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Introductory remarks by Philipp Hildebrand

I would like to use today's publication of our *Financial Stability Report* as an opportunity to share some thoughts with you on the current situation of the financial system. I will start with the most important message – the Swiss banking sector and the financial system in general are in very good shape at the moment. Based on our analysis, the outlook for the future is also essentially positive.

As stated in our report, the favourable situation in the Swiss banking sector comes as no real surprise. Developments in the economy and the financial markets in recent years have been very positive, both in Switzerland and abroad. Although economic growth has been strong, it has had practically no impact on inflation to date. The credit standing of borrowers remained high. In addition, despite repeated, significant short-term price corrections – as was the case last week – the stock markets rose sharply overall in an environment of low volatility.

How can these positive developments be explained? And are there any risks involved – in particular for the stability of the Swiss financial sector?

The good performance is not solely attributable to the favourable economic situation. Structural aspects have also played a role. With that I mean first and foremost the increased level of efficiency that has been achieved in the financial system in the past few years. This rise in efficiency can be ascribed to the innovativeness of financial markets. New financial instruments, such as credit derivatives, enable banks to separate their credit risk and transfer it either completely or partially. This facilitates a better distribution of credit risk in the financial system and means that the risk is borne by those who want to and are able to bear it.

The improved efficiency has resulted in a reduction in the financing costs of companies and households. Lower financing costs help the economy and stock markets to achieve greater growth. The increased efficiency also appears to have improved the ability of global financial markets to absorb shocks. The downgrading of General Motors' credit rating in 2005, for instance, or the major losses suffered by the hedge fund Amaranth last year had no lasting impact on stock and credit markets.

All in all, global financial markets are currently better able to absorb shocks, at least small to medium-sized ones. Accordingly, serious turbulence in the financial system seems less likely today. From a financial stability perspective, this is a positive development indeed.

However, the greater the stability of the financial markets, the greater the risk appetite of market participants tends to be. This in turn can increase the likelihood of a crisis and, in the event of one occurring, the extent of the damage. The greater concentration and interconnectedness in the global financial system may also have increased the magnitude of a potential crisis.

The greater risk tolerance of market players is ultimately a logical consequence of the exceptionally long and stable period of calm in the financial markets. Market participants have had no reason of late to keep their risk-taking in check. Basically, anyone who held back felt they were missing the opportunity to generate high returns. Even the short-term corrections in the financial markets in February of this year and May of the previous year did not result in a change of attitude in this regard. On the contrary, the low impact made by these corrections and the ability of the markets to absorb them may have served as a confirmation for those operating a high-risk strategy to continue, and as an indication for the more risk-averse to take greater risks.

The risk appetite is also fairly high in the Swiss banking sector at present. In our *Financial Stability Report*, we indicate for instance that the domestically oriented banks – Raiffeisen, cantonal and regional banks – are currently incurring a relatively high interest rate risk. At the same time, the big banks have also exhibited an increased risk tolerance in recent years. Although Credit Suisse Group's overall risk has declined in the past year, following the sale of Winterthur, both big banks have significantly increased their risk-taking in the banking business; particularly their exposure in trading and in foreign lending business. As a result, their trading books have virtually doubled since 2003 and are now clearly in excess of CHF 1,000 billion. This accounts for roughly two-thirds of the assets managed by the entire hedge fund industry.

The fact that market participants take more risks in a stable environment is in itself not a problem. What is important is that they correctly assess their ability to bear risks and are able to handle poorer conditions. Driving 120 km/h along an empty motorway in good weather conditions is generally not dangerous for an experienced driver. It is a different story, however, if visibility is poor and traffic is heavy. If the speed is not adjusted accordingly, the chances of having an accident increase. Driving fast becomes dangerous if the speed is no longer in line with the driver's capability and external conditions.

Using this analogy, how does the current situation in the global financial markets and Swiss banking sector compare? As already mentioned, the overall impression at the moment is that we are driving quite fast. Unlike on the motorway, however, there are three reasons why it is difficult to judge if the speed is too high or if the market participants would be able to slow down in time were conditions to deteriorate.

Firstly, it is not clear just how fast the car is going, or rather, how much risk is being entered into. This not only applies to the less regulated players in the financial system, such as hedge funds, but also to a certain extent to banks. For instance, the rating agency Moody's came to the conclusion in a report[1] published last year that banks generally do

[1] Risk Disclosures of Banks and Securities Firms, Moody's Investors Services, May 2006.

not disclose their risks sufficiently. In our *Financial Stability Report*, we also point out that it would be beneficial if Swiss banks were to provide more data in this regard. By providing more comprehensive data, banks would be helping investors and authorities to better assess the risks banks take. Banks should, for example, publish more results from their stress tests. Similar to crash tests, stress tests examine how severely the bank would be affected by a major crisis.

Secondly, it is difficult to assess how the traffic would react in poor weather conditions. Even though the braking distance is relatively short on a dry surface, this is by no means a guarantee that the car will react in the same way on a wet or even icy road. A number of instruments currently in use in the financial system have not yet had to prove their worth in extreme stress situations. It is therefore not clear whether the risks for these new and complex products have been adequately assessed. These products are typically not assessed in a central market, but by using complex models. In other words, the analysis is not a mark-to-market one, but a mark-to-model one. The reliability of the mark-to-model approach, however, relies heavily on assumptions and on the availability of reliable data. Data on tail events (events that occur rarely, but have major repercussions) would be particularly beneficial for the calibration of models. There is, however, by definition hardly any data on such events. This begs the question as to whether the dangers associated with tail events are being correctly assessed using the available models, or whether model risks pose a problem.

Thirdly, it is unclear whether the finance industry's capital buffer – in the form of equity capital – is adequate to weather particularly bad storms. Like airbags in a car, equity capital is only rarely called into action. Yet, the more serious the accident, the more generously the bags should be filled with air. In the current economic environment, many market participants are highly leveraged, in other words, they have a low ratio of debt to equity capital. Low levels of equity capital can be compared to a thin airbag – they only protect against moderate shocks. It would only take a loss of 2–3% of the balance sheet total, for instance, for Swiss big banks to use up all their equity capital. Of course, a loss of this magnitude is highly unlikely. After all, the Swiss big banks are well-diversified, have sophisticated risk management models in place and have high risk-weighted capital ratios. This notwithstanding, such a loss cannot be ruled out. In fact, it represents a classic tail event: a loss of this kind is highly unlikely, yet would have dire consequences, particularly for the stability of the entire Swiss banking sector. In view of the aforementioned uncertainties in connection with risk assessment, would it not be justified to aim to create a somewhat more 'well-padded' cushion of security, even if equity capital – like airbags – comes at a price?

Finally, I would like to point out that central banks do not know better than banks or the market as to if and when and in what form a major crisis could hit the financial markets. In principle, we believe that the likelihood of severe disruptions in the financial system has actually declined as a result of innovations in the financial markets. At the same time, the repercussions of a crisis – should one occur after all – could be particularly severe given the current situation. With this in mind, I feel it is important that market participants – including the Swiss banks – should increasingly take tail events into consideration in their assessments. Stress tests are especially suitable in this regard. In our *Financial Stability Report*, we also underline the importance of stress testing. This calls for an intensification of the cooperation between the authorities and the big banks so as to enhance the transparency and comparability when evaluating the resilience of the Swiss big banks. Within the context of this cooperation, it should also be ensured that the cost/benefit ratio of such an exercise remains adequate.