Jean-Pierre Danthine: Presentation of the Swiss National Bank's Financial Stability Report

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, 18 June 2015.

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As my colleague Thomas Jordan has explained, global economic growth in the first quarter of 2015 was below expectations. However, over the last 12 months, we have seen an improvement in international economic and financial conditions, although substantial risks remain. The domestic environment has become more challenging due to the strong appreciation of the Swiss franc that followed the discontinuation of the minimum exchange rate in January 2015. Against this background, I would like to examine the situation at Swiss banks from a financial stability perspective, looking first at the big banks and then moving on to a discussion of domestically focused banks. A more detailed assessment of the situation can be found in the latest *Financial Stability Report* published today.

Big banks

Further improving resilience

Over the past year, the Swiss big banks have continued to improve their capital situation, albeit at a slower pace than the year before. They already meet most of the requirements which will apply from 2019. While acknowledging the progress made, the SNB recommends that the big banks do not lose momentum in their efforts to improve their resilience. This is particularly warranted with regard to the leverage ratio.

Resilience needs to be further improved for three reasons: First, the big banks' loss potential relative to their capitalisation continues to be substantial. Second, while the Swiss big banks' risk-weighted capital ratios are above the average for large globally active banks, the same cannot yet be said for their leverage ratios. Third, it can be expected that regulatory developments at both international and national level will result in increased capital requirements.[1] The Swiss big banks should prepare for these developments.

RWA problem identified, but not yet resolved

In the capital regulation of banks, risk-weighted assets (RWA) play a key role. As mentioned in previous *Financial Stability Reports*, both markets' and authorities' confidence in RWA calculated using banks' internal models has steadily declined. A number of studies have shown that, in some instances, model-based RWA do not properly reflect a bank's economic risks.[2] As a consequence, capital ratios calculated using model-based RWA may overstate the true level of resilience.

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1 Based on the review of the Swiss "too big to fail" regulations by the group of experts on the further development of the financial market strategy (Brunetti group of experts), the Federal Council has instructed the Federal Department of Finance to prepare legal adjustments, which primarily concern more stringent capital requirements. Cf. media release of the Federal Council, 18 February 2015.

2 For instance, international studies have revealed significant differences in RWA between banks using the model-based approach. These can only be partially explained by differences in the level of risk taken by the banks. Cf., for example, Basel Committee on Banking Supervision, *Regulatory consistency assessment programme (RCAP) – Analysis of risk-weighted assets for market risks*, January 2013; cf. also EBA, *Interim results of the EBA review of the consistency of risk-weighted assets,* 26 February 2013; Barclays, *The dog that dug*, 21 September 2012. Studies at national level have also shown that model-based RWA are too low in some cases. Cf. FINMA Annual Media Conference, "Models and their limitations", 31 March 2015.

To address this problem, regulatory initiatives have been launched at international and national level. At international level, the Basel Committee on Banking Supervision is fundamentally revising the standardised approach. The Committee is also examining the introduction of a floor for internally modelled RWA based on this revised standardised approach. One important objective of the floor would be to ensure that capital requirements based on banks' internal models do not fall below a prudent level.

At national level, FINMA – together with the big banks and with the support of the SNB – has conducted a comparison between RWA calculated using the model-based and standardised approaches. The results of this comparison, in addition to the measures already taken by FINMA and those expected at the international level, will be taken into account by a working group led by the Federal Department of Finance. This working group will draw up proposals and the associated legal adjustments for implementing the recommendations in the Federal Council's 'too big to fail' evaluation report.

Alongside these regulatory initiatives, the SNB still considers it necessary that the big banks increase transparency with regard to RWA. FINMA has now called on these banks to disclose the differences between calculations using the model-based and standardised approaches. Such enhanced transparency is necessary to restore the credibility of model-based RWA and to strengthen market discipline.

The SNB continues to hold the view that risk-weighted capital requirements – including a floor for model-based RWA – and leverage ratio requirements should complement each other. Risk-weighted requirements should guide economic decisions at the margin, while the leverage ratio should serve as a backstop. Yet, until the measures to resolve the RWA problem take effect, it is prudent to give a greater weighting to the leverage ratio when assessing the big banks' resilience. Indeed, analysts increasingly pay attention to the leverage ratio when assessing and comparing banks.

Domestically focused commercial banks

Increased mortgage exposure, capital situation stable

I would now like to turn to the domestically focused commercial banks. In 2014, these banks further increased their exposure to the Swiss mortgage and residential real estate markets. While the share of new loans with high loan-to-income ratios – a measure of affordability risk – remained persistently high, mortgage lending growth and the share of new mortgage loans with a high loan-to-value ratio decreased. Hence, the increase in exposure was lower than in previous years.

With respect to bank capitalisation, the situation remained largely unchanged in 2014. First, the domestically focused commercial banks' leverage ratios remained stable at high levels by historical standards. Second, these banks' risk-weighted capital ratios increased slightly and are significantly above regulatory minimum requirements overall. Furthermore, stress test results suggest that most domestically focused banks should be able to absorb estimated losses without seeing their capitalisation fall below the regulatory minimum. Nevertheless, under the most relevant adverse scenarios for these banks, the losses would deplete a large proportion of their surplus capital.

Experience in Switzerland in the 1990s, as in other countries, suggests that this would lead to a general weakening of the banking sector and significantly affect banks' ability to lend, with negative and lasting repercussions for the real economy.

The stress test results highlight the importance of banks holding significant capital surpluses relative to the regulatory minimum requirements. The activation of the countercyclical capital buffer in 2013 and its increase in 2014 has made a significant contribution in this respect.

Risk of renewed increase in imbalances on mortgage and real estate markets

Overall, imbalances on the mortgage and residential real estate markets have remained broadly unchanged since the last *Financial Stability Report*. From a financial stability perspective, this is a positive development.

However, it is still too early to give the all-clear. On the one hand, imbalances remain at a high level and have not yet started to decline. On the other hand, the further decline of capital and money market interest rates observed since January 2015 carries the risk of a renewed increase in imbalances on the Swiss mortgage and residential real estate markets over the medium term.

First, compared to alternative assets, investments in real estate appear to have become more attractive for banks, commercial investors and households. In the residential investment property segment in particular, additional demand from investors searching for yield might push prices up further.

Second, the unprecedented interest rate environment creates additional incentives for banks to incur higher interest rate and credit risks. They might be tempted to increase both maturity transformation and lending to compensate for the additional pressure on margins and to stabilise short-term profitability. Such strategies would further increase banks' exposure to large interest rate shocks and to a correction on the mortgage and real estate markets. Given these risks to financial stability, banks and authorities should remain alert and, if necessary, take measures to contain such risks.

In particular, should momentum on the mortgage and residential real estate markets pick up again, additional measures might become necessary. In this regard, particular attention should be paid to the investment property segment. This segment is more likely to be materially affected by the additional demand from investors searching for yield in the current environment. Furthermore, the measures taken so far have predominantly addressed the segment of owner-occupied residential real estate.

For its part, the SNB will continue to monitor developments on the mortgage and real estate markets closely, and will reassess the need for an adjustment to the countercyclical capital buffer on a regular basis.