Speech

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Comments on monetary policy and banking regulation

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Mr President of the Bank Council
Dear Shareholders
Dear Guests

It gives me great pleasure to welcome you to our Annual General Meeting. As is customary, the first part of my speech will be devoted to comments on the current economic situation and monetary policy. Ten years after the start of the global financial crisis, we can now look back on a year in which economic momentum has been much more positive – both in Switzerland and worldwide. The question is: has the global economy now finally completed its unusually sluggish recovery process? As I will show, there are indeed grounds for optimism, but it is still too early for this to give way to euphoria.

In the second part of my speech, I would like to look at the state of play in banking regulation. A decade on from the global financial crisis, we should not just be asking whether we have recovered from the consequences of this event; we should also take stock of what we have done to improve the ability of our banking system to withstand future crises. As I will set out, the regulatory measures put in place have clearly strengthened the resilience of our banking system, and we therefore have reasons to be optimistic in this regard as well. That said, if we are to sustainably safeguard the stability of the financial system, it is imperative that we implement in full the regulatory measures that have already been agreed. We must also continually review them to ensure they are fit for purpose.

Let me begin with some comments on the current economic situation and monetary policy.

The economic situation and the SNB's monetary policy

Economic situation

The Swiss economy improved continuously last year. Capacity utilisation increased and unemployment declined. Real GDP in the fourth quarter of 2017 was up 1.9% year-on-year, while inflation also returned to positive territory last year for the first time since 2011.

The improved economic situation is not only attributable to the upturn in the global economy. There have also been favourable developments on the foreign exchange markets, as the Swiss franc has weakened since the second half of 2017, against the euro in particular. This has boosted the price competitiveness of export-oriented industries and provided welcome relief for the Swiss economy.

The Swiss franc's trade-weighted real external value is currently around the same level as prior to the discontinuation of the minimum exchange rate in January 2015. There has thus been a reduction in the significant overvaluation, but our currency nevertheless remains highly valued.

Monetary policy

With a view to ensuring appropriate monetary conditions, we are continuing to pursue our expansionary monetary policy. This is based on the negative interest rate that banks and other financial market participants are charged on their sight deposits at the SNB and on our continued willingness to intervene in the foreign exchange market as necessary.

Both instruments remain essential as the situation is still fragile. While the foreign exchange market has largely shrugged off recent equity market turbulence, circumstances in the financial markets – and thus by extension monetary conditions for the economy – could rapidly deteriorate again.

Such a development would be undesirable in the current environment. Inflation is now within the range that the SNB equates with price stability, and capacity utilisation in the economy has continued to improve. Nevertheless, inflation remains low and inflationary pressure is modest despite our expansionary monetary policy. Tightening monetary conditions would be premature at this juncture, and would risk unnecessarily jeopardising the positive economic momentum that has been established.

The Swiss economy picked up markedly last year against a positive global economic backdrop. However, we should not let ourselves get carried away. Despite the easing on the foreign exchange market in the past twelve months, both short-term (cyclical) and longer-term (structural) challenges remain. Competition with other business locations around the world remains as intense now as it was prior to the crisis. Switzerland will only be able to preserve its economic competitiveness and prosperity if its companies continue to be highly flexible and innovative, and if our politicians succeed in maintaining our country’s particularly favourable economic conditions.

Turning now to the second part of my speech, I would like to once again take a look back at the global financial crisis.

Regulation ten years after the UBS incident

Banking system weaknesses exposed by financial crisis

Almost ten years ago, the federal government, FINMA[1] and the SNB were forced to take steps to stabilise UBS and the Swiss financial system, with the state and taxpayers having to temporarily take on the big bank’s risks. Many other countries found themselves confronted with similar problems and also had to rescue banks.

The financial crisis brought to light fundamental weaknesses in the international financial system. As regards the banking system and regulation, two aspects stand out in particular. First, at that time many banks’ resilience was inadequate. Relative to their risk exposure, their liquidity and equity buffers were insufficient to absorb major outflows of funds and losses.

1 At that time, Switzerland’s financial market supervisory authority went by the name of the Swiss Federal Banking Commission.

Second, certain banks were so large and interconnected that their collapse would have triggered a chain reaction, dragging down other – fundamentally healthy – financial institutions with them. This would have resulted in considerable costs to the economy. When such banks got into difficulties, the states in question had no option but to rescue them.[2] This has become known as the 'too big to fail' issue.

International measures to strengthen financial stability

In the aftermath of the crisis, the relevant international bodies defined new standards and revised existing regulations to strengthen financial stability. In December last year, for example, the Basel Committee on Banking Supervision finalised the Basel III international regulatory framework for banks. Prior to that, the Financial Stability Board (FSB) had already adopted new rules to address the 'too big to fail' issue.

These regulatory approaches have tackled the weaknesses that were uncovered. An initial set of measures sought to strengthen the resilience of all banks, with more effective rules being issued with regard to liquidity and capital adequacy.

The new liquidity standards ensure that banks can absorb exceptionally high outflows of funds over a period of 30 days, and that they have sufficient amounts of stable funds to finance their activities for the next twelve months.[3]

The capital requirements were amended in two respects. First, deficiencies in the risk-weighted capital ratio (that is to say, the ratio between capital and risk-weighted assets) were remedied; the changes restrict the banks' scope in calculating their risk-weighted assets.[4] Second, a non-risk-based measure was added to the capital requirement. I would like to look at this briefly now.

In making business decisions, for example when granting a loan, banks have to weigh up risk and return. The risk-sensitive management of a bank therefore needs to be matched by risk-sensitive regulation. The risk-weighted capital ratio requirements address this, ensuring that a bank engaging in transactions with higher returns – and hence higher risk – also has to hold more capital. Accordingly, the risk weight applied to a speculative foreign investment is markedly higher than that applied to a mortgage in Switzerland.

That being said, it is often difficult to estimate and model risks precisely. For this reason, a simple, non-risk-based capital ratio has now also been introduced, stipulating that a bank's

2 These banks thus had a de facto state guarantee – their creditors could assume that the government would cover large losses and indemnify them in the event of a bankruptcy. Accordingly, they were prepared to deposit money with the banks at comparatively favourable terms. This funding advantage in turn allowed the banks to take on large risks. Overall, such a constellation is not ideal from the perspective of society as a whole as it creates a 'moral hazard' issue.

3 The short-term parameter is referred to as the Liquidity Coverage Ratio, while the longer-term requirement is known as the Net Stable Funding Ratio.

4 The risk-weighted capital requirement is referred to as the Risk-Weighted Assets Ratio, or RWA Ratio for short. Banks are permitted to use their own models for calculating RWA. However, to prevent overly low RWA figures being reported and ensure comparability between banks, the framework stipulates an 'output floor' for the RWA calculated by the banks. These must not be less than 72.5% of the RWA calculated using a standardised approach defined by the regulator.

capital may not fall below a certain percentage of its total assets.[5] By setting a minimum capital requirement, this ratio protects against overly optimistic risk assessments.

The new liquidity and capital requirements apply to all banks. They strengthen the ability of an individual bank to withstand major outflows and losses without becoming illiquid or insolvent.[6] A second set of measures is aimed exclusively at large and highly interconnected banks, and addresses the 'too big to fail' issue.[7]

Banks whose collapse would have a significant impact on the economy and financial system were thus made subject to more stringent requirements than other banks.[8] These systemically important banks must hold an additional capital buffer to bolster their resilience and reduce the likelihood of them getting into difficulty.

However, the possibility of major shocks in the financial industry and real economy causing systemically important banks to get into existential difficulties can never be entirely ruled out. Systemically important banks must therefore take financial and organisational precautions to prepare for such an event.[9] Specifically, they must hold sufficient loss-absorbing capital to enable them to carry out a restructuring or wind-down on their own, i.e. without taxpayers' money.[10] They must also put measures in place to ensure that they will remain able to act in the event of a crisis and that the bank can be restructured or wound down in an orderly fashion.

This second set of measures thus reduces the risks stemming from systemically important banks in that it strengthens the crisis resilience of such institutions while also enabling a restructuring or orderly wind-down.

5 The ratio of capital to total assets is known as the Leverage Ratio.

6 The financial crisis showed that it is not only the amount of capital that is important, but also its quality. Basel III therefore also raised capital quality requirements. In particular, the regulation ensures that eligible capital can already be used to absorb losses before insolvency proceedings are initiated. This is the only way that such capital can act as a buffer and counter the threat of the bank having to cease operations.

7 The international regulatory framework has also put in place further measures to reduce systemic risks in the banking sector. For example, the risk of contagion within the banking sector is to be reduced through more consistent measurement and control of concentrations of exposure to specific counterparties (e.g. other banks). The procyclicality of regulation is also addressed – in phases of excessive lending the regulator can set a countercyclical capital buffer. This increases the capital requirements for banks during upswings, releasing the capital again in downturns. The measure is designed to prevent banks from having to increase their capital and restrict their lending activities during a downturn, thereby exacerbating cyclical fluctuations.

8 The FSB ranks Credit Suisse Group AG and UBS AG as global systemically important banks (G-SIBs). In Switzerland, the Banking Act gives the SNB the authority to designate banks as being systemically important for the Swiss market, following consultation with FINMA. Banks are deemed to be systemically important if they perform functions in the domestic lending and deposit-taking business, as well as in the payment transactions area, which are essential to the Swiss economy and cannot be substituted at short notice. In addition to Credit Suisse Group AG and UBS AG, the SNB has designated Zürcher Kantonalbank, the Raiffeisen Group and PostFinance Ltd as systemically important.

9 These are referred to as gone-concern requirements. A fundamental distinction is drawn between going-concern and gone-concern requirements. The former address the ongoing business activities of a bank, whereas the latter relate to the event of a bank having to be restructured or wound down.

10 The fact is that banks typically get into difficulty precisely when they no longer have sufficient capital available. The regulations therefore allow for debt to be written off or converted into equity in such instances. Such instruments, which are designed to absorb losses in the event of a resolution, are referred to as bail-in instruments.

Banking regulation in Switzerland

With these two packages of measures, the international bodies have defined global minimum standards. However, many countries have gone further than these requirements, Switzerland among them.

Why does it make sense for us to set high standards in this area? Switzerland has a particularly large financial centre relative to the size of its economy. The banking sector is directly responsible for around 5% of value added in Switzerland, and employs more than 115,000 people. Moreover, in its role as a financial intermediary it is essential for the efficient functioning of the economy. It is therefore of major importance to the economy as a whole.

Efficient and internationally active banks play a key role in this context. A break-up of systemically important banks would therefore not be in Switzerland's overall economic interests, making it all the more crucial that these banks be sufficiently robust. For this reason, the Swiss regulations require systemically important banks to hold a larger capital buffer than the minimum standard laid down in the international framework.

You might argue that higher capital requirements are detrimental to the financial centre. In the case of Switzerland in particular, however, such requirements must not be viewed solely as a cost driver. In today's world, a robust banking system is a significant advantage for a business location in the face of international competition. It attracts clients and businesses, and is therefore desirable not only in the interests of financial stability, but also from the perspective of the banks themselves.

Furthermore, Swiss regulators have opted for a streamlined regulatory approach compared with other countries with major financial centres. Switzerland refrains from actively intervening in the business models or organisational structures of the banks, and no distinction is drawn between desirable and undesirable banking practices. Our regulation focuses on the essentials, specifically on ensuring that banks can themselves absorb any losses resulting from the risks they take on, without destabilising other parts of the financial system or damaging the economy.

Taking stock

What have we achieved with the measures that have been put in place? Is the Swiss banking system more resilient to crises today? Please allow me to give you our take on this. I will first look at those banks with a domestic focus before moving on to the big banks.

Switzerland's domestically focused banks were not at the centre of the financial crisis, and all in all the new regulations are also likely to have little effect on them; their liquidity and capital buffers are mostly well above the regulatory minimum requirements. The stress tests that the SNB regularly conducts to assess risks also show that the banking system is largely well capitalised.

Notwithstanding this, the risk appetite of domestically focused banks has increased again in recent years, not least due to the low interest rate environment. There are also imbalances on the mortgage and real estate markets. It is therefore important that the domestically focused banks are aware of the risks they have assumed and ensure that they remain well capitalised in the future.

And what about the two big banks? Both have clearly strengthened their resilience in recent years, and are on track to meet the required standards within the stipulated time frame. They have continually improved their capitalisation with respect to maintaining operations as a going concern and ensuring their loss-absorbing capacity in the event of a restructuring or orderly wind-down.[11] They have also put in place key organisational measures to increase their resolvability. For example, both have set up Swiss subsidiaries that would continue their systemically important functions in Switzerland in the event of a crisis. The big banks have therefore already made substantial efforts on this front.

What still remains to be done? First, the process of building up capital to absorb losses in a resolution scenario must be completed, and this will be achieved in the near future. Second, by the end of 2019 the two big banks have to demonstrate that in the event of a crisis, they would still be able to maintain the functions that are systemically important for Switzerland. In other words, the Swiss entities that cover the systemically important functions must be sufficiently independent of the remainder of the bank, both operationally and financially. In addition, plans for a restructuring or wind-down of the entire bank (at the global level) have still to be finalised.

Looking at the domestically focused banks and the big banks together, we can say that the resilience of our banking system as a whole has increased significantly. We are convinced that our banks are better able to withstand a crisis today than they were ten years ago. What is more, banks' management bodies and the supervisory authorities alike now have a better understanding of how to assess risks.

The comprehensive implementation of the agreed measures will further improve the stability of our financial system. We will still have systemically important banks in the future. However, these must no longer be too big to fail; that is to say, the state and taxpayers must no longer have to fear being held hostage. The new banking regulations therefore contribute to reducing risks, but they also take into account both the considerable economic importance of Switzerland's banking sector and our interest in having a significant financial centre.

I would like to cross over here, if I may, to the sovereign money initiative. The authors of this initiative hope that, if adopted, it would result in a more stable financial system. However, switching to an untested sovereign money regime would radically transform Switzerland's tried-and-tested financial framework. Given the lack of empirical data and comparable systems worldwide, such a transformation risks plunging Switzerland into a period of great

[11] From the end of 2019, both of Switzerland's big banks must have a Leverage Ratio of at least 5.0% and an RWA Ratio of at least 14.3% on a going-concern basis, excluding the countercyclical capital buffer. Added to this are the gone-concern requirements in the same amounts (without taking any reductions into account). Overall, both of the big banks must thus have total loss-absorbing capacity (TLAC) of 28.6% of their RWA and 10.0% of their total assets.

uncertainty. The SNB therefore considers that the most effective approach is to make our banking centre more crisis resilient using the measures I set out before.

It is now incumbent on us to complete the implementation of the new regulations rigorously. A large part of this has already been done. The authorities will of course have to review the effectiveness of the regulations going forward, and in so doing must also consider the costs of such regulation for the banks and the economy. The goal here has to be to keep costs as low as possible without diluting the fundamental elements of financial stability.

Concluding remarks

Ladies and Gentlemen, in my speech I have painted a positive picture of regulatory efforts and of our banks' ability to withstand a crisis. The resilience of our banking system has increased significantly, and will be improved yet further once all of the regulations have been implemented in full. Nonetheless, we would be wise to keep our feet on the ground.

The new banking regulations will not be able to prevent all crises – indeed, it is not claimed that they can. Their purpose is to substantially reduce the likelihood and severity of any future financial crisis. At the same time, the Swiss regulations will resolve the 'too big to fail' issue. Together these measures will strengthen the resilience of the banking sector, which can surely only benefit our economy and enhance our prosperity.

Allow me to conclude by taking this opportunity, also on behalf of my Governing Board colleagues, Fritz Zurbrügg and Andréa Maechler, to thank our employees for their hard work and dedication. We also thank you, our shareholders, for your loyalty to the SNB and your faithful support. Let me also thank our young guests from Gymnase intercantonal de la Broye in Payerne and Kantonsschule Schüpfheim in Canton Lucerne for their interest in monetary policy and the SNB. Thank you all for your attention.