime mortgage market. The slowdown in the US real estate market as well as surging interest rates in sub-prime mortgages led to a rise in loan defaults. Consequently, from July the prices of mortgage-backed securities (MBS) collapsed, after having remained practically constant for a long time. Even top-rated securities were affected by this slump. In the last few days, these prices have recovered a little, but volatility remains unusually high (cf. graph 1).

**Graph 1: prices of securities backed by sub-prime mortgages with AAA ratings<sup>1</sup>**



<sup>1</sup> US Subprime Residential Mortgage Backed Securities price index (ABX.HE, subprime RMBS), 2-2006 vintage with AAA rating. Source: Markit.

## **Crisis caused by high risks, insufficient transparency and inadequate risk management**

The sub-prime segment accounts for 12 to 15 percent of the US mortgage market. The US mortgage market, in its turn, corresponds to significantly less than 10% in value terms of total bonds and shares traded worldwide. How was it possible, then, that problems which were initially limited to just one segment could spread, triggering such widespread turmoil? Unfortunately, a lot of what has been unfolding has confirmed our fears of last June.

First, it has become evident that the risks incurred by many banks were too high overall. There was an ever increasing willingness on the part of banks to accept high risk, which, for example, resulted in strong growth in lending and expanding balance sheets. Moreover, markets probably assessed existing risks too optimistically, as was evident in view of the extraordinarily low risk premiums on bonds, for example.

Second, banks' increasing uncertainty about their own risks in the structured credit market and the creditworthiness of their counterparties turned out to be a handicap. Even the affected banks themselves did not know which contingent liabilities should be recorded on their balance sheets. Moreover, they had a lot of difficulty gauging the creditworthiness of their counterparties quickly and with sufficient accuracy. This confidence problem was particularly apparent in the interbank market. The risk premium for unsecured interbank loans has more than tripled since the onset of the US mortgage crisis.

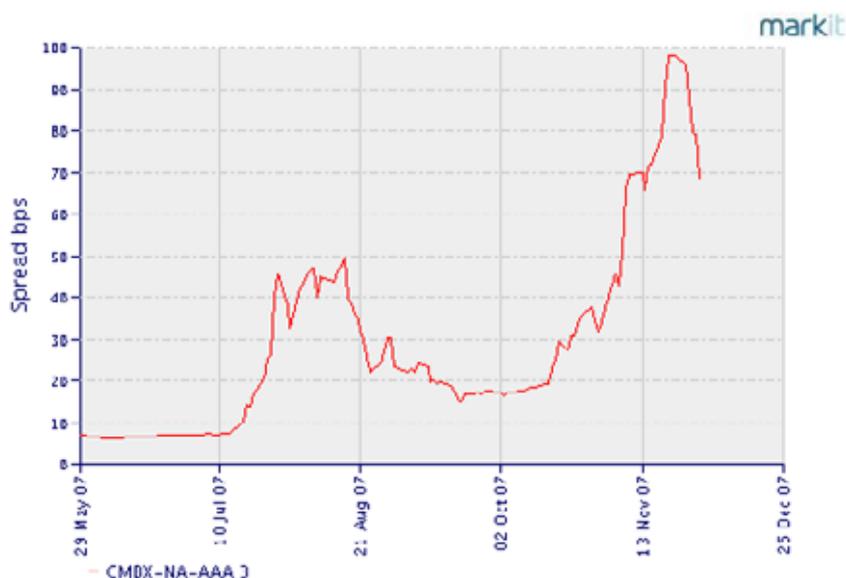
And, third, it has become clear that risk management has its limitations. In the area of market risk, events have occurred that – according to the models used – should not even have been possible, or at least would have been considered extremely unlikely. In the case of liquidity risks, it has become clear that assumptions and precautions based on normal times are not appropriate in extraordinary market situations.

## **Possible risks: contagion effects in related markets and deterioration of environment**

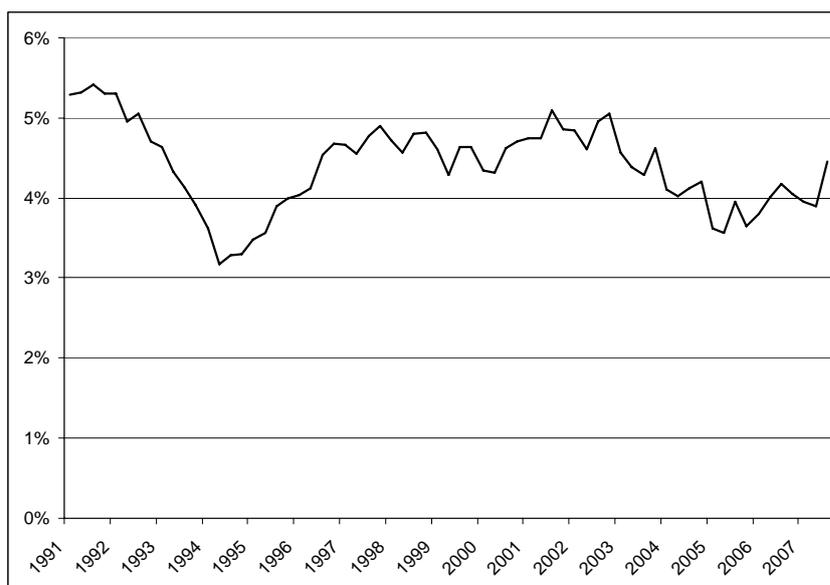
What comes next? Is the worst already past? Unfortunately, there is no clear answer to this question. A risk analysis reveals that, ultimately, the future course of the crisis is likely to be determined by two major risks.

First, it is not impossible that problems which have so far been limited to a few partial markets could spill over to additional markets. Such a danger of contagion mainly exists for related credit markets that have so far been largely unaffected by the turmoil. These include, for example, commercial real estate. Risk premiums on these securities have been pointing in a clear upward direction of late (cf. graph 2). The same development can be observed for US corporate bonds. However, by historical standards, the delinquency rate on credit card loans remains at a very low level, even though it rose in the third quarter (cf. graph 3).

**Graph 2: Risk yield premiums on commercial mortgage-backed securities<sup>2</sup>**



**Graph 3: Delinquency rate on credit card loans<sup>3</sup>**



The second risk is that the excellent economic environment in which we have operated until now might deteriorate. Of particular note here is the global economy, which so far has proved to be extremely resistant to the sub-prime crisis. The same applies to the stock markets. Save for a few corrections, they have held up fairly well since the middle of the year. This has strengthened banks' earnings situation in areas outside of the real estate business, thereby enabling banks affected by the credit crisis to compensate part of their losses. If the

<sup>2</sup> Benchmark index of credit default swaps (CDS) on US securities covered by commercial mortgage-backed securities (commercial MBS), 2-2006 vintage with AAA rating. Source: Markit.

<sup>3</sup> "Delinquency Rate on Credit Card Loans (All Commercial Banks)", USA. Source: Federal Reserve.

general economic environment were to deteriorate, this previous important source of stability would be adversely affected. Nevertheless, we must stress that the banks are still operating in a stable real economic environment, and that economic data from Europe, Latin America and Asia continue to provide evidence of robust growth momentum.

### **What can be learned from the current crisis?**

How can we ensure that the kind of market turmoil we are experiencing at present can be avoided in the future, or at least does not occur on this kind of scale? And how can we make sure that the banking sector will be in a position to emerge from comparable or even worse disruptions unscathed? Once again we need to stress that definitive conclusions cannot yet be drawn because the current crisis has not yet been overcome. However, as initial provisional lessons from the crisis, the following points seem particularly important to me.

First, banks need to improve their transparency on a sustainable basis. The fact that, last summer, most banks came out with information on their positions in the sub-prime market only hesitantly, providing an incomplete picture, has made a significant contribution to the uncertainty in the interbank market. Consequently, we are reiterating our request that banks do a better job in making information available on their existing risks. In order to promote market discipline, it must be possible for outsiders to be able to assess a bank's resilience under both normal and stress conditions.

Second, recent events highlight the limitations of risk-weighted capital adequacy requirements. The problems in risk management have made it clear that the modelling of bank risks will always remain imperfect. In interpreting capital adequacy requirements which are based on such risk models, we must therefore proceed with appropriate caution. This is particularly relevant in view of the new capital adequacy requirements that will also be introduced in Switzerland next year. The main change under these requirements, known as Basel II, is that capital adequacy requirements will rely more heavily on banks' own risk assessments. Bearing this in mind, the lesson learned last summer may well have come at the right time. This now begs the question as to whether – in addition to the complex, risk-weighted capital adequacy requirements – other criteria, such as volume limits or the simple debt-equity ratio should not also be considered. The reason for this is that the higher this ratio, the greater the leverage effect of losses on the soundness of a bank. It is not that I intend to question the concept of risk-weighted requirements in any way. Rather, it is my wish to possibly strengthen these requirements by introducing supporting measures. For example, compared with risk-weighted requirements, volume limits or the debt-equity ratio have the advantage that such key figures are basically very transparent and are not based on complex models. Moreover, they calculate the only element that is relevant in a crisis, and that is the size of the buffer that a bank needs to absorb losses.

Third, it is a striking fact that, to date, hedge funds have not been a focus of the current crisis. To a considerable extent, this is attributable to a much improved management of counterparty risk in recent years. It is my view that banks should strengthen their risk management as regards their own refinancing decisions and risk allocation and not just with respect to external customers such as hedge funds. The kind of internal subsidising of refinancing costs for individual business areas observed in some cases creates false incentives. In future, the refinancing costs that a bank charges its internal risk centres should constitute an integral element of its risk management approach.

To sum up, I would like to state that it is certainly true that the current situation in the credit markets is very serious. At the same time, I want to stress that, fundamentally, the earnings capacity of our international banks is high, thanks to their diversified business model, and this increases their resilience. In this respect, the measures announced by UBS, which are aimed at strengthening its capital base, are to be welcomed. The fact that UBS has been able to attract a large and internationally recognised Asian investor for this purpose serves

as an illustration of one of the ways in which globalisation of financial markets has been to our advantage.