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## Introductory remarks by Jean-Pierre Danthine

As my colleague Thomas Jordan has explained, economic and financial conditions for the Swiss banking sector continue to be challenging. 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.

### **Big banks: Strengthening resilience**

Over the past year, the Swiss big banks have substantially improved their capital situation. Risk-weighted capital ratios have been raised markedly, and both banks are now very well placed in an international peer comparison. Moreover, with its capital-building, Credit Suisse has also raised its leverage ratio considerably. Measured in terms of loss-absorbing capital – defined as Common Equity Tier 1 capital plus high-trigger contingent capital instruments – leverage ratios at the big banks are now at roughly the same level.

However, given the prevailing risks in the environment and the losses incurred in the recent crisis, the SNB still considers current leverage ratios at the Swiss big banks to be low. In addition, a number of comparative studies imply that, in terms of leverage ratios, UBS and Credit Suisse are currently below the international average.

The big banks' published plans on strategy and capital-building envisage a further improvement in their capital situation. According to these plans, and measured in terms of loss-absorbing capital, by the end of 2014, Credit Suisse and UBS are likely to have already met the risk-weighted capital requirement of 13% which will apply from 2019. Moreover, these plans will lead to a substantial increase in their leverage ratios by the end of 2014. The SNB acknowledges the big banks' progress to date and recommends that they consistently and fully implement their plans, in order to further strengthen their resilience and, in particular, to improve their leverage ratios. Improving the leverage ratio is all the more crucial given the growing importance of this indicator as a measure of banks' resilience.

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### **Credibility of model-based risk-weighted assets**

The risk weighting of assets plays a key role in determining the capital requirement for a bank. All of the bank's on and off-balance-sheet positions are multiplied by a risk weight. The riskier the position, the higher the weight. The figure for risk-weighted assets (RWA) represents the sum of these risk-weighted positions. Required capital, in turn, is defined as a percentage of RWA. There are two different approaches for setting risk weights. Under the standardised approach, risk weights are prescribed for broad asset classes. Under the model-based approach, by contrast, banks can use their own internal models to determine the risk weights for different assets.

The credibility of RWA based on banks' internal models is increasingly being called into question by market participants, analysts and authorities worldwide. It is widely accepted that a bank's risks can, in principle, be more accurately quantified using the model-based approach than using the standardised approach. Yet banks' internal models are extremely complex and can vary widely between banks, owing to the use of different model choices and model parameters. This can result in different capital requirements for banks with a similar asset structure. This makes it difficult to accurately assess a bank's resilience, and to compare one bank with another.

To increase the usefulness and credibility of the model-based approach, in-depth analyses need to be carried out to determine whether and to what extent the model-based approach and the standardised approach lead to differences in RWA. The standardised approach does have shortcomings. Yet, since it is independent of bank-specific modelling assumptions, it provides market participants with an additional point of reference for assessing both the level of and changes in model-based RWA. Differences between the two approaches must be well explained and have a sound economic rationale. If the analysis does not reveal any substantial inexplicable differences, this will strengthen market confidence in the model-based approach. Otherwise, appropriate measures should be considered. This could, for instance, entail setting a floor for some model-based RWA, such as that recently introduced for banks in the US. Another option would be to introduce a multiplier on model-based risk weights for specific positions, as already imposed by FINMA for some mortgage loans. Efforts are underway at FINMA, supported by the SNB, to analyse potential differences between the two approaches.

In this context, the SNB recommends that the big banks increase transparency with regard to their risks. This includes, among other things, publishing their internal measures of total risk. Disclosing RWA according to the standardised approach in addition to model-based RWA would likewise lead to greater transparency with regard to risks. Greater transparency would help to make changes in model-based RWA easier to understand, and thereby increase the credibility of the model-based approach.

### **Domestically focused banks: Resilience and lending policies**

I would now like to turn to our assessment of domestically focused commercial banks.

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At present, the risks for these banks are primarily linked to the situation and momentum on mortgage and real estate markets.

In an environment of historically low interest rates, there has been a build-up of imbalances on these markets. On the one hand, the ratio of mortgage loans to GDP has increased to very high levels in a historical comparison. On the other, growth in real estate prices has been persistently stronger than what can be explained by fundamental factors. Owing to these developments, measures were announced in June 2012 to reduce risks in the Swiss mortgage market. These measures include a revision of the self-regulation rules for mortgage lending and stricter capital requirements for mortgage loans. Despite the measures taken, however, imbalances continued to build up in 2012. Against this background, the Federal Council decided in February 2013 to activate the countercyclical capital buffer, at the proposal of the SNB.

In the light of this risk situation, the fact that the capitalisation of domestically focused banks is significantly above the regulatory minimum requirements is a welcome development. Indeed, compared to the previous year, these banks have even improved their regulatory capitalisation slightly. Moreover, most domestically focused banks already meet FINMA's capital buffer requirements, which go beyond Basel III.

However, figures on regulatory capital may overestimate the true resilience of these banks. For one thing, the risks in the real estate market in particular are not or only partly taken into account in the regulatory capital requirements. For another, neither interest rate risk nor the low diversification of these banks – whose activities are centred on the domestic mortgage market – are fully reflected in the capital requirements.

These aspects are currently of particular importance for three reasons. First, as already mentioned, mortgage and real estate markets have seen a further build-up of risks since June 2012. Second, there has been further significant growth in mortgage lending at domestically focused banks. Although growth momentum has declined year-on-year, the volume of mortgage claims at these banks has increased by around 5%. Third, banks' risk appetite in lending has remained persistently high. For instance, a large proportion of new mortgages granted for owner-occupied residential property still have a loan-to-value ratio of over 80%. Furthermore, the share of new loans with stretched affordability has also remained at a high level. At the same time, the interest rate margin of domestically focused banks narrowed further in 2012, while interest rate risk remained historically high.

In view of the persistently low level of interest rates, there is the risk that, despite the measures already implemented, imbalances on the Swiss mortgage and real estate markets will continue to build up. This would increase both the likelihood and the consequences of a price correction in the medium term. Such a price correction could be triggered, for example, by a sharp increase in interest rates. Against this background, domestically focused banks should therefore continue to ensure that their resilience is sufficiently high, irrespective of the regulatory requirements, and make adjustments where necessary. They should be able to

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maintain their economically important functions, even if real estate prices were to fall sharply and interest rates were to simultaneously rise.

In particular, domestically focused banks should make sure that the currently high direct interest rate risk is assessed and managed using conservative assumptions. In this context, the assumptions applied by banks with regard to savings and sight deposits are especially important. In an environment of historically low interest rates, these deposits have proven to be very stable sources of financing in recent years. This does not mean, however, that the situation will remain stable in the future. Were the general level of interest rates to rise, these funds could quickly flow elsewhere. Banks should therefore include these assumptions in their assessment and management of their interest rate risk.

Furthermore, domestically focused banks should exercise greater caution in residential mortgage lending. When determining and applying their lending criteria with respect to loan-to-value ratios, banks should bear in mind that the risks in the real estate market have increased. Moreover, when assessing the affordability for their borrowers, banks should be aware that mortgage rates can rise rapidly. The application of conservative lending criteria is important, on the one hand, as a precautionary measure for the banks themselves, in view of the prevailing risks in the market. On the other, a more prudent lending policy would help to counter a further build-up of imbalances.

From a financial stability perspective, in the event of a further build-up of risks in the Swiss mortgage and real estate markets, it might prove necessary to take further regulatory measures. The SNB, for its part, will regularly assess whether an adjustment of the countercyclical capital buffer is necessary.