Philipp Hildebrand: Current state of the Swiss financial system and lessons learnt

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, 11 December 2008.

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When we published our report on financial stability six months ago, I talked to you about the most important lessons that the SNB had learned from the financial crisis. Today, after a brief assessment of the current state of the financial system, I would like to tell you about progress in the follow-up from these lessons. The focus here is on capital and liquidity regulation. Finally, I will speak briefly about a more cheerful topic that is unrelated to the financial crisis – the launching of a new series of Swiss banknotes.

The economic environment has sharply deteriorated ...

As you have already heard from Mr Roth, the economic environment has sharply deteriorated. The three big economic blocs – Europe, Japan and the US – are in recession, and growth in the emerging economies has slowed markedly. For Switzerland, we also expect a period of negative growth.

The situation on the US real estate market has not yet stabilised. Futures on the Case-Shiller index indicate a further drop in prices of around 15% until 2010. Thereafter, the contracts suggest that prices will stabilise. Falling prices can also be observed in some European countries, in particular in the English and the Irish real estate markets. The past few weeks have seen some calming of global financial markets, but we are still a long way away from normalisation.

With the worldwide deterioration in the economy, credit risks at banks will rise considerably. Attention was drawn to this in June 2008, in our last report on financial stability. Bank provisions for credit risks are currently at a historically low level, and they will need to be substantially increased. This will have a negative impact on their profitability. In the case of the big banks, the situation also involves considerable risks for trading portfolios.

The worldwide economic downturn comes at a time when the international financial system is already in bad shape. In particular the big banks that have been hit especially hard by the crisis could be forced to curtail, or further curtail, their lending. This, in turn, could have additional negative effects on the real economy. In order to put a halt to this negative spiral, we consider it important that the economy be supported with monetary and fiscal measures. The interest rate reductions carried out by the Swiss National Bank (SNB) should be seen as part of these measures.

... but the resilience of the big banks has been increased

Given this situation, the fact that it has been possible to increase the resilience of the Swiss big banks is crucial. Credit Suisse boosted its capital through private investors by a total of CHF 10 billion. It thereby strengthened its equity position substantially and increased its capacity for absorbing additional shocks. The losses of CHF 3 billion announced by the bank for the fourth quarter show how important it was to reinforce the capital base.

At UBS, the government package provided significant relief to the balance sheet from the burden of illiquid positions particularly affected by the crisis. With this package, the SNB made it possible for UBS to transfer illiquid positions to a special purpose vehicle. The UBS provided this special purpose vehicle with equity amounting to USD 6 billion. The Confederation compensated UBS for the capital requirement arising for this purpose by subscribing to mandatory convertible notes (MCN). Since the announcement of the package, the UBS liquidity situation has stabilised.

The numerous international measures aimed at stabilising the financial system have also had a positive effect on the position of the Swiss big banks. Nevertheless, further losses cannot be ruled out in view of the difficult market conditions. The situation remains serious, and the SNB will continue monitoring it closely together with the Swiss Federal Banking Commission (SFBC) and the Federal Department of Finance.

Lessons from the crisis and reforms in Switzerland

I would now like to speak about the lessons learned from the crisis. The continuing financial crisis is almost unprecedented, in terms of both extent and duration. It is also unprecedented in terms of the measures taken by the authorities and the central banks with the aim of stabilising the situation and minimising the impact on the real economy. This also applies to Switzerland.

At the presentation of the last report on financial stability, we expressed our conviction that the financial system needs to be made more resilient to possible shocks. This is all the more valid if we consider the hundreds of billions of taxpayers' money that had to be spent worldwide on stabilising the financial system over the past few months. The focus is on the need for improvement in the "shock absorbers": capital and liquidity. The crisis has shown that the current regulation in these areas is no longer sufficient in the case of the big banks. Their level of capital is inadequate when set in relation to their risks. In the area of liquidity, events have occurred that were not taken into account in any of the big banks' scenarios.

The reform of the capital adequacy regulation for big banks, drawn up by the SFBC with the support of the SNB, represents an important step in the right direction – for the area of capital. It specifies an increase in risk-weighted capital together with the introduction of a leverage ratio. The leverage ratio is a supplementary instrument and does not call into question the principle of risk-sensitivity with regard to the capital regulation. An essential constituent of the reform are countercyclical mechanisms whereby, in good times, banks are required to considerably exceed the minimum requirements for capital and the leverage ratio. This ensures that a buffer is created to absorb losses during crises. This kind of flexibility is explicitly provided for in the new SFBC capital regulation.

The orders already issued by the SFBC relating to the reform of the capital regulation state that the big banks will not be required to comply with the higher risk-weighted capital ratio and the leverage ratio until 2013. However, if the situation on the capital markets or the individual earnings position of the big banks make it impossible to achieve the objectives by 2013, it may be possible to defer this date. The long time period allowed for implementation is crucial. It will prevent the new regulation from having a procyclical effect. In the short term, priority will clearly be devoted to managing the crisis.

In the area of liquidity, the SFBC and the SNB are in the process of drawing up a new regulation. The basic objective is to obtain higher liquidity buffers that better reflect the great complexity of liquidity risks. When calculating liquidity requirements for various crisis scenarios, the authorities use internal model calculations by the banks. In order to ensure the comparability and transparency of the internal calculations, the new regime foresees certain standardisations. The conclusion of the project is scheduled for early 2009.

Both regulatory measures – capital regulation and liquidity regulation – are in line with proposals made by the Financial Stability Forum and the G20 action plan. The reforms are also compatible with the strategy of the Basel Committee on Banking Supervision for implementing the lessons from the crisis. In a recent speech in Beijing, the chairman of the committee, Nout Wellink, said that the main objectives of the strategy were to strengthen capital and liquidity buffers and to restrict leverage in the banking system.[1] In the area of capital regulation, he also stressed the importance of countercyclical mechanisms and the possibility of combining risk-weighted and simple unweighted instruments.

We believe that the crisis should prompt the big banks to consider where the core competences of bankers lie, and that it should not be left to the authorities alone to think about the lessons to be drawn from the turmoil. In our view, long-term risk-adjusted considerations should take on more of a leading role in bankers' decisions. In this situation, we believe, the apparent contradiction between supervisory demands for more capital and liquidity, on the one hand, and banks' competitiveness, on the other, will be dissipated.

Preparations for the new series of banknotes running according to plan

As announced, I would like to close with a more cheerful topic that is unrelated to the financial crisis. A number of you will remember the SNB's artistic design competition for a new series of Swiss banknotes, which was held in 2005. Since then, design work has continued and the technical requirements for the creation of an innovative series of new banknotes have now been fulfilled.

Manuela Pfrunder, the graphic artist, has further developed her drafts and completed the design for the CHF 50 note, taking the technical aspects of banknote production into account. At its meeting of 29 August 2008, the SNB Bank Council approved the design of the new CHF 50 banknote and gave the go-ahead for the further work that is to be done.

Preparations for the technical aspects of implementation of banknote production are now in full swing. A particular challenge is posed by the security features that will be used in the new banknote series for the first time. Based on the progress of work to date, the SNB is confident that the first banknote in the new series will be ready for production within the planned time period. The CHF 50 banknote will mark the beginning of the new series of banknotes and is scheduled to be issued in autumn 2010. The appearance of the new banknote and the security details for the entire series will be presented shortly before the scheduled issue date.

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[1] Nout Wellink, The Importance of Banking Supervision in Financial Stability, High Level Meeting, 17 November 2008, Beijing