Jean-Pierre Danthine: Resilience of Swiss banks from a financial stability perspective

Introductory remarks 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, 12 December 2013.

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In my remarks, I would like to look at the situation at Swiss banks from a financial stability perspective, taking the big banks first and then moving on to a discussion of domestically focused banks. To close, I will say a few words on the subject of banknotes.

Big banks: strengthening resilience

Since the last media news conference in June, the two Swiss big banks have improved their capital situation further. This applies particularly to their risk-weighted capital ratios, where, in an international comparison, they are above the average for large global banks. Credit Suisse, for example, has already met the requirement of 13% loss-absorbing capital to risk-weighted assets, which comes into force in 2019. According to its published plans, UBS should be able to meet this target by the end of 2014. As regards total capital – which, in addition to loss-absorbing capital, also comprises low-trigger contingent capital instruments – the big banks have also made great progress; however, they have not yet achieved the ratios that will apply from 2019.

Unweighted capital ratios – leverage ratios – generate a different picture. Both banks have also been able to improve their leverage ratios considerably; yet in an international comparison based on a number of commonly used definitions, they are still below the average of large global banks.

As my colleague Thomas Jordan has explained, economic and financial conditions for the Swiss banking sector continue to be challenging. For this reason, it is vital for the big banks to continue improving their capitalisation, and in turn their resilience, particularly as regards the leverage ratio. This is especially important because the leverage ratio is growing in significance as a measure of bank resilience. In times of crisis, in particular, the leverage ratio often becomes the focus of market attention.

In the SNB's view, the top priority for the big banks is the consistent and rapid implementation of the "too big to fail" (TBTF) regulations. The focus should be on the following areas:

First, the credibility of risk-weighted asset calculations based on banks' internal models should be strengthened. As outlined previously, risk-weighted ratios yield a different picture of a bank's capital situation than leverage ratios. In this context, the SNB is currently supporting FINMA in an examination of whether and to what extent risk-weighted assets based on banks' internal models differ from those based on the standard approach, which is model-independent. If this examination reveals no substantial inexplicable differences, this would strengthen market confidence in the model-based approach. Conversely, if there are any substantial differences that cannot be explained, corrective measures would need to be considered and implemented. Such measures would also boost confidence in the model-based approach.

Second, it must be ensured that, if necessary, there can be an orderly resolution of a big bank in the event of a crisis. From the Swiss perspective, the emergency plans on maintaining systemically important functions are particularly important in this regard. The emergency plans must be credible and workable in a crisis. For this reason, the big banks should continue to push forward consistently with their emergency plans. Moreover, global resolution plans must ensure that the non-systemically important units of a big bank can be resolved in an orderly fashion. Adjustments to the group structure, as recently announced by both big banks, represent a first step in this process. An additional tool which can facilitate global resolution is based on the bail-in concept, which is the subject of widespread discussion at international level. With a bail-in, debt can be converted to equity capital, which would enable the big banks to carry additional losses in the event of a crisis. However, the effectiveness of a bail-in essentially depends on whether appropriate debt is available in sufficient quantities, and whether its characteristics are such as to ensure a smooth conversion into equity capital in the event of a crisis. In this regard, the authorities will have to examine the extent to which it is necessary to expand the existing TBTF regulations to take account of Swiss specificities.

Domestically focused banks: resilience and lending policies

I would now like to turn to the domestically focused banks. In Switzerland, there has been a further increase in risks on the mortgage and real estate markets since the end of 2012. This development poses the greatest challenge to the stability of domestically focused banks over the medium term.

Conditions on the mortgage market, in particular, have deteriorated. In Switzerland, growth in mortgages for residential real estate continued to exceed GDP growth in 2013. In the first three quarters of this year, mortgage volumes increased by CHF 27 billion, or an annualised 4.4%. Over the same period, annual economic output, i.e. aggregated economic output over four quarters, rose by CHF 8.4 billion from the end of 2012, or an annualised 1.9%. This means that, for Switzerland as a whole, the already high indebtedness is continuing to grow faster than people’s capacity to offset this debt with income.

The situation on the residential real estate market has also deteriorated slightly. Depending on the segment, real estate prices have risen in real terms by between 2.6% and 3.5% on average since the beginning of the year. Despite a slowing of momentum compared to last year, these growth rates are still high in a historical comparison. In addition, overall, prices for residential real estate have increased more strongly than rents or income since the beginning of the year.

There is also no sign of a reversal of domestically focused banks’ risk appetite. With regard to mortgage lending for owner-occupied residential property, the proportion of new loans with high loan-to-value ratios has decreased slightly. Where affordability risks are concerned, however, no such development can be identified. Moreover, domestically focused banks remain the driving force behind the strong domestic mortgage growth. While a few individual banks have reined in their lending considerably compared to last year, others have maintained a high level of lending growth, or have even stepped up lending. Finally, interest rate risk exposure is extremely high by historical standards, whereas average interest rate margins have narrowed further over the same period.

On a positive note, domestically focused banks’ capitalisation as measured by regulatory requirements remains at historically high levels. However, as discussed in this year’s *Financial Stability Report*, these regulatory capital ratios could be overstating the banks’ resilience, because the major risks prevailing in the mortgage and real estate markets or the interest rate risk exposure are not, or only partly, taken into account. Against this backdrop, banks should – irrespective of the regulatory requirements – continuously assess their resilience, and make adjustments where necessary. They should be able to maintain their economically important functions, even if real estate prices were to fall sharply and interest rates were to simultaneously rise.

Over the last few years, a number of measures have been taken to reduce the risks to financial stability arising out of developments in the mortgage and real estate markets. The most recent of these measures is the activation, in February this year, of the countercyclical capital buffer (CCB). These measures were necessary and useful. For example, this year a few large domestically focused banks – citing, among other reasons, the activation of the CCB – have taken steps to strengthen their capital and thereby their resilience. So far, however, the package of measures has not been enough to prevent a further build-up of imbalances on the mortgage and real estate markets.

In an environment of persistently low interest rates, coupled with banks' undiminished appetite for risk, the danger of a further build-up of imbalances remains considerable. For this reason, the SNB continues to monitor the situation very closely, and regularly assesses whether the CCB should be adjusted.

Supply of secure banknotes ensured at all times

Now I would like to say a few words on the subject of banknotes. At the beginning of October, we informed the public that, since autumn 2012, a small number of Swiss 1000-franc banknotes have been in circulation which were not issued by the SNB. As you know, these notes were abstracted during the production process at Orell Füssli, before they had been through all stages of production.

Out of consideration for the investigation by the Office of the Attorney General, this information was only made public after some of these notes appeared in Switzerland. As previously announced, those in possession of such banknotes will be reimbursed the nominal value by Orell Füssli.

For the SNB, security is paramount in the production of banknotes. Orell Füssli has reviewed its security arrangements, and has taken the necessary measures to ensure that such events are precluded to the greatest possible extent in the future.

I would like to emphasise that the SNB and Orell Füssli have been working together in the area of banknote production for about a century. The supply of secure banknotes for our country has been, and will continue to be, guaranteed at all times. We will also be pursuing the development of the new banknote series in close collaboration with Orell Füssli.

As you are aware, the new banknote series has suffered a series of delays. The SNB is committed to putting banknotes into circulation that are state of the art in terms of both design innovation and technology. Our current banknote series was unique in this respect when it was issued in the mid-1990s. And it still has a very high security standard today, as a result of this commitment to quality. This means that the SNB is not under any pressure to roll out a new banknote series quickly. The new series must meet very high security, quality and technical production standards – and will have to do so for at least 15 years after its first release. So it is worth taking the time to ensure that the new security features, which are complex, technologically innovative and have never before been applied to banknote design, can also stand up to the rigours of industrial production processes. A number of tests are currently being carried out. The first denomination in the new series – the 50-franc note – will not be issued until 2015 at the earliest. We will announce the exact issue date as soon as production of the first banknote denomination has been completed.