

Mr Gehrig focuses on special structural characteristics involved in solving the Year 2000 problem for the financial sector in Switzerland

Speech by Prof Bruno Gehrig, a member of the Governing Board of the Swiss National Bank, at the Global 2000 Coordinating Group Meeting in Montreux on 30 April 1999.

I am most delighted to be your luncheon speaker today and thank you for your invitation. I am sure that Montreux provides you with a highly stimulating environment for today's Global 2000 meeting.

As you are no doubt aware, you are leading the way in tackling the Year 2000 issue. I would like to thank you for your extremely important and valuable commitment, and I am certain that I also speak on behalf of my colleagues from other central banks, bank supervisors and - even more importantly - countless customers in the financial industry.

On the threshold of the third millennium we are indeed confronted with most complex and - in many regards - unique challenges. In terms of methodology, I believe it is essential to realise that we are dealing with complex network problems which cannot be solved on the basis of the behaviour patterns of market and competition we are all familiar with. In this context, external or third-party effects are in fact so significant that remarkable collective effort is necessary in order to minimise potential damages resulting from malfunctions. This applies both to the preparatory work and the challenge to overcome frictions which - in spite of our best efforts - will be unavoidable. Public institutions and private companies are equally called upon to engage in a high level of cooperation and coordination beyond competition, even if, and especially where no individual business case can be made. The scope of preparations for the Year 2000 is unprecedented in many dimensions. I cannot think of any other project which requires a similar degree of cooperation and coordination within and across organisations, industries, sectors and countries.

Features of the Swiss case

Even though preparations are generally making good progress in Switzerland, the country's readiness chart exposes areas in which efforts will have to be strengthened. As far as the financial sector is concerned, which will be the focus of my remarks, there are some special structural characteristics involved in solving the Year 2000 problem. Our financial centre is the home of some large global players in the banking and insurance sectors as well as the place where numerous cross-border customer relationships are concentrated. We are, therefore, exceptionally vulnerable to international shocks. On the other hand, this also means that we must take on more responsibility with regard to the risk of inflicting damage on third parties through our own failure. A second phenomenon, which is germane to Switzerland, is the fact that - in comparison with other countries - the two big banks, CS and UBS, garner a very significant share of all banking transactions. Without doubt, this results in a high concentration of risk, but also yields some significant advantages. Two such advantages stand out:

- The collective efforts of our banking sector are governed by a natural leadership structure which facilitates and accelerates development processes,
- and, secondly, the two big players act in some measure as know-how brokers, swiftly incorporating the Year 2000 experiences gained abroad into the process of solving the problem in this country.

More generally speaking, our long tradition of practical cooperation between competitors and of close ties between regulators and banks is a distinct plus in the preparatory work. Jointly managed institutions like the Swiss Exchange, our central securities depository, or the Swiss Interbank Clearing System are well-known examples of this spirit of cooperation.

I am confident that the large-scale interbank tests scheduled to begin in May will provide us with a positive picture of the state of preparations.

Assuring liquidity

From the viewpoint of a central banker, assuring adequate liquidity must be the prime concern. Based on the nature of their business, banks are inherently vulnerable. Withdrawals and redistribution of deposits can jeopardise the banks' capacity to pay. Such effects, should they materialise at all, may take place as a millennium shadow before or during entering the next millennium.

It is primarily the duty of individual banks to brace themselves for such events. They must undertake careful liquidity planning, comprising both a normal scenario as well as different stress scenarios. They must have a clear idea where, in what form, and to what extent they can cover their liquidity needs and make the necessary limits and collateral available. In this process, it is crucial that banks - interfacing with large customers - enter into agreements with one another, thus creating a high degree of transparency. The goal is to limit the range of unexpected behavioural changes by creating transparency and reaching an understanding.

Looking at the issue from this vantage point also makes it clear that a strategy of avoiding transactions is completely contra-productive. Even though it makes sense to avoid settlement dates of forward contracts falling immediately before and after the millennium transition, it is vital that transactions can be carried out and that markets remain liquid. It is at least conceivable that smaller banks or those with a somewhat lower rating will be confronted with an outflow of deposits while the top names in the industry receive an influx of deposits. This generates stress which can only be reduced by efficiently re-channelling funds between banks. It is obvious that the availability of sufficient collateral is crucial.

The availability of collateral - just in case - is therefore the central focus of liquidity planning. In the case of Switzerland, the potential re-channelling problem has both an aspect ameliorating the problem and one making it more difficult. What may actually ease the situation is the fact that the cantonal banks, with roughly one-third of the market share, operate with a state guarantee. They are, therefore, not likely to face any outflows of deposits. The Swiss franc money market, on the other hand, is dominated by the two big banks. These play a key role in ensuring the stability of the system and therefore must shoulder a heavy responsibility.

Role of the Swiss National Bank

Central banks also play a significant role in the preparations toward securing liquidity. They are the providers of central bank money which is the medium with which the final settlement of payments is carried out. I would like to give the following brief outline of our plan:

1. Banks and the public can count on our providing the liquidity necessary for coping with the millennium generously and flexibly, i.e. by maintaining a continuous presence in the market. I do not think that there is any basis to the objection that such a promise will lead to a moral hazard. Firstly, because the liquidity planning of each bank is monitored and enforced by a supervising body. Secondly, because we will create liquidity on a collateralised basis only.
2. We will provide liquidity with the usual monetary policy instruments on a spot and - if appropriate - forward basis. We are aware, however, that the processes connected with the individual instruments differ considerably as regards their vulnerability to malfunction or breakdowns. Settlement of a foreign exchange purchase against Swiss francs, for instance, is relatively complex and therefore exposed to a non negligible operational risk. Settlement risks

with repo transactions, however, are significantly lower because in our system, collateral must only be transferred between accounts by the central securities depository. This is a simple and straightforward process which - if necessary - could even be implemented manually. Consequently, we encourage banks to pay special attention to their holdings of repo collateral when engaging in their liquidity planning. Furthermore, we will considerably expand our repo basket by including selected foreign currency securities. This step which is primarily motivated by our intention to transact also with counterparties abroad obviously produces a useful side-effect on collateral availability over year-end. It is our clear commitment to provide liquidity sufficient to smooth market developments before and at the transition. Of course, all banks, especially those which do not engage in repo transactions, can avail themselves of significantly increased lombard limits just for the year-end, if they wish so.

As regards the distribution and the available stock of banknotes, we have made the necessary provisions. After having put a new banknote series into circulation recently, our inventories are more abundant than they would have to be even in a worst-case scenario.

Final remarks

Let me conclude by making two final remarks.

Firstly, the need for successful active and reactive communication can hardly be overestimated. The millennium has an almost magical fascination which may stimulate crisis fantasies and is perfectly capable of triggering herd effects. We must counter this by creating credible transparency and reacting to any possible alarming rumours swiftly and in a co-ordinated fashion. This is one of the tasks of the Swiss Staff 2000 which involves the Bankers' Association, the important providers of services like clearing, settlement and the Exchange, banking supervision and the central bank. It seems indispensable that the authorities play an important part both in active and reactive communication.

And, secondly, we must diligently carry on our preparatory work, continuously and openly report on the progress made, as well as adjusting the allocation of resources in accordance with the risks involved. At the same time, we must bear in mind that we will be faced with unexpected friction and bottlenecks. While it is true that the millennium transition poses a veritable challenge, I am fully convinced that it is manageable and that we will rise to the occasion. Let us all build on the positive relationship between our ongoing efforts to improve our readiness including a whole variety of contingency plans and the chance to eventually enjoy the pleasure of having been wrong and unnecessarily pessimistic in providing for all kinds of gloomy scenarios.