

President's address by Hansueli Raggenbass,
President of the Bank Council,
to the General Meeting of Shareholders of the
Swiss National Bank, 30 April 2010

Adjusting the policy on provisions

Dear Shareholders

Ladies and Gentlemen

Dear Guests

In December 2009, the SNB announced that over the next few years it would be increasing the allocation to its provisions. By adjusting its policy on provisions, the National Bank aims to strengthen its equity capital. I would like to use today's occasion to explain to you the background and the significance of this decision.

Swiss National Bank equity capital

The provisions constitute the most important part of the SNB's equity capital. They are accrued from retained profits and have essentially two functions. First, they serve to finance the currency reserves. According to the National Bank Act, the SNB is required to accrue provisions that allow it to maintain its currency reserves at a level that is adequate for its monetary policy. Second, the provisions have the traditional function of equity capital: they must be large enough to absorb even exceptional losses.

Equity capital also consists – along with the provisions – of the distribution reserve. While the level of the provisions reflects the *targeted* equity capital, the distribution reserve is of a temporary nature, in that it is used to smooth the annual SNB profit distribution payments to the Confederation and cantons. The SNB tempers the effects of large fluctuations in the annual results by allocating a portion of the distributable profits in good years to the distribution reserve. These funds are available for distribution at a later date. In this way, in leaner years the SNB can resort to the distribution reserve and thereby continue to carry out the agreed profit distribution.

Increase in assets

Why was it necessary to adjust the policy on provisions? As you know, since the onset of the financial and economic crisis the SNB's balance sheet has almost doubled. Higher currency reserves account for a major part of this. In 2009 alone, these reserves increased by more than CHF 50 billion, due largely to the SNB's purchase of foreign exchange to counter the threat of deflation. In the same year, the value of gold climbed by more than CHF 7 billion. Furthermore, the loan to the stabilisation fund set up by the SNB to take over illiquid assets from UBS lengthened the SNB balance sheet by a further CHF 20 billion.

While the stabilisation fund will be gradually phased out, the additional currency reserves are set to remain on the balance sheet for some while to come. In the past, the SNB's currency reserves have tended to be relatively low, owing to the fact that over the years the level of reserves had not kept pace with the extensive and steadily growing integration of the Swiss economy and financial centre into the global economic system.

Although it was not necessary to tap into the currency reserves during the recent crisis, their presence nevertheless contributed to the SNB's credibility and ability to act. The crisis demonstrated the importance of being equipped to deal with the unexpected. Sufficient currency reserves are essential if the National Bank is to be able to act rapidly and autonomously.

Provisions unchanged

The additional foreign exchange reserves, the valuation gains on gold, and the stabilisation fund together constitute a significant increase in risky assets on the balance sheet. Because there has been no corresponding increase in the provisions to offset this, the provisions to risky assets ratio has deteriorated significantly. This applies also more generally to the total equity capital. Taking into account the distribution reserve, the SNB's equity capital at the end of 2009 amounted to approximately CHF 63 billion. Almost a third of this was made up of the distribution reserve. The reserve, as part of the equity capital, also serves to absorb losses. However, once the existing distribution reserve has

been depleted, the equity capital will consist almost solely of the provisions. In the absence of other measures, the SNB would then be confronted with a provisions to risky assets ratio which would, again, have deteriorated. Its ability to absorb even substantial losses using its equity capital would therefore be less assured.

Adjusting the rule for allocation to the provisions

To avoid this predictable scenario, the SNB has decided to gradually increase its provisions. In the past, the SNB has increased these provisions year-on-year at a rate equivalent to average nominal GDP growth for the preceding five years. This transparent approach has proved its worth, and we will continue to adhere to the principle of allocating the provisions according to a fixed rule and taking account of nominal GDP growth. What is new, however, is that henceforth, the provisions will increase at double this growth rate. Thus the allocation for 2009, instead of being CHF 1.5 billion as per the original rule, now amounts to CHF 3 billion. The adjustment to the allocation rule – seen from the current perspective – applies to the financial years 2009 to 2013.

Influence on profit distribution

This measure affects future distributions in two opposing ways. In the short term, the additional provisions will not be available for distribution. The measure therefore reduces the potential for distribution. In the long term, however, the increase in assets will contribute to a rise in earnings potential. Moreover, as the higher level of assets will be financed in the future by more equity capital, there will also be less interest on borrowed capital, and this, too, will increase the potential for distribution.

The current agreement on profit distribution between the Swiss National Bank and the Federal Department of Finance still applies. It envisages until 2017 an annual distribution to the Confederation and cantons of CHF 2.5 billion, and from the current perspective, it appears likely that this distribution will be met. I must, however, explicitly stress the qualification 'from the current perspective'. As we have always made clear, the SNB earnings can fluctuate substantially from one year to the next. They are particularly susceptible to movements in exchange rates and the gold price, and major losses can

never be completely ruled out. In the event of serious losses, profit distribution could be affected. The agreement caters for this scenario with different measures, which, depending on the level of the distribution reserve, range from a review of the agreement to a reduction or suspension of the distribution. Irrespective of this, the agreement is due to undergo a routine review in 2013.

Concluding remarks

The SNB balance sheet remained largely robust even during the financial and economic crisis.

On the one hand, this is due to the foresight and long-term thinking underpinning the profit distribution agreement. When the agreement was revised in the early nineties, it was determined that each year a portion of the annual profits would be allocated to the provisions. This has ensured a consistent increase in the SNB's equity capital despite the rise over the years in the distributions. The decision taken at that time to couple the accrual of equity capital with the distribution of profit has since proved its worth.

On the other hand, the SNB has also benefited from the exceptional rise in recent years in the price of gold. That we have, at CHF 19 billion, a very solid distribution reserve at our disposal is due almost solely to this surge in the gold price.

Therefore I want to point out that favourable market conditions as well as responsible management have contributed towards the healthy state of our balance sheet. However, as has been amply demonstrated, we cannot afford to rely on favourable market conditions. The SNB balance sheet is in its current state by virtue of events which, in the time leading up to their occurrence, seemed very unlikely indeed. Nobody can predict what surprises the next few years have in store for us. It is our duty, therefore, to equip ourselves against the possibility of serious shocks.

The fact is the current resilience of our balance sheet depends to a large extent on the size of the distribution reserve. Once the existing reserve has been depleted, should major shocks subsequently occur, those shocks would have to be absorbed by the provisions alone.

Against this backdrop, the Bank Council and the Governing Board have decided to adopt a forward-looking approach and begin taking the necessary steps to ensure the long-term strength of the balance sheet. Increasing the allocations to the provisions will help to ensure that the SNB balance sheet continues to meet the high demands on its robustness even after the distribution reserve has been depleted. It means that the SNB will continue to have at its disposal the currency reserves necessary for the fulfilment of its responsibilities, and it will ensure that in future crises, it still has the leeway it needs to carry out its monetary policy.

Thank you for your attention.