News conference

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Introductory remarks by Philipp Hildebrand

Introduction

This time last year we reported that the overall market environment had calmed somewhat. However, we also stressed that it was too early to sound the all-clear, and that there was considerable uncertainty about the future development of the crisis. Our concerns at that time proved more than well-founded. Indeed, the actual events outstripped our expectations. If I may, I will start with my conclusion: the state of the Swiss and international financial system is – and remains – vulnerable overall. Consequently, we are still maintaining close contact with the big banks and with Swiss and foreign authorities, and are monitoring further developments with great attention. In addition we are continuing our intensive efforts at national and international level to improve the regulatory framework. Given the scale of the crisis, the Swiss National Bank (SNB) is convinced that although the measures taken so far in this area are heading in the right direction, some of them do not yet go far enough. I will therefore begin by briefly assessing the situation of the financial system, and then present the issues to which the SNB attaches medium to long-term priority with regard to reform of the banking sector operating environment. In the short term, however, the main focus is on overcoming the crisis.

Situation in the banking sector

As our *Financial Stability Report* published today describes in detail, the situation in the Swiss banking sector deteriorated considerably in 2008. The turbulence in the money and credit markets that had erupted in mid-2007 worsened in 2008, also spilling over to other areas. The two big banks, in particular UBS, were hit hard by these negative developments. As you know, together the two institutions recorded a total loss of some CHF 30 billion in 2008.[1] They took extensive measures to strengthen their resilience. In addition to reducing risky positions, they raised sizeable amounts of private capital. The

[1] The figures published in our publication, *Banks in Switzerland,* are reported at parent company level, not at group, or consolidated level. According to these figures, the total loss for the big banks amounted to some CHF 38 billion. Cf. press release of 18 June 2009 on *Banks in Switzerland* for further details.

resilience of UBS was further strengthened by the package of government measures announced by the Federal Council, the SNB and the then Swiss Federal Banking Commission (SFBC, now FINMA or Swiss Financial Market Advisory Authority) in October 2008. Owing to all of these measures, the big banks' capital situation at the end of 2008 improved slightly compared to the end of 2007, despite the massive losses incurred. However, our assessment is that, overall, risks in the big banks' books are still material. This is all the more serious since, compared to the end of 2007, the profit potential of the big banks is lower.

Banks with a domestic business focus, i.e. cantonal, regional and Raiffeisen banks, present a much more favourable picture. Although the overall profitability of these bank categories declined in 2008, it still remains above the long-term average. Their capital base is high by historical standards and they were able to build up their liquidity reserves last year. However, for these banks, too, the economic downturn will represent an increasing challenge.

The outlook for the banks is also shaped by the negative forecasts for the entire world economy. These suggest a substantial deterioration in credit quality – including for Switzerland. Consequently, increasing loan losses, substantial reductions in earnings and a deterioration in the capital situation may be expected for a large number of banks. However, cantonal, regional and Raiffeisen banks appear in relatively good shape to withstand these negative developments. The situation for the big banks appears more difficult. In addition to the still sizeable market risks, they face significant credit risks overall. Simple comparisons with earlier crisis periods show that potential losses on traditional lending are high, when set in relation to the capital cushion. The longer and deeper the recession, the greater these potential losses will be.

In our basis scenario we expect the economy to recover gradually as of 2010, both internationally and in Switzerland.

However, we cannot rule out a significantly deeper and longer-lasting recession than that forecast in the basis scenario. In this adverse scenario of a deep and long-lasting recession, large losses would be possible for banks with a domestic business focus as well as for big banks. Such losses might lead to a depletion of a substantial share of the banks' current capital reserves. This might in turn impair market confidence in their soundness.

Given this risk potential, it is therefore essential that the big banks take all the necessary measures to ensure their resilience to any further significant deterioration in conditions. These measures include another reduction in their risk positions, a further strengthening of their capital base, the preservation of an adequate liquidity cushion and the alignment of their cost structure with the changed market environment. The opportunity offered by the somewhat calmer environment at present should be used to take these measures. The SNB and FINMA will monitor developments in these areas closely. In this respect, the SNB explicitly welcomes the fact that, at their last General Meetings, the big bank shareholders agreed to the creation of authorised capital. This allows the big banks to react appropriately and flexibly to market developments.

Regulatory agenda

However, if the stability of the financial system is to be increased in the medium and longer term, the authorities themselves face challenges, and not just the banks. Intensive efforts are currently going into the development of appropriate solutions, both at the international level and in Switzerland.

Last autumn, for instance, the then SFBC issued decrees imposing tighter capital adequacy requirements on the big banks. In future, the capital base at these institutions will have to exceed, in good times, the minimum risk-weighted capital requirements by 100%. As a complement to this, FINMA has also introduced a 'leverage ratio', i.e. a limit to the banks' leverage. The SNB considers that leverage of over 20 in the banking sector is not prudent and thus is undesirable in good times. In other words, we consider that, in good times, the capital base should account for at least 5% of the balance sheet total. This is in line with FINMA's requirements. FINMA expects the big banks' 'leverage ratio' to be well over 3% at group level and well over 4% for individual institutions in good times. To prevent the capital requirements from having a procyclical impact, two steps have been taken. First, there will be a long time delay before they are implemented. The new FINMA targets will apply as of 2013 at the earliest, and an extension would be an option for the big banks if compliance becomes impossible due to the situation on the capital markets or the big banks' individual earnings position. Second, an anticyclical element is explicitly built into the new Swiss regulations. In bad times, the big banks will be allowed to fall short of the new targets. In other words, a capital cushion will be built up in good times to absorb losses in crises.

Alongside reinforcement of the capital base, liquidity also needs to be strengthened to increase the resilience of banks. Consequently, a comprehensive revision of the liquidity regulations for big banks is currently underway. Nonetheless, better capital and liquidity requirements do not rule out the possibility that banks will again face existential difficulties in the future. The SNB therefore considers all of the efforts that are going into facilitating orderly wind-downs of large international institutions in future to be just as important. The lack of any clearly defined and internationally coordinated wind-down procedure contributes to a de facto obligation on the part of the state to provide assistance to these institutions. Any rescue of a large financial institution brings more than just high costs. The 'too big to fail' issue also has a tendency to harbour incentives for banks to enter into excessive risks. In Switzerland, the 'too big to fail' question is particularly relevant and, in many respects, unique, given the importance of the big banks for the country's banking sector and its economy. A clearly defined and internationally coordinated wind-down procedure would help to ease this problem. The interplay between national jurisdictions is, however, extremely complex, and finding a solution for a predefined and internationally coordinated procedure of this kind is correspondingly challenging and time-consuming.

The SNB therefore believes that careful consideration must also be given to alternative approaches. These include rules governing the organisational structure of large financial institutions. The aim of such rules would be, in a crisis situation, to split off those units of a bank that are important for the functioning of the economy and wind down the rest.

This does not mean, however, that this type of approach would question the universal bank model as such. The SNB is aware that rules governing the organisational structure of large financial institutions are not easy to draw up. Legal and operational aspects would therefore need to be analysed with the requisite care and any regulations drawn up in close collaboration with the banks affected.

We are convinced that everything needs to be done to implement one of these approaches for facilitating the wind-down of large financial institutions. If significant progress is not achieved within a reasonable time frame, measures that address the size of the banks should also be examined. One way in which the size of a bank can be influenced is through capital regulations. Capital requirements that are dependent upon size reduce a bank's incentive to inflate its balance sheet without restraint. Measures with a direct impact on the size of banks are also conceivable. A size restriction would of course be a major intervention in an institution's corporate strategy. Naturally the SNB is aware that there are advantages to size. For this reason, the advantages and disadvantages of such a measure would have to be examined and weighed up very carefully. Nevertheless, in the case of the large international banks, the empirical evidence would seem to suggest that these institutions have long exceeded the size needed to make full use of these advantages. It should be noted that although the instrument of size restriction is far-reaching, it is by no means new in economic policy. For decades it has been one of the tools for preventing market dominance in the area of competition policy. Within the context of financial stability, the objective of such a measure would be to reduce risks to the stability of the banking and financial system, rather than to maintain competition.

I would like to run through the last few points again briefly. In the short term, priority must be given to overcoming the crisis. However, in order to increase the stability of the financial system in the medium to long term, we consider a reform of the operational environment in the banking sector to be essential. We attach particular importance to alleviating the 'too big to fail' problem. Apart from stricter rules for systemically important institutions, the SNB currently envisages two further options that it intends to examine – first, measures to facilitate the wind-down of large, international institutions and, second, direct and indirect measures to limit their size. The SNB will examine all of these in depth, in close collaboration with FINMA, alongside possible further options. There can be no more taboos, given our experiences of the last two years.

The role of the authorities

What are the lessons to be learnt from this crisis with respect to the role of the authorities? If the regulatory progress we are aiming for is also to be enforced, we need strong authorities. This applies, on the one hand, to FINMA, which is charged with oversight of individual banks, or microprudential oversight. FINMA needs sufficient qualified resources to fulfil its oversight responsibilities. On the other hand, the SNB must step up its own activities through an even closer collaboration with FINMA and also by reinforcing our macroprudential oversight. Unlike FINMA, the SNB does not supervise banks. We do not focus our attention on individual institutions but on the banking system as a whole. Our macroprudential oversight is largely complementary to the microprudential oversight carried out by FINMA. However, in Switzerland, overlaps occur naturally between the microprudential and macroprudential perspectives due to the systemic importance of the two big banks.

Within the ambit of its mandate, the SNB therefore considers it imperative to maintain direct and frequent contact with the big banks. Where necessary, we will step up the frequency and intensity of these contacts. Their purpose is to obtain information of relevance for macroprudential oversight, but also to inform the big banks of our risk assessment. The SNB will also become increasingly involved in regulatory projects that are relevant from a systemic point of view. Initial examples are the work on the introduction of a leverage ratio and on the reform of liquidity regulations, which FINMA and the SNB have been driving forward together. This development does not essentially call into question the division of responsibilities between the supervisory authority and the central bank. However, because of the importance of the big banks for our financial system and our economy, greater weight must be given to the macroprudential perspective, both in the oversight of the financial system and in its regulation.