

Berne, February 2014

Implementing the countercyclical capital buffer in Switzerland: concretising the Swiss National Bank's role

1. Introduction

The countercyclical capital buffer (CCB) is a pre-emptive measure that requires banks to build-up capital gradually as imbalances in the credit market develop. It has two main objectives. First, it aims to protect the banking sector from the consequences of excessive credit growth by increasing its loss-absorbing capacity. Second, it aims to lean against the build-up of excesses by reducing the attractiveness of credit provision, as well as limiting the overall potential for lending, given the capital currently available. The CCB will only be activated when imbalances appear to be building up.

The CCB is an important component of the Basel III framework and will be introduced by most countries within the next few years. Its early introduction in Switzerland is justified by concerns about the risks of cyclical imbalances developing in the domestic mortgage and real estate markets. These developments have been driven in particular by the persistently low interest rate environment since 2008, coupled with the relatively good economic conditions in Switzerland. The CCB should be seen as a complement to other measures such as a tightening of microprudential supervision, a structural revision of capital requirements and revisions of the self-regulation guidelines.

In accordance with the revised Art. 44 of the Capital Ordinance (*Eigenmittelverordnung, ERV*), an activation of the CCB became possible in Switzerland from July 2012. Two important characteristics are embedded in the Swiss CCB framework. First, the buffer is developed in such a way that it can be implemented on a broad basis or it can target specific segments of the credit market. Second, in line with Basel III, the maximum level of the CCB is set at 2.5% of total domestic risk weighted assets of an individual bank. The CCB is applicable to Swiss banks and to subsidiaries of foreign banks in Switzerland. It will supplement other capital requirements.

The goal of this text is to clarify the Swiss National Bank's (SNB) role in the process of activating, adjusting and deactivating the CCB. Moreover, it outlines the SNB's internal

approach for reaching a CCB decision. The focus is on a sectoral CCB targeted at the imbalances developing in the domestic mortgage and residential real estate markets.

2. Division of responsibilities

The SNB will conduct a regular assessment of the mortgage and real estate markets to determine whether the sectoral CCB should be activated, adjusted or deactivated. If the SNB determines that it is necessary to activate, or adjust the buffer, the SNB will additionally establish the level at which this buffer should be set, as well as the time that the banks will have to adjust their own buffer of additional capital.

As specified in Art. 44 of the Capital Ordinance, the SNB will consult the Swiss Financial Market Authority (FINMA) regarding its view of the situation before deciding whether to issue an official proposal (*Antrag*) to the Federal Council. The Federal Council will take the decision on the stance of the buffer. FINMA will supervise the implementation of the CCB at the individual bank level.

3. Activating, adjusting and deactivating the CCB: an overview

3.1 A guided discretion approach

The SNB decision on whether to propose an activation, adjustment or deactivation of the buffer, will be based on an approach of guided discretion.

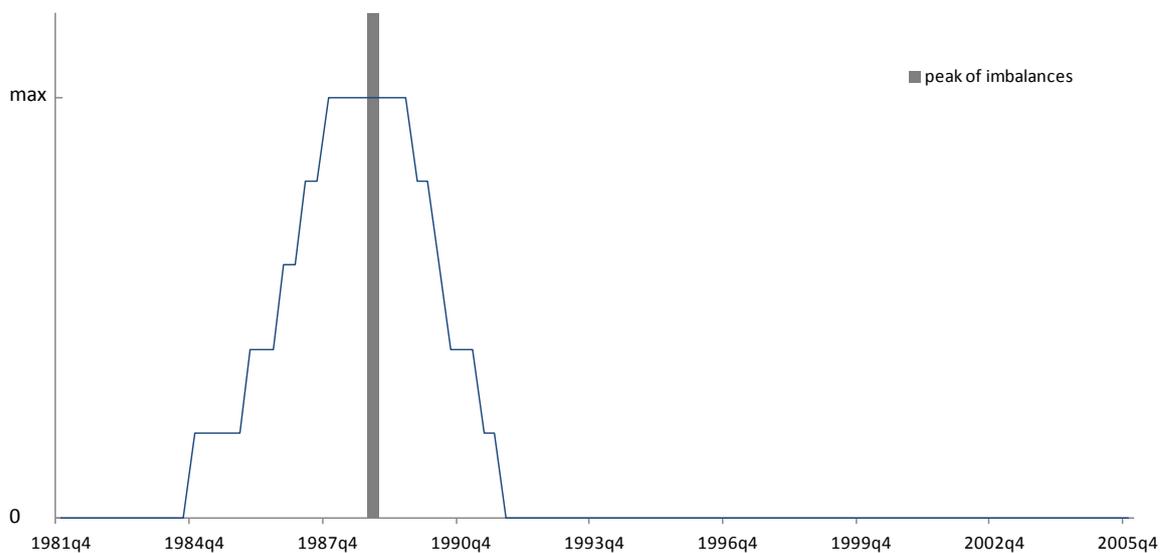
The approach developed by the SNB (cf. section 4) delivers guidance regarding the appropriate stance of the CCB. This approach is based on a systematic analysis and aggregation of a set of key quantitative indicators (cf. section 4.1). When these key indicators depict a homogeneous image of the imbalances building up in the system, the SNB decision will draw heavily on this guidance. When a heterogeneous picture of the situation on the domestic mortgage and real estate market is conveyed by the key indicators, more discretion enters the decision (cf. section 4.2). In this case, the analysis of a broader set of additional quantitative and qualitative indicators also flows into the decision. Once activated, the level of the buffer will be set proportionally to the degree of imbalances (cf. section 4.4).

This guided discretion approach is designed to ensure a degree of consistency over time in the decision taken, while providing the necessary flexibility, given the inherent uncertainty and the lack of experience associated with operating a CCB.

3.2 An illustration based on historical data

The guided discretion approach developed by the SNB, and described in this note, would have led to the buffer being activated during the late 1980s and early 1990s. Following the development of imbalances in the mortgage and real estate markets, the CCB would have increased gradually over a four-year period, reaching its maximum level twelve months before the peak of the imbalances (cf. chart 1).

Chart 1: Evolution of the CCB based on a systematic analysis of key indicators



A gradual release of the buffer would have started in 1989Q3 and would have been completed by 1991Q4. As described in section 4.5, a swifter release of the CCB would also have been possible. First signs that might have justified a swifter deactivation were visible from 1989Q1.

A precise assessment of the implications of having a CCB in place during the previous crisis period is difficult. However, an analysis of the banks' capital situation at that time suggests that the activation of the CCB to 2.5% of domestic risk-weighted assets would have significantly increased the resilience of the banking system. From an aggregate perspective, the additional capital that would have been built up would have absorbed a large portion of the losses reported as a result of the crisis. Moreover, by increasing the cost of providing credit, it is likely that the CCB would have helped to lean against the build-up of excesses in the credit and real estate markets during the second half of the 1980s.

4. Activating, adjusting and deactivating the CCB: a detailed description of the approach

4.1 Key indicators

For the sectoral CCB applied to the residential mortgage loans segment, two categories of indicators will feed into the systematic analysis: domestic mortgage volume indicators and domestic residential real estate price indicators. The key indicators have been chosen based on their ability to act as early warning indicators both for Switzerland and abroad.

Mortgage volume indicators

Prolonged phases characterized by unusually strong dynamics in bank lending are often followed by major crises. This pattern has been observed on numerous occasions across several countries. In Switzerland, the banking crisis of the 1990s followed a build-up phase during which credit growth was high by historical standards – in particular when compared to economic activity. This led to a significant and rapid increase of the ratio of mortgages to gross domestic product (GDP).

Drawing on this experience, the set of key indicators will include measures capturing the dynamics of the domestic mortgage market.

Real estate price indicators

Strong dynamics in bank lending are particularly problematic if they go hand in hand with an increase in property prices. There is widespread historical evidence suggesting that the correction of such imbalances leads to long and severe phases of financial instability and, as a consequence, generates substantial costs to the economy. In Switzerland, the late 1980s, the period before the onset of the real estate crisis, was marked by a strong growth of real estate prices significantly exceeding historical averages. This led to price levels that could no longer be justified based on fundamental economic factors and, eventually, to large price corrections. More recently, in the context of the recent global financial crisis, several countries, including the United States, Ireland and Spain, experienced large scale corrections of credit-funded housing booms which negatively impacted the broader economy.

To capture this dimension, the set of key indicators will include measures summarising the dynamics of domestic residential property prices.

4.2 Additional indicators

In addition to the key indicators outlined above, supplementary quantitative and qualitative indicators will also flow into the decision. These additional indicators include measures of banks' risk-taking such as interest-rate risk, interest-rate margins, credit-condition indicators and leverage. The set of additional indicators will also include alternative credit and real estate price indicators. Finally, an in-depth analysis of general economic condition indicators will also flow into the decision. Together this will help to ensure that the decision is based on a comprehensive view of the developments in the domestic mortgage market.

4.3 Activating the CCB

The decision to turn the buffer on should strike an adequate balance between requiring banks to build up capital early and gradually enough before the onset of a crisis, while not undermining the desired cyclical properties of the buffer. This means that the CCB should not be activated in normal times.

The SNB will rely on historical evidence and, in particular, on the behavior of the key indicators during build-up phases that were followed by periods of financial instability, in order to assess the degree of imbalances. The greater the degree of imbalances measured by the key indicators, and the more homogeneous the picture conveyed by the key indicators, the more likely it is that the SNB will propose an activation of the buffer.

4.4 Determining the CCB level and timing of implementation

The level of the buffer will be set according to the degree of imbalances that appear to be developing within the system, as measured by the key indicators. A comparison of indicator behaviour during previous crisis periods both internationally and in Switzerland will be used to map the build-up of imbalances to an appropriate buffer level. The objective is that the buffer reaches its maximum level before imbalances become extreme, in line with the pre-emptive nature of the instrument.

In addition to determining the level of the CCB, the SNB will make a proposal to the Federal Council concerning the time available to banks for building up the buffer of additional capital. This decision will be based primarily on an assessment of the severity of imbalances. The implementation period will vary between three and 12 months. The greater the severity of imbalances and the stronger the dynamics, the shorter the implementation period. This should ensure that no time is lost in building up the resilience of the system.

4.5 Deactivating the CCB

One goal of this instrument is to build a buffer of capital that can be used to help absorb losses. In principle, the decision to deactivate the buffer, and thereby release the additional capital, will follow a similar approach to that adopted for activation.

However, since financial stability risks tend to build up gradually in good times but their consequences can materialise quite suddenly, the buffer may need to be released more swiftly. Hence, in addition to the set of key and additional indicators, higher-frequency information will be monitored on an on-going basis. Historically, systemic stress episodes have manifested themselves through a variety of forms. Judgement will therefore play an important role in the decision to release the buffer in response to a stress period.

5. Communication

The SNB will publish and motivate its proposal (*Antrag*) after consultation with the Federal Council. If no proposal is made for a long period of time, an annual statement will be published by the SNB explaining its position. As more experience in operating the instrument becomes available, the SNB might review its communication strategy related to the CCB.

6. Impact, uncertainties and the way forward

An activation of the sectoral CCB is expected to have a positive impact on the banking sector's resilience. Furthermore, it should have a dampening effect on the dynamics of mortgage lending and, as a consequence, on the dynamics of property prices. The impact on mortgage lending is expected to work primarily through the relative change in capital requirements associated with residential mortgage loans, but also through limiting the overall potential for lending, given the capital currently available. Due to its targeted nature, the sectoral CCB should have no major impact on other segments of the credit market.

Expectations concerning the effect of the countercyclical capital buffer must remain realistic, however. Future imbalances in the Swiss mortgage and real estate markets will not be fully eliminated by activating the countercyclical capital buffer. Furthermore, even though the channel through which the CCB is expected to work is well understood, inherent uncertainty regarding the strength of its impact and hence the appropriate calibration exists. This uncertainty justifies a careful use of this instrument. Furthermore, it justifies an on-going analysis of its consequences on the economy as a whole, which the SNB will conduct as part of its monetary policy mandate.

Numerous crises both in Switzerland and abroad have shown that the costs of inaction when imbalances develop in the credit market can be huge. Used as a pre-emptive instrument, the CCB is a tool that can help reduce the amplitude and the consequences of

such imbalances for financial stability. Thanks to its dynamic nature, the CCB can be adjusted should its impact be larger or smaller than anticipated. This flexibility also allows for a reaction to potential unintended consequences in other segments of the credit market and makes it possible to account for the impact of other measures targeted at addressing risks in the mortgage lending market.

The decision making approach described in this text should be considered a starting point from which to derive experience in operating the CCB. The process will continue to evolve over time and will be adjusted if necessary.