Financial Stability Report 2024

SNB BNS

Executive Summary

Macroeconomic and financial environment
Since the publication of the last Financial Stability Report in June 2023, developments in the economic and financial environment of the Swiss banking sector have been mixed, with financial market indicators generally painting a more positive picture than other indicators.

In an environment of declining inflation, financial market indicators have improved overall. Global equity prices have increased and credit risk premia have narrowed further in both the sovereign and the corporate segments. In addition, the increase in global interest rates over the past two years has allowed banks to expand their interest rate margins and to increase their profitability. Global residential real estate markets have been fairly resilient to the higher interest rate levels so far. This is also the case in Switzerland, where growth has declined but remained positive for residential real estate prices in the owner-occupied segment and for mortgage volumes. In the Swiss residential investment property segment, prices have increased slightly but remained below the peak levels observed in 2022.

However, the adverse effects of higher interest rates and subdued global economic growth are visible in a number of segments according to indicators outside of financial markets. In the commercial real estate segment, these factors have added to the structurally lower demand for office and retail space. Commercial real estate prices have dropped substantially in several countries, entailing adverse effects for the credit quality of companies and financial institutions specialised in this sector. There are also signs of declining credit quality outside the commercial real estate sector, as default rates have increased in several jurisdictions, albeit from historically low levels. In Switzerland, cooling in the commercial real estate sector has been comparatively mild so far. Swiss corporate bankruptcy rates have continued to increase but remain below pre-pandemic levels.

Going forward, the SNB's baseline scenario assumes that global economic growth will be moderate in the coming quarters. Consumers' purchasing power is expected to gradually recover and the dampening effect of the monetary policy tightening to ease slowly. Inflation is projected to decline further. In Switzerland, growth is moderate and inflation remains within the range of price stability.

The current global environment carries risks for financial stability. The vulnerabilities in the global real estate, credit and stock markets persist and the level of debt remains high. In addition to the already observed downside effects described above, the current high level of interest rates may result in further adverse developments in real estate and credit markets, as historical evidence indicates that the effects of interest rate hikes may materialise with a significant time lag. The increased potential for rapid outflows of bank deposits, in particular due to advances in digitalisation and shifts in the composition of deposits, adds to global financial stability risks.

To assess the main risks to the Swiss banking sector stemming from adverse macroeconomic and financial market developments, the SNB considers four stress scenarios. These assume highly unfavourable developments that are unlikely but possible, and they cover a broad spectrum of relevant macroeconomic and financial risk factors. The first scenario assumes a global recession coupled with a deterioration in asset market conditions and decreasing interest rates (global recession scenario). In the second, inflation and inflation expectations pick up again, triggering a renewed, substantial increase in global interest rates, a decline in real estate and financial asset prices, and a stagnation in global economic activity (interest rate shock scenario). The third scenario involves a major crisis in emerging economies (emerging markets crisis scenario). The fourth considers a protracted recession in the euro area coupled with an extended period of low interest rates (protracted euro area recession scenario). The first two scenarios are of particular interest in the current environment as they offer benchmarks for adverse developments in real estate markets, including a substantial price correction in the commercial real estate segment – the global recession scenario in an environment of low interest rates, the interest rate shock scenario in an environment of high interest rates.

In addition to their exposure to adverse macroeconomic and financial market developments, banks are also exposed to operational risks such as legal and cyber risks (cf. special topic in subchapter 5.5). The purpose of the SNB's scenario analysis is not to assess banks' resilience to operational risks per se. This task requires in-depth, off and on-site bank supervision, and it lies within the remit of the Swiss Financial Market Supervisory Authority (FINMA).

Domestically focused banks
Domestically focused banks (DFBs) were able to benefit from higher interest rates and markedly improved their profitability in 2023. The most important driver was rising net interest income, reflecting a significant widening of their net interest rate margins. In addition, increases in net fee and commission income and in trading income contributed to offsetting a rise in operating costs.

Hence, as expected, the increase in interest rates observed in Switzerland in 2022 and 2023 enabled most of these banks to restore their net interest rate margins (cf., for example, SNB Financial Stability Report 2022, p. 37, and special topic in subchapter 5.4), thereby strengthening their first line of defence against losses. As in previous years, DFBs again retained a significant share of their earnings and further built up their total loss-absorbing capacity – the second line of defence. Overall, these banks' capital buffers are substantial, and high by historical comparison.

The SNB's scenario analysis suggests that, thanks to their profits and capital buffers, DFBs should be able to absorb the economic impact of relevant adverse shocks. Given their exposures, these banks are primarily vulnerable to a significant rise in interest rates coupled with price corrections in the domestic real estate market, as depicted in the interest rate shock scenario. Under this scenario, banks would suffer sizeable credit losses. Furthermore, net interest income would decline as higher funding costs would outweigh the positive contribution from higher interest income. The resulting impact on banks' earnings would deplete a substantial part of the DFBs' capital buffers. However, most of these banks would be able to absorb the losses incurred, even in the absence of counteracting measures such as reducing lending or building up capital. The sectoral countercyclical capital buffer (CCyB), which requires banks to hold additional capital when cyclical risks exist, plays an important role in this respect.

UBS

With the acquisition by UBS, the situation of the former Credit Suisse entities has stabilised. UBS plans to fully merge the Credit Suisse and UBS entities at the respective levels, with the formal merger of the parent banks executed at the end of May 2024 and that of the Swiss entities envisaged for Q3 2024. The integration and restructuring programme is to be completed by the end of 2026. The development of market indicators, such as credit default swap (CDS) premia and the share price since the acquisition in June 2023, indicates that the market is taking a positive view of the prospects for the combined bank.

As regards profitability, UBS posted an exceptional profit for 2023. This was primarily attributable to an accounting gain from the acquisition of Credit Suisse in Q2 2023.[1] Excluding this one-off accounting effect, the bank's profit in 2023 was reduced by the integration of Credit Suisse, especially in the combined wealth management and investment banking divisions. Moreover, significant losses occurred in connection with winding down Credit Suisse positions that are no longer part of the bank's core business. The Swiss division increased its profitability during the same period. In Q1 2024, profitability improved across all business divisions.

At group level, as of the end of Q1 2024, UBS already meets its estimate of the future capital requirements under the 'too big to fail' (TBTF) regulations.[2] The current requirements will increase due to the bank's larger market share and size following the acquisition of Credit Suisse. The combined bank has been granted a transition period, with phase-in starting from 2026 and ending in 2030 at the latest, to comply with the higher requirements.

Figures for the Credit Suisse and UBS parent banks as at the end of Q1 2024 indicate that UBS is also well on track to meet its estimate of the future Common Equity Tier 1 (CET1) capital requirements at parent bank level.[3] However, the crisis at Credit Suisse has shown that the treatment of a parent bank's participations in its subsidiaries should be improved.[4] The risk of these participations is currently not adequately reflected in regulatory requirements,[5] leading to capital ratios that are vulnerable to impairments of these participations. To address these weaknesses in the current capital regime, the Swiss Federal Council has proposed a strengthening of the capital regulation of parent banks. The current capitalisation of the combined UBS parent bank is stronger than that of the Credit Suisse parent bank before the crisis. Still, the weaknesses of the current regime remain and should be addressed (cf. following section, 'Lessons from crisis at Credit Suisse').

At group level, UBS has to manage a significant portfolio of legacy risk positions following the acquisition of Credit Suisse. It plans to largely unwind these risk positions by the end of 2026. In addition to credit and market risk, UBS, as a universal bank that is also globally active, is exposed to elevated operational risk and business risk. While these risks are not strictly related to specific risk positions, their materialisation can have a strong impact on the overall economic situation of a bank, as shown by the crisis at Credit Suisse. Therefore, the stress tests for UBS take into account all risk categories, including operational risk[6] and business risk. In its stress scenarios, the SNB continues to regard the loss potential as substantial. In the current situation, integration-related costs and the expected losses in the non-core and legacy division affect UBS's capacity to absorb losses. This is a natural consequence of integrating and de-risking a bank with lower financial strength. Going forward, the wind-down

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1 Specifically, this accounting gain was negative goodwill, which arises when the purchase price for a company is lower than the difference between the value of the assets acquired and the liabilities assumed.

2 Cf. UBS, Q4 2023 Fixed income investor presentation, 6 February 2024.
3 Figures on the combined UBS parent bank are not yet available.
4 Between Q3 2021 and Q3 2022, the Credit Suisse parent bank's participations in foreign subsidiaries lost approximately 60% of their value due to lower expected profits in these subsidiaries, leading to a substantial deterioration in the parent bank's capital ratios. The 60% depreciation in the value of Credit Suisse AG's foreign participations was primarily due to idiosyncratic stress in an otherwise relatively benign economic and financial market environment. In a recession or in the context of a strong real estate or financial market correction, the value of the participations would depreciate further given the systemic stress.
5 A participation in a financial subsidiary relates to the capital that the parent bank has granted to this subsidiary. As a participation is the most junior claim on the assets of a wholly owned subsidiary, the parent bank bears the entire risk of these assets. With a partial capital backing of the participation, the parent bank can back this risk with less capital than if it had the subsidiary's assets on its own balance sheet. Partial capital backing allows the bank to partially finance capital at a subsidiary through debt. This practice is referred to as 'double leverage'.
6 Operational risk is reflected by a flat-rate surcharge.

of the legacy positions will reduce UBS's risk positions and the associated costs.

Lessons from crisis at Credit Suisse

The crisis at Credit Suisse has highlighted weaknesses in the regulatory framework. The SNB shares the Federal Council's view[7] concerning need for action in the areas of capital requirements, liquidity requirements, early intervention, and recovery and resolution planning. The proposed changes are aimed at strengthening banks' resilience and their resolvability in a crisis. The SNB is participating at both national and international level in the ongoing discussion about necessary regulatory adjustments.

In the area of capital, the focus is on remedying weaknesses in the regulatory architecture in order to ensure that reported capital ratios reflect a bank's actual loss-absorbing capacity. The SNB supports a consistent implementation of the measures proposed by the Federal Council in the following three areas of capital regulation.

First, the contribution of the Additional Tier 1 (AT1) instruments to stabilising a bank as a going concern should be strengthened. Measures should aim at ensuring a timely suspension of buybacks and coupon payments following sustained losses, as well as a write-off or conversion of these instruments into CET1 capital at a time when the bank is still able to stabilise its situation before it reaches the point of non-viability. This was not the case during the crisis at Credit Suisse. Such measures would bolster the intended purpose of AT1 instruments as going-concern capital.

Second, the prudent calculation of CET1 capital should be strengthened. The credibility of CET1 capital as a measure of financial strength relies on a prudent valuation of assets. Therefore, the calculation of CET1 capital should be adjusted for assets, such as software and deferred tax assets, that are likely to lose most of their value during a restructuring. Moreover, regulatory requirements in Switzerland with respect to prudent valuation of complex or illiquid positions should be tightened to adequately reflect the valuation uncertainty for such positions – especially in times of stress.

Third, the capital regime for parent banks should be strengthened. Under the current regime, a parent bank's participations in its subsidiaries are only partially backed by capital. As a result, standalone capital ratios of the parent bank overestimate the true resilience of this bank and are highly vulnerable to impairments of its participations. This risk materialised in the case of Credit Suisse as the value of its participations fell sharply due to lower estimated profits in foreign subsidiaries, leading to a substantial deterioration of the parent bank's capitalisation. Under a robust regulatory treatment, participations are sufficiently backed by capital. This ensures that capital that is passed on to subsidiaries cannot simultaneously be used to cover the parent bank's own risks. The Federal Council therefore proposes strengthening the capital backing for participations in foreign subsidiaries (cf. special topic in subchapter 5.3).

Even with the above-mentioned improvements to the architecture of capital regulation, regulatory ratios remain to a large extent a static measure and should be complemented by elements that contain forward-looking components, such as a bank's expected profitability. The crisis at Credit Suisse has shown that forward-looking elements can fundamentally change the assessment of a bank's resilience, particularly in times of stress. Stress tests and market indicators can supplement the current capital regulation, as they provide a more comprehensive and forward-looking assessment of a bank's resilience.
In this regard, the SNB supports a stronger legal basis for institution-specific capital surcharges (i.e. Pillar 2 capital surcharges) based on forward-looking elements.

In the area of liquidity, the experience with Credit Suisse in March 2023 has shown that neither its compliance with the current liquidity requirements nor the collateral prepared by the bank for obtaining emergency liquidity assistance from central banks were sufficient to cover a sharp rise in its liquidity needs. Some of the insights have already been taken into account with the amended liquidity regulations for systemically important banks that came into force in 2022 and are applicable as of 2024. Other aspects such as heightened liquidity outflows, especially in the case of high-value retail deposits, are not addressed in the current regulations. These outflows were much faster and larger than assumed in the liquidity coverage ratio (LCR). The high proportion of very short-term funding amplified the impact of the loss of confidence. The SNB supports a review of the LCR by the Basel Committee on Banking Supervision (BCBS). According to the Federal Council's report on banking stability, the effectiveness of the new liquidity provisions for systemically important banks will be reviewed by the end of 2026 (cf. special topic in subchapter 5.1).

Furthermore, as proposed by the Federal Council, banks should be required to prepare an adequate volume of eligible collateral for obtaining emergency liquidity assistance from central banks. The SNB accepts a broad range of eligible collateral, which it reviews on an ongoing basis and develops in dialogue with the banks. The focus is on illiquid assets which the banks are unable to use at short notice during a crisis to generate liquidity. To ensure that the SNB can sell such assets in the case of non-repayment of a loan, a valid and legally enforceable security interest in favour of the SNB must be established on these assets, for example through a pledge or assignment as security. The banks must make the necessary preparations for this, in particular in relation to legal aspects such as the amendment of transfer clauses and, with regard to loans to foreign clients, securitisation. In the case of Credit Suisse,

7 Cf. Federal Council report on banking stability of 10 April 2024.

it was not the range of collateral accepted by the SNB and other central banks that limited the provision of liquidity assistance. Rather, the insufficient preparations made by Credit Suisse were the main factor limiting emergency liquidity assistance (cf. special topic in subchapter 5.2).

However, even with better preparation of collateral by the bank, extreme situations remain possible where a bank does not have sufficient collateral to obtain the required liquidity from the central bank. The SNB therefore supports anchoring the public liquidity backstop (PLB) in ordinary law. The PLB allows the SNB to provide a systemically important bank with additional liquidity as part of a restructuring of the bank concerned, the repayment of which is guaranteed by the federal government (cf. special topic in subchapter 5.2).

The SNB also sees a need for improvement in the area of recovery and resolution planning, and supports the proposals of the Federal Council in this regard. The early intervention toolkit should be expanded through the inclusion of market-based and forward-looking indicators and the recovery planning strengthened in order to stabilise a systemically important bank in a timely manner. Experience with Credit Suisse has also revealed potential obstacles related to the execution of a resolution, in particular legal risks and possible contagion effects in the case of a bail-in.[8]

8 Cf. Financial Stability Board (FSB), '2023 Bank Failures – Preliminary lessons learnt for resolution', 10 October 2023.