Thomas Jordan: Challenges for Switzerland as a financial centre

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the NZZ (Neue Zürcher Zeitung) Capital Market Forum, Zurich, 3 September 2012.

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Introduction

“If you see a Swiss banker jumping out of a window, follow him, there is sure to be a profit in it.” This famous saying, attributed to the French writer and philosopher Voltaire, has been in circulation for more than two centuries. In recent years, however, the reputation that Swiss bankers have for turning a profit under all circumstances has been somewhat tarnished. Pressure on the Swiss financial centre has been intensifying, due mainly – but not exclusively – to the financial crisis. For banks domiciled in Switzerland, doing business and making money has become more difficult. But this is not the first time that Switzerland as a financial centre has faced stiff headwinds. Throughout our history, Swiss bankers have managed to draw the appropriate conclusions, and change course in time. Allow me, therefore, right at the outset, to say this: I am convinced that the Swiss financial centre will be successful in overcoming the many challenges ahead, and that it will remain an important pillar with regards to the wealth of our nation.

The Swiss National Bank (SNB) has also faced a number of challenges since the onset of the global financial crisis in 2007. We have repeatedly been forced to counteract the adverse effects of enormous shocks to the Swiss economy, in line with our mandate to ensure price stability, while taking due account of economic developments in Switzerland.

At the current juncture, the economic uncertainty in the euro area, in particular, is of great concern to Switzerland and the SNB. While we cannot influence the developments in the euro area, we can act in a resolute and timely manner to dampen the negative implications for our country.

The most visible measure we have taken is undoubtedly the introduction, almost exactly one year ago, of the minimum exchange rate. In the current situation, a further appreciation of the Swiss franc would constitute a very substantial threat to the Swiss economy, and would carry with it the risk of deflationary developments. With this in mind, we will continue to enforce the minimum exchange rate with the utmost determination, in line with our mandate.

Today, however, I do not want to talk primarily about monetary policy, but about the Swiss financial industry. Allow me to start by explaining why the financial industry, in general, and a healthy and stable banking sector, in particular, are of vital interest to the SNB.

There are two main reasons.

First, the banking system fulfils a key financial intermediary role in the economy. Due to this pivotal function, the banking sector plays a crucial part in the transmission of monetary policy. On the other hand, however, it may also be the source of financial shocks that impact on the real economy.

Second, the industry is itself a large part of the Swiss economy. The significance of the financial industry and our position as a global financial centre are important contributors to the wealth of our nation. This is especially apparent here in Zurich, where the financial sector generates much employment, wealth and tax revenue.

In my remarks, I will first discuss the macroeconomic challenges associated with the banking sector’s key role in the transmission of monetary policy, as well as the risk that it may propagate financial shocks to the economy. Then, I will discuss the challenges for the industry itself. Lastly, I will address the main implications from the SNB's point of view.

Macroeconomic challenges

Let me start by focusing on the macroeconomic challenges associated with the importance of the Swiss financial industry, and, in particular, the banking sector, for the rest of the economy.

The main reason why the banking sector is so important for the Swiss economy and the SNB lies in its traditional function as financial intermediary. As banks collect funds and provide financing to firms and households, they are the "life blood" of the economy.

Related to this traditional function, there are two distinct aspects I would like to point out. First, banks play a crucial part in the transmission of monetary policy. There are various channels through which monetary policy is transmitted to the economy, but the primary channel is via changes to the short-term nominal interest rate, in other words, via the cost of borrowing and the return on savings. Monetary policy thereby affects investment and consumption decisions throughout the entire economy, thus influencing business level activity and price dynamics.

In its implementation of monetary policy, the SNB provides short-term liquidity to the banking system, and not directly to firms and households. Banks, as financial intermediaries, in turn transmit these monetary policy decisions to the real economy. The extent, however, to which the banks respond to these decisions – by changing their interest rates on deposits, loans and their credit supply – depends on a number of factors, such as the degree of competition, but also the banks' balance sheets. The effects of monetary policy can thus be impaired if banks have poor balance sheets.

Thus, the banks' function as financial intermediaries is a welcome and influential channel through which the SNB's monetary policy decisions affect the economy. There is, however, a downside to this role. The banking sector can also propagate large financial shocks to the rest of the economy. In other words: the financial industry itself can have a large impact on the economy.

In Switzerland, the propagation of financial shocks to the real economy is potentially large in magnitude. There are two reasons for this: the size and the international orientation of the financial industry.

First, the financial industry makes up a large share of gross domestic product (GDP) in Switzerland – larger than in other rich nations. For example, at its peak in 2007, the financial industry contributed around 13.5% to GDP in Switzerland, compared to just 8% in the US, 7.5% in the UK, and less than 5% in Germany[1].

In countries with large financial industries, households and non-financial companies generally rely more on external capital. Consequently, in these nations, shocks to the financial system have larger output effects. The financial industry's considerable share of GDP thus implies that shocks to the financial system potentially have more substantial effects on the real economy of Switzerland than in other countries[2].

Second, parts of Switzerland's financial industry are very internationally oriented. In the aggregate, around half of the entire value added by banks in Switzerland stems from

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1 Source: OECD, Structural Analysis Database.

2 This has been documented empirically by Levintal (2009), who shows that the effects of fluctuating bank profits on GDP growth are related to the size of the financial industry as a share of GDP; Kroszner, Laeven and Klingebiel (2007) find that bank crises have more pronounced real effects in countries with a higher ratio of loans to GDP.

business conducted with foreign customers. Over half of all assets under management by Swiss banks come from foreign customers[3].

The international orientation of the industry has contributed to Switzerland's success as a financial centre. This orientation also implies that its business is diversified and less dependent on the domestic economy. For example, during the Swiss real estate crisis of the 1990s, profitable international business activity helped to stabilise the banking sector.

However, the downside of the international focus is that susceptibility to foreign shocks is considerable. Because foreign business is sizeable, shocks abroad can cause substantial losses for Swiss banks. An example of this are the huge losses some Swiss banks have experienced in recent years due to their US subprime mortgage positions. Where banks have to absorb such losses on their balance sheet, they may encounter refinancing difficulties and be forced to sell assets at any price. This may in turn lead them to cut back their credit supply, and the monetary transmission mechanism may be impaired[4]. In the worst case, the financial system could be destabilised, threatening the whole economy. Fortunately the Swiss economy has not suffered a credit crunch – not even in 2008 and 2009. A package of public sector measures greatly contributed to the stabilisation of the Swiss financial system.

To sum up, our economy is especially susceptible to financial shocks due both to the size of the Swiss financial industry and its international exposure. As a consequence, a major challenge that arises for Switzerland as a financial centre is to make sure the banking sector is resilient so it can cushion shocks when they occur. Otherwise the financial industry will be unable to fulfil its role as a financial intermediary.

A lot has been achieved in recent years to strengthen the resilience of the banking system. In particular, the two big banks have made progress in this area. They have increased their highest-quality capital and reduced their risk-weighted assets. This is an on-going process that will further increase the stability of the system.

Challenges for the financial industry

Ladies and Gentlemen, so far I have focused on the macroeconomic challenges arising from the importance of the financial industry for the economy. Let me now turn to the challenges the Swiss financial industry itself faces.

Obviously, like its peers abroad, the Swiss financial industry has to cope with several challenges. Let me focus on three which I consider to be most relevant for Switzerland – wealth management, residential mortgages and regulatory measures addressing "too big to fail" issues.

Wealth management is challenged on several fronts. Revenues in wealth management will continue to be depressed. In jittery financial markets, client trading volumes are low. The flat yield curve reduces the margin between deposits and credits. In addition, competition in private banking with foreign clients will continue to intensify. And finally, wealth management

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[3] Data from the SNB's Swiss Balance of Payments 2011 report shows that international receipts from bank financial services stood at CHF 15.1 billion in 2011, equivalent to 43% of the total value added in the banking sector in 2011 (CHF 35 billion as reported by the Swiss Bankers Association). The Swiss Bankers Association reports that in 2011, around 51% of assets under management at Swiss Banks originated from foreign customers (cf. "Der Finanzplatz Schweiz und seine Bedeutung", Swiss Bankers Association, 2012).

[4] It is important not to underestimate the economic importance of international transmission of financial shocks via bank linkages. Goldberg and Cetorelli (2010) document the fact that global banks transmitted the international shock during the 2007–09 financial crisis to emerging market economies, leading to both cross-border lending contraction and contraction of domestic lending.

will have to adapt to changing international standards and international tax agreements. In such an environment, it is hard to maintain profit margins and retain clients.

The second challenge for the Swiss financial sector relates to signs of overheating in the Swiss residential real estate market. Over the past two years, the SNB has repeatedly drawn attention to these risks. Residential mortgages are very important in Switzerland since they account for around 70% of the assets of domestically oriented Swiss banks. There are signs that residential properties are overvalued in the Geneva, Zurich and Zug regions, for instance, as well as some tourist areas. Even though, there were recent indications of a possible slowdown of momentum, the risk remains of a further build-up of imbalances followed by a significant price correction in the residential real estate market[5]. Against this backdrop, it is important that banks use prudent credit standards to limit potential default risks and are well-capitalised so they can withstand such potential losses should they arise[6].

The third challenge is specific to Switzerland's systemically important global banks. Like their peers abroad, they will have to adapt to new supervisory requirements that address "too big to fail" issues and the resulting moral hazard. In the past, systemically important banks enjoyed an implicit bailout guarantee by their governments. Not only did this lower their refinancing costs, but it also led to various distortions in the areas of leverage, excessive risk taking and compensation. A wide range of measures will address problems caused by institutions that are too big to fail. These include a systemic risk capital surcharge, recovery plans and organisational measures. The systemically important banks will have to adjust to these measures. This process will take time and will not occur overnight.

Implications for the Swiss National Bank

I have discussed the challenges that arise for Switzerland as a financial centre from the SNB's perspective.

Our mandate is to maintain price stability, while taking due account of the development of the economy. To ensure that we can always conform to this mandate, we need a stable banking system. Monetary policy transmission could not work properly without such a system. At the same time, it is equally important that the financial system itself is not a source of excessive risk for the rest of the economy.

Our efforts are thus concentrated on increasing resilience by mitigating systemic risk. To ensure this, we work closely with the Financial Market Supervisory Authority, FINMA, the Federal Department of Finance and various international standard-setting bodies. A great deal has been achieved in our country so far.

One of these achievements is the countercyclical capital buffer (CCB)[7], which has recently generated a number of headlines. As you know, the SNB has, for the time being, decided against proposing the activation of the CCB. There are two reasons for this. First, as I have already mentioned, we have observed some indications of a possible slowdown of price momentum in the market for residential real estate. Second, two other measures came into effect at the beginning of June – stricter capital requirements for mortgages and a revision of the self-regulation rules for mortgage lending.

However, this is far from an all-clear for the real estate market – I want to underline again that the risk of a further build-up of imbalances followed by a significant price correction is

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[5] Cf. SNB press release, 27 August 2012.

[6] Cf. SNB, Financial Stability Report, 2011 and 2012

[7] Cf. SNB fact sheet "Implementing the countercyclical capital buffer in Switzerland: concretising the Swiss National Bank's role."

still present. The CCB is a key element in the package of measures recently approved by the Federal Council. These measures should help to mitigate the risks to financial stability from imbalances developing in the real estate and mortgage market. The CCB enables the authorities to temporarily raise capital requirements in the banking system, as imbalances in the credit market develop. It serves two purposes, strengthening the resilience of the banking system by increasing its loss absorbing capacity and helping to lean against the build-up of excesses. It is a very flexible instrument and may be activated for specific sectors of the credit market only.

Let me at this point also stress two – in my view – important principles in the context of rules and regulation. First, authorities should define the framework for the financial system, but they should not propagate a specific business model for the industry. That means it is up to companies and individuals to take business decisions, to choose the most promising business model and to adapt to the changing environment.

Second, we have to acknowledge that it is very difficult for banks to do business without a predictable set of rules and related interpretations. In this regard, after a period of rapid changes, we should aim for a stable banking regulation framework at both the national and the international level. Our focus should now move to a consistent and rigorous implementation of the Basel III framework across the globe.

Concluding remarks

Ladies and Gentlemen, I have discussed the challenges Switzerland faces as a financial centre.

While I consider these challenges to be high hurdles, they are not insurmountable. The Swiss financial industry has constantly adapted throughout its history; it will continue to adapt to the current challenges and continue to be successful.

What can the SNB contribute to the success of the financial industry? I am convinced that an independent, stability-driven central bank with a clear mandate, willing and able to act forcefully if appropriate, is a necessary condition for a competitive and vibrant financial centre. However, this condition is far from being sufficient.

In that spirit, allow me now to throw the ball into your court.

The future of the Swiss financial industry is in your hands. It is your integrity, your power of innovation and your service to the customer that is pivotal for the Swiss financial industry. It is up to you to shape the future of this industry.

While I certainly do not pretend to know the business decisions you will have to take in the years to come, I am pretty sure that jumping out of the window is not the best option. In this regard, it may be worthwhile remembering that Voltaire himself made a fortune, and went on to be celebrated as an old wise man – without, to my knowledge, ever following his own advice.

I thank you for your attention.