
Speech by Mr Jean-Pierre Danthine, Vice Chairman of the Governing Board of the Swiss National Bank, at the Media News Conference of the Swiss National Bank, Berne, 14 June 2012.

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Introductory remarks by Jean-Pierre Danthine

I, too, would like to welcome you to this news conference, which for me is also the occasion to present the 2012 edition of the Swiss National Bank’s Financial Stability Report. The report contains the SNB’s assessment of the risks to the stability of the Swiss banking system, and of the need for action. This promotes risk awareness among Swiss banking sector agents, thereby contributing to financial stability.

Introduction

Economic and financial conditions for the Swiss banking sector have deteriorated since the last Financial Stability Report. The sovereign debt crisis escalated, threatening to spill over from peripheral euro area countries to the core countries of the euro area. In addition, global economic growth lost momentum and tensions grew in the international banking system. There was, likewise, no easing of tension on the Swiss mortgage and real estate markets. The momentum observed in real estate prices and mortgages continued.

As my colleague, Thomas Jordan, has already mentioned, under its baseline scenario the SNB expects a gradual improvement in economic and financial conditions over the next 12 months. Although this is considered to be the most likely scenario, the risk of a renewed deterioration in the environment remains high. In the short term, under the adverse scenario there could be a substantial price correction on financial markets, and economic growth could slow markedly. Such a scenario would affect the two big banks in particular. For domestically focused commercial banks, the main risk stems from a potential fall in Swiss real estate prices over the medium term. This risk increases the more market prices diverge from those justified by fundamentals.

Given the high risks in the economic and financial environment, the SNB considers that there is a need for action by big banks and domestically focused commercial banks alike. The SNB’s recommendations are aimed at strengthening the resilience of the Swiss banking system, to ensure that it is in a position to continue performing its essential functions for the Swiss economy, even if the adverse scenario I have just described were to materialise.

Situation at the big banks

I would now like to present the key points of our assessment of the big banks.

Since June 2011, both big banks have made further progress in improving their resilience; first, by increasing their highest-quality capital – by which I mean loss-absorbing capital – and, second, by reducing their risk-weighted assets. CDS spreads, for example, suggest that the market considers the solvency of both big banks to be above average compared to other international banks. This is partly explained by the fact that they are only moderately exposed to the most vulnerable peripheral euro area countries.

Despite the fact that this progress has been achieved, the SNB considers that the big banks’ loss-absorbing capital is still below the level needed to ensure sufficient resilience. This assessment is based on three factors: First, in the event of a further escalation of the euro
area crisis, the loss potential for the big banks would be substantial compared to their loss-absorbing capital. As I have just pointed out, the big banks have only moderate direct exposure to the most vulnerable peripheral euro area countries, yet if the crisis in these countries were to deepen, a general deterioration in economic and financial conditions could be expected. In such a case, the potential losses for the banks would extend to a significant portion of their credit and trading positions.

Second, the SNB’s assessment is based on a comparison with capitalisation levels at other international big banks. This comparison uses the definitions of the Basel III framework once fully implemented. These definitions yield the most accurate picture of a bank’s true resilience. The comparison based on these definitions reveals that both Swiss big banks – and in particular Credit Suisse – are below the international average. Given the importance of the big banks for the Swiss economy and for financial stability, an above-average capitalisation level would be appropriate.

Third, the leverage of both big banks remains very high, despite a reduction in risk-weighted assets. At end-March 2012, the share of loss-absorbing capital in the net balance sheet total was 2.7% at UBS and only 1.7% at Credit Suisse. This capital would, for example, be insufficient to absorb losses such as those experienced by UBS in the recent financial crisis (over 3% of the net balance sheet total). In addition, the question remains as to what extent the reduction of risk-weighted assets is matched by an effective reduction of economic risks, if the balance sheet total remains unchanged.

For these reasons, the SNB considers that it is essential for both big banks to further strengthen their resilience. It recommends that UBS continue with the capital strengthening process – including, in particular, pursuing a policy of dividend restraint. Credit Suisse, meanwhile, should accelerate its process and take all action necessary to expand its loss-absorbing capital base significantly during the current year.

The SNB also recommends that both big banks increase their transparency with regard to resilience. Concretely, they should publish information on their capitalisation as defined under Basel III once fully implemented – as, indeed, UBS has done in the two most recent presentations of its quarterly results. They should also regularly calculate and disclose their risk-weighted assets according to the Basel standardised approach. The results of such calculations would provide a basis for comparison with risk-weighted asset figures calculated using internal risk models. This comparison would enable the ongoing reduction of risks to be presented more transparently.

Implementing these two measures is necessary from a financial stability perspective. However, it is also in the big banks' own interest to hold sufficient loss-absorbing capital, as a high level of resilience strengthens their competitiveness in the core business of wealth management, and boosts market confidence.

**Situation at domestically focused commercial banks**

I would now like to turn to our assessment of domestically focused commercial banks.

There are clear and growing signs of a build-up of imbalances on the Swiss mortgage and real estate markets. Over the past 12 months, mortgage lending volumes and real estate prices have once again grown strongly. Thus, the mortgage-to-GDP ratio, which was already high in a historical comparison, continued to increase. At the same time, residential real estate prices have reached levels that, in some cases, exceed those that can be justified by fundamental factors, such as demographics or per capita income. Taking the national average, this is the case for prices of owner-occupied apartments. In some regions such as Lake Geneva, Lake Zurich and Lake Zug, this is the case, on average, for all segments of the residential property market.
Under the baseline scenario, the momentum in the mortgage and real estate markets continues. It is therefore to be expected that imbalances will continue to build up, and that, consequently, the risk of an abrupt correction of these imbalances will increase over the medium term.

For domestically focused commercial banks, average capitalisation relative to regulatory requirements is at a historically high level. Moreover, most of these banks’ capital is of the highest quality, and thus loss-absorbing. However, in the current environment, the resilience of these banks, as measured by the regulatory capital indicators, is overestimated.

- First, certain risks are not captured by the regulatory requirements. This applies, in particular, to interest rate risk in the banking book, which covers traditional deposit and lending activities. In the current situation, with historically high interest rate risk exposures, this is a significant shortcoming.

- Second, the current capital requirements have a procyclical effect. Thus rising real estate prices, by causing loan-to-value ratios to fall, can lead to lower capital requirements. Given the growing imbalances on the real estate market, banks’ resilience, as measured by the regulatory capital indicators, is overestimated.

- Third, the low level of diversification of most domestically focused commercial banks is not taken into account in capital requirements. The main focus of these banks’ business activities, and their risk exposures, relate to mortgage lending. This concentration of activities is compounded by a geographical concentration at the cantonal or regional level.

In the light of these factors, the SNB considers that action is needed on two fronts: First, the capacity of some banks to bear the risks incurred must be reviewed, and strengthened if necessary. This applies particularly to banks which have cumulative risks, such as high interest rate risk and high exposure to the mortgage and real estate markets. FINMA’s microprudential measures will play a key role in this regard. Second, as the SNB has repeatedly emphasised, given the cyclical risks in the Swiss mortgage and real estate markets, a temporary adjustment of banking system-wide capital requirements may have to be considered. To this end, on 1 June the Swiss Federal Council announced that a macroprudential instrument will be made available to the Swiss authorities from 1 July, in the form of a countercyclical capital buffer.

Introduction of a macroprudential instrument

To conclude, I would like to briefly describe how the countercyclical capital buffer will work. This instrument will enable the authorities to adjust capital requirements in the banking system, depending on potential excesses in the Swiss credit market. It is a preventive instrument that can be activated if necessary, to a level deemed appropriate. It can also be targeted to a specific segment of the credit market. Once the imbalances have been corrected, the countercyclical capital buffer will be deactivated, either immediately or gradually.

In activating the countercyclical capital buffer, the aim of the authorities is twofold: First, it should increase the resilience of the banking sector, thereby helping to protect against the consequences of a correction of excessive credit growth. Second, it should help to lean against the build-up of such excesses.

The Federal Council decides on the activation, deactivation and level of the countercyclical capital buffer, upon the proposal of the SNB. The SNB consults FINMA before submitting its
proposal. The proposal will be based on an in-depth analysis and assessment of the situation on the Swiss credit market, which will, in principle, be carried out once a quarter.¹

The signs of a build-up of imbalances on the Swiss credit market relate to the residential mortgage segment. Thus, if the buffer had to be activated, it would be aimed solely at this segment of the credit market. When assessing the necessity of activating the buffer, the SNB will take into account the impact of other recently announced measures focusing on the mortgage and real estate markets. These measures include a further revision of the self-regulation rules and a tightening of risk weightings for mortgage loans. In addition, as part of its monetary policy mandate, the SNB will closely monitor the impact of a possible activation of the countercyclical capital buffer, in order to assess the consequences for the economy as a whole.

The current situation justifies the fact that this instrument, scheduled for implementation under Basel III, has been made available to the Swiss authorities at an early date. Numerous past crises have highlighted the costs associated with credit market excesses. Even if the countercyclical capital buffer does not enable us to prevent the build-up of all imbalances in the Swiss credit market, it should help to reduce these costs in the future, provided it is activated early enough for its preventive properties to take full effect.

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