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Introductory remarks by Thomas Jordan

Introduction

A year ago, the financial system was still in an extremely fragile state. Crisis management was at the centre of our efforts. Yet even then, we were emphasising the urgent need to alleviate the 'too big to fail' issue. Much has happened since that time. The financial sector, hit hard by the crisis, has recovered considerably, and on a national and international level, politicians, supervisory authorities and central banks are working intensively to ease the 'too big to fail' issue. The goal is clear: in future, the public and the taxpayer should not have to shoulder the responsibility for rescuing banks.

Based on our latest *Financial Stability Report*, I would like to review first the situation in the banking sector, and second, the next steps in resolving the 'too big to fail' issue.

Conditions in the Swiss banking sector

Conditions in the Swiss banking sector have improved. Following a catastrophic 2008, the situation at UBS stabilised over the course of last year. With regard to Credit Suisse, it is now even possible to speak of a return to normal. Large-scale support measures deployed by governments and central banks played an essential role in ensuring that the global economy, the financial markets and thus also the banks recovered sooner and more vigorously than had been anticipated a year ago. For the banking sector alone, the major industrial nations committed funds amounting to almost 20% of gross domestic product. As a result of the different measures to support the economy and the banking sector, there has been a considerable rise in the indebtedness of many countries, and also, in some countries, in sovereign credit risk.

The international big banks – including the Swiss big banks – benefited substantially from these support measures, and were able to increase their profitability in 2009. At the same time, the Swiss big banks reduced their balance sheets by approximately a quarter. Compared to the previous year, their capital situation improved substantially. Their risk-weighted capital ratios, in particular, have increased markedly, and are high also by international standards. This is a very positive development. However, it should not be allowed to conceal the fact that the leverage of both big banks is still high – both per se and when compared with banks in other countries. The big banks are still a long way from meeting the leverage target that will apply in Switzerland from 2013. With this in mind, a

further strengthening of the capital situation and – in conjunction with this – a further realignment of the business model in order to achieve sustainable profitability, are still central challenges facing the big banks.

The profitability and the capital situation of the banks with a domestic business focus – the cantonal, regional and Raiffeisen banks – were significantly higher in 2009 than the long-term average. The dip in GDP from mid-2008 to mid-2009 has so far barely had any effect on these banks, with the result that the provisioning requirement for credit risk continued at a low level in 2009. Nevertheless, in our estimation, the position of these bank categories is less comfortable than may appear at first glance. First of all, the capital situation of the Raiffeisen banks and the state-guaranteed cantonal banks needs to be put into perspective: the Raiffeisen banks can count the additional funding obligation required of members in the cooperative as capital until the end of 2011, and the cantonal banks are entitled to a reduction in required capital due to the state guarantee. In the absence of these concessions, the capital ratios – particularly for the Raiffeisen banks – would be markedly lower. Second, according to our assessment, the risk exposure of the domestically focused banks is higher now than it was in 2009. For one thing, the interest rate risk of cantonal and Raiffeisen banks is at historically high levels. For another, the sharp increase in loan volumes – especially for mortgages – against a backdrop of persistent economic uncertainty and the substantial rise in real estate prices points to higher credit risk. In addition, for first mortgages on residential properties, banks are required to have less capital backing under Basel II than they did under Basel I – before 2007 (i.e. under Basel I), a mortgage had to be backed with 4.0% capital; since then (i.e. under Basel II), that figure is only 2.8%. This not only gives banks an incentive to grant more mortgages, but also enables them to reduce the capital buffer used to absorb loan losses.

In view of the increased interest rate and credit risk, we urge the domestically focused banks to be prudent. They must be prepared for interest rates to rise. Besides the direct effect on the interest rate margin, particular attention also needs to be given to the indirect effect of an interest rate increase, namely that if loans are granted without sufficient attention being paid to borrowers' financial situations, a rise in the interest rate will inevitably result in higher loan losses. As I have mentioned, the domestically focused banks are well capitalised by historical standards. But in view of the risks and uncertainty, they will also need to maintain a large capital buffer.

The jump in domestic mortgage lending and in property prices in an environment of historically low interest rates prompted us in the first quarter of this year to conduct a survey among the major banks in the Swiss mortgage industry. We must not forget the lessons learned from previous crises. The property bubble of the 1990s, with its dire consequences for the Swiss banking sector, but also the most recent example – the sub-prime crisis – serve to remind us that adverse developments in the mortgage market can threaten the stability of the banking system, and are thus deserving of the Swiss National Bank's (SNB) fullest attention. The results of the survey give no cause to sound the all-

clear. These may show that there was no relaxation of internal lending standards by the banks between 2005 and 2009, but for banks with a significant overall market share these standards lack conservatism. More than a few banks, for instance, are determining the affordability of a mortgage loan based on an interest rate which is at a historically low level. In addition, based on statements made by survey participants, in practice, deviations from internal lending standards occur frequently: banks with a market share of almost 25% reported such 'exceptions to policy' for more than 20% of new mortgage loans granted in 2009. Furthermore, the banks provided only incomplete data on their actual lending practices. This could be a sign that some banks are inadequately informed of the risks in their mortgage portfolios.

The SNB is treating this issue as a high priority, and will continue to monitor the mortgage market carefully. We will analyse the risks in greater detail – in close cooperation with FINMA and the banks themselves – and examine whether there is a need for action. In any case, caution should be exercised in lending. When assessing affordability, it must be taken into account that interest rates are, by historical standards, exceptionally low. It is essential that loan-to-value ratios be set conservatively, especially for regions and property types that have seen prices rise sharply in recent years.

Outlook

We expect the global economy to continue recovering this year. This recovery, however, is fragile, for it has until now been based largely on the support measures deployed by governments and central banks. Uncertainty is still at an above-average level. Downside risks have gone up again in recent months due to the financing difficulties faced by some European countries. Urgently needed cost-cutting measures and rising risk premia could jeopardise the recovery and trigger another lengthy period of higher credit default rates, and even renewed turbulence on the financial markets. A development of this kind would present the Swiss banking sector with a serious challenge: besides an economic slowdown and a slump in the financial markets, a further destabilising influence could be the spread of problems throughout the global banking system. Thus indirect risks pose a serious threat to Swiss banks, even if direct risks – measured by the direct claims on those countries particularly affected until now – are moderate. In this climate, it seems inappropriate to us that banks increase their appetite for risk.

Reforming the regulatory framework / 'too big to fail'

A year ago, we emphasised the urgency of alleviating the 'too big to fail' issue. Where do we stand today? Allow me to state clearly right now: the 'too big to fail' issue will not resolve itself. Last year, the big banks significantly reduced their balance sheets – a move explicitly welcomed by the SNB. The 'too big to be rescued' issue has thus also receded somewhat. However, there has been hardly any alleviation of the 'too big to fail' issue. Big bank liabilities, which at the end of 2008 were still almost six times Swiss GDP, were reduced by the end of 2009 to just over four times GDP. Nevertheless, the big banks' share of markets relevant to the Swiss economy – and hence their systemic importance –

remains just as high as before: the big banks grant a third of domestic loans and hold a third of domestic deposits. In other words, Switzerland is still vulnerable, and the need for action remains great. This opinion is shared by the commission of experts appointed by the Federal Council on 'Limiting the economic risks posed by large companies', of which I am Vice Chairman. It is the commission's assessment that in their current form and size, the big banks are clearly systemically important.

The commission of experts published its interim report at the end of April. The 'too big to fail' issue is to be addressed through a package of key measures encompassing special requirements for systemically important banks in the areas of capital, liquidity and organisational structure. These key measures are compatible with the approach discussed by the Financial Stability Board. Besides those proposed by the commission of experts, other measures being considered at the international level include the breaking-up of big banks, the prohibition of certain activities such as proprietary trading, and the taxation of balance sheets and transactions.

The SNB fully supports the proposals put forward by the commission of experts to date. The overall direction is correct. What is important now are the details of the measures. Our position is clear. It is essential that capital requirements be significantly increased and that they rise in line with the degree of systemic importance of a bank. This is the only way to ensure that the banks internalise the risks which, until now, they have been able to pass on to the general public, to some extent. Moreover, progressive capital requirements should create an incentive for banks to reduce their systemic importance, with its associated risk potential.

Allow me to point out that the tightening of capital regulations and the introduction of a leverage ratio that occurred at the end of 2008 were not aimed at reducing the systemic importance of the big banks to an acceptable level. These measures were much more a response to regulatory shortcomings revealed by the recent crisis, which were insufficiently conservative backing of risk with capital (particularly in the trading book) and the lack of a countercyclical component in capital requirements. As regards more stringent liquidity requirements for systemically important banks, specific measures have already been implemented. The liquidity requirements have been thoroughly revised by FINMA and the SNB in collaboration with the big banks, and will come into effect at the end of this month.

The final key measure, which is aimed at organisational structure, is also important. The organisation and legal structure of systemically important banks must be adapted to ensure that an orderly liquidation is possible should it become necessary. In particular, it must be possible for systemically important functions to be maintained without the bank as a whole having to be rescued. Clearly, this is not easy to achieve. The implementation of this measure must take into account the challenges posed by the considerable complexity and cross-border activities of the big banks. It must be credible and robust – both operationally and legally. An unworkable approach in this area could have fatal consequences in the next crisis.

The SNB will continue pushing hard for a genuine alleviation of the 'too big to fail' issue. We are confident that the banks in the commission of experts will continue to cooperate constructively on achieving a solution. We are aware that, for the big banks, the regulatory measures being discussed are associated with costs. However, first of all, these costs are primarily a reflection of the fact that a subsidy in the form of a de facto 'too big to fail' guarantee will be reduced. Yet since the cost to the taxpayer is reduced to the same extent, this does not constitute a cost to the economy as a whole. And second, alternative measures, such as the prohibition of business activities, would be associated with considerably higher costs for the banks. In addition, we are convinced that, in the long term, the big banks will also benefit from more stringent regulatory requirements. The most recent crisis showed that a stable financial system is a basic prerequisite for the long-term competitiveness of our financial centre. This is particularly true of wealth management, an important line of business for Swiss banks. Consequently, an appropriate solution to the 'too big to fail' issue in Switzerland could strengthen our banking system in the long term and ensure that it is well placed strategically.