SCHWEIZERISCHE NATIONALBANK
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SWISS NATIONAL BANK

Berne, 21 June 2018
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Introductory remarks by Fritz Zurbrügg

In my remarks today, I will present the key findings from this year's *Financial Stability Report*, published by the Swiss National Bank this morning. In the first part of my speech, I will talk about the big banks, before going on, in the second part, to outline our current assessment of the situation at domestically focused banks.

Big banks

In October 2018, it will be ten years since the Federal Council, FINMA and the SNB decided to implement far-reaching measures to strengthen the Swiss financial system. These measures were needed during the global financial crisis as the possibility of UBS suffering a deeper crisis of confidence could not be ruled out. This would have resulted in a massive burden on the Swiss financial system and Switzerland's economy as a whole.

Since then, the two Swiss big banks have implemented a number of measures, alongside enhanced regulations to increase their resilience and reduce the risks to the Swiss economy that would arise if they got into financial distress. In particular, over the past ten years, Credit Suisse and UBS have built up a substantial amount of capital, reduced their exposures, and adjusted their business model and corporate structure. Moreover, in recent years, the global economic environment and conditions on the financial markets worldwide have improved.

In light of the positive developments at these banks and in the economic environment, Credit Suisse and UBS's focus is gradually shifting, away from downsizing and reducing legacy assets from the financial crisis, and towards growth strategies and new business initiatives. Both banks are looking at growing their business again and increasing shareholder remuneration.

At the same time, from a financial stability perspective, it is important that the implementation of the revised 'too big to fail' regulations (TBTF2) be completed as planned.

Full implementation is a necessary condition for resolving the ‘too big to fail’ issue in Switzerland. The state should no longer be obliged to use government funds to rescue a bank.

So, what progress have the two big banks made in implementing the TBTF2 regulations? Both banks are on track with regard to the first pillar of these regulations, namely resilience. They already meet all ‘look-through’[1] risk-weighted capital requirements for going-concern loss-absorbing capacity. As regards their leverage ratios, further improvement is needed.

With respect to the second pillar, which is aimed at ensuring the orderly resolution of a distressed systemically important bank without the use of public funds, both big banks have made further progress. Over the past year, they have expanded their holdings of bail-in instruments, in particular. They are now fully compliant with the look-through requirements for gone-concern loss-absorbing capacity.

To enable orderly resolution, however, further progress is needed in three areas in particular. First, FINMA, as the competent authority, is currently developing resolution funding plans. These are intended to make sure that a bank has sufficient liquidity to implement a resolution. Second, it must be ensured that big banks’ loss-absorbing capacity is adequate, not only at a consolidated group level, but also on a stand-alone basis at the level of the individual group entities. Third, both banks must further reduce their financial and operational dependencies within the group.

In the context of resolution planning, the two banks must demonstrate by end-2019 that, in the event of impending insolvency, they are able to continue their systemically important functions in Switzerland without interruption. This is part of the emergency plan, which is a key element of the overall resolution planning. And, since Credit Suisse and UBS are active internationally, they also have to comply with the requirements of foreign authorities.

Domestically focused banks

Turning now to the domestically focused banks, the mortgage and real estate markets remain their biggest source of risk. I would like to make three points in this connection.

First, domestically focused banks further increased their risk exposure in 2017. This occurred against the backdrop of persistent imbalances on the mortgage and real estate markets. Despite the relatively low growth in mortgage lending volume overall, the rise continued unabated at domestically focused banks. Furthermore, affordability risks for new mortgage loans in the residential investment property segment rose significantly last year. There are also signs of an accumulation of affordability and loan-to-value (LTV) risks in this segment: A large share of new mortgages with a high loan-to-income (LTI) ratio also have a high LTV ratio. These loans are particularly vulnerable to a substantial interest rate rise coupled with a real estate price correction. The risk of a price correction in the medium term is comparatively

[1] Look-through requirements refer to the requirements that will apply after expiry of all transitional provisions. In particular, they concern the qualitative requirements for going-concern capital.

high in the residential investment property segment because of the strong growth in property prices in recent years.

Second, the interest margin of domestically focused banks decreased further in 2017. This renewed reduction illustrates the considerable pressure that these banks still face in their core business in an environment of exceptionally low interest rates. Nevertheless, they were able to maintain their net interest income at levels similar to those of 2016 by offsetting the decline in margins with an increase in their lending volume. As long as pressure on margins persists, incentives for domestically focused banks to increase risk-taking will remain substantial.

Third, despite this high-risk environment and banks' strong appetite for risk, the resilience of domestically focused banks remains adequate overall. SNB stress tests indicate that most of these banks have a sound capital base enabling them to absorb the losses they might incur under the relevant adverse scenarios.

It is crucial for the stability of the financial system that banks continue to hold sufficient capital to cover the risks they incur. In this connection, I would like to highlight two important changes being made as part of the ongoing reform of banking regulations in Switzerland, which will have a major impact on the resilience of domestically focused banks.

First, the capital requirements for mortgage loans are being revised in connection with the national implementation of the Basel III reform package, making them more sensitive to mortgage risk. As a result, the requirements for individual banks may increase or decrease, depending on the structure of their assets. In principle, the SNB takes a positive view of such risk-based differentiation of the capital requirements. From a financial stability perspective, when implementing these reforms it is important to preserve the capitalisation of the banking sector at its current, adequate level.

Second, additional capital requirements will be introduced for domestically focused systemically important banks.[2] These gone-concern capital requirements are necessary to enable a potential orderly resolution of these institutions, without the use of public funds. In 2017, the Federal Council defined the key principles of these requirements – particularly in relation to the level and quality of capital. The SNB deems these requirements necessary and therefore supports the Federal Council's key principles.

Given the previously mentioned heightened risks in new mortgage lending, the SNB is of the opinion that targeted measures for residential investment property lending should be considered. For its part, the SNB will continue to monitor developments on the mortgage and real estate markets closely, and regularly reassess the need for an adjustment of the countercyclical capital buffer.

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[2] The institutions concerned are PostFinance, Raiffeisen Group and Zürcher Kantonalbank.