

## News Conference

Geneva, 15 June 2006

### **Introductory remarks by Niklaus Blattner**

The *Financial Stability Report* (2006 edition) is being published for the fourth time today. In this report, the Swiss National Bank (SNB) provides information about its assessment of the stability of the financial system. The first part of the report focuses on the banking sector. In the second part, the SNB reports on its activities in connection with the oversight of payment and securities settlement systems. I will concentrate on the banking sector in the considerations I present to you today.

The *Financial Stability Report* aims to highlight tensions and imbalances that represent a risk to the stability of the financial system. This information should prove particularly useful for four different groups. For the SNB, first of all, the report facilitates the periodic review of priorities linked to its statutory task of contributing to the stability of the financial system. Second, the report makes it possible for the Swiss Federal Banking Commission to classify individual findings it has obtained through the supervision of institutions within the overall banking industry context. Third, banks and other financial intermediaries obtain inputs for their own risk analyses and last but not least, the report is intended to help the other market participants, i.e. financial sector customers as well as the business media that observe the market for them, to round off their assessment of the risk situation. Naturally, all public authorities, market participants and observers bear responsibility for the conclusions they reach on the basis of the SNB report.

#### **The situation in the banking sector**

The banking sector is currently in good shape. In fact, the stress index developed by the SNB – which combines many different sources of information about possible symptoms of stress – even suggests that the Swiss banking sector has been in a particularly favourable phase for more than two years now.

That is not surprising. The banking sector has benefited from an extremely favourable environment. In Switzerland and in the world economic regions of importance for the Swiss banking sector, the economy and the stock markets were booming. Despite an upward trend, interest rates remained relatively low, particularly in Switzerland, and in 2005 the credit standing of borrowers improved further from a level that was already high. In this environment, the Swiss banking sector maintained the high profit levels of the two previous years and, in most cases, even exceeded them in 2005. As in 2004, costs were appreciably higher in some areas, so that the good results were mainly attributable to higher operating earnings, especially from commission business and trading. In addition,

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all bank categories, apart from the big banks, again recorded slight improvements in interest differential business. Moreover, provisioning (which had already been at a historically low level) was further reduced by most banks.

The majority of banks took advantage of the favourable environment to strengthen their capital base. As a result, their ability to absorb shocks has been further enhanced. As in 2004, one major exception were the big banks. Due in particular to the rapid growth in their balance sheet totals, their capital ratios fell on average in spite of the high profits. On the basis of the risk-weighted equity ratios relevant for regulation, they still rank among the best when compared with their foreign competitors, though. Measured by the unweighted capital ratio, however, the capital levels of the big banks remain low by international standards. Although there is no formal regulation of unweighted capital ratios in Switzerland, they should nevertheless be taken into account when assessing the soundness of the banking system.

### **Outlook and sources of risk**

Given the bright outlook for the economy, the stability of the Swiss banking system looks promising also in the near term. Even so, some potential problems need to be pointed out.

Although the market for credit risk transfer products (CRT products) does not appear to pose a particular threat to the Swiss banking sector despite its lack of transparency and its very rapid expansion, we cannot rule out any risks. This assessment is based on the following findings. In principle, CRT products neither eliminate risks nor generate additional risks. Rather, they facilitate the transfer of existing risks. The benefits of risk transfers depend on a number of conditions, however. It is crucial that the market participants correctly assess the risks associated with CRT products and solve the resulting operational tasks. Market disturbances, such as a drop in liquidity in the highly concentrated CRT market, are possible and must be taken into consideration. However, this risk is neither CRT-specific nor acute. The Swiss banks that are active in the CRT market seem to be handling the risks described quite well. The recent measures taken by the financial industry to reduce operational problems in the settlement of CRT products should also be regarded as positive.

It is indispensable that the public authorities as well as market participants and their organisations maintain their critical attention. With respect to Basel II, we should add that the limitations on large credit exposures on the interbank market will remain relatively generous in future. The large credit exposures at the big banks should continue to be carefully monitored so as to recognise any negative trends early on.

Naturally, this does not conclude the assessment of potential sources of risk.

For one thing, there are signs of increased appetite for risk on the part of investors, as both credit volume and trading portfolios of the big banks soared, while the loan quality improved only slightly. For another, the interest rate risk increased for all bank categories and reached a relatively high level, particularly in the case of the cantonal banks.

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The risks differ depending on the bank category: whereas the cantonal banks, Raiffeisen banks and regional banks, all of which are active primarily in domestic lending, mainly seem to be confronted with the risk of rising interest rates, a deterioration in the international capital and credit markets would pose a particular challenge the international players, i.e. the big banks.

At present, we cannot detect any concrete signs that these risks are going to materialise. However, the recent sudden correction in the stock markets after three years of strong growth is a reminder that even a favourable environment can deteriorate surprisingly quickly and markedly. As has been observed in similar situations in the past, very low spreads and interest rates can rise sharply within a short time. However, our scenario analyses suggest that the Swiss banking sector should be capable of withstanding a substantial deterioration in its environment.

### **Strengths and limitations of our analysis**

Stability in the Swiss banking sector thus seems to be high overall despite some obvious risks. Is this assessment too good to be true? Or, in other words, does our analysis really cover all risk factors relevant to the Swiss banking sector? An appraisal of the strengths and shortcomings inherent in our methods of analysis should shed some objective light on this question.

The main strength of our analysis is that it provides a relatively accurate and complete snapshot of the situation in the banking sector. In view of this snapshot, we are convinced that the banks are in good shape at the moment and would be capable of withstanding larger shocks despite the comparatively low unweighted capital base of the big banks.

Another advantage of our analysis lies in its ability to identify the risk factors in the *macroeconomic* environment which are potentially relevant to the stability of the banking system.

However, establishing a precise picture of the current situation in the banking sector and identifying the relevant macroeconomic risk factors is only part of the task. Another part relates to the future: Ideally, it should be possible to reliably predict the timing and scale of disruptions and their effects on the stability of the banking sector. Obviously, we are not able to do that, nor are other central banks, supervisory authorities or analysts.

But in order to at least take some steps towards this goal, we aim to empirically identify imbalances in the real estate and stock markets, both of which are particularly significant for the banks. In other words, we attempt to establish whether real estate or stocks are underpriced or overpriced. An overpriced market would indicate that the probability of a price correction and the extent of the correction are quite high. Past experience has shown, however, that the duration of a period with exaggerated prices varies strongly, as do the extent and pace of a correction in the event of an overvaluation. In other words, even if we actually identified an imbalance, our instruments would not allow us to predict the timing of the correction and the extent of the effects on the banks with sufficient

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accuracy. Nonetheless, methods that help diagnosing imbalances are valuable, as they allow us to evaluate the risk situation at least in part.

In addition, we use two instruments allowing us to judge the effects of a shock on the stability of the banking sector. One of these instruments estimates how changes in the macroeconomic environment affect the banks' performance components. Since stress periods and actual losses in the banking industry are not necessarily linked, we also use a model that directly assesses the effects of a shock on the stress level in the banking sector. Yet again, caution is called for when interpreting the outcomes of these models, as they are based on the assumption that the correlations observed in the past between fluctuations in the macroeconomic environment on the one hand and performance components or the stress level in the banking sector on the other hand are still valid today. Experience has taught us, however, that these correlations do not necessarily remain stable.

Another limitation of our analysis is its almost exclusive focus on the risk factors in the banks' environment. However, bank crises in the past have shown that operational risks, i.e. risks within banks, can also play a prominent role. This is illustrated by the collapse of Barings Bank in 1995 or the Chiasso affair in 1977, which dealt Credit Suisse a severe blow. However, we have no reason to assume that operational risks pose a particular threat to Swiss banks.

Our radar reading of the current robustness of the banking system is relatively favourable. However, we cannot rule out that we may overlook external or internal threats, thus presenting a distorted picture of the risk situation. But just like in the Alps, the weather could change without warning, even if the data had forecast a cloudless sky.