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SWISS NATIONAL BANK

News conference

Geneva, 19 June 2008

Introductory remarks by Philipp Hildebrand

The Swiss National Bank publishes its sixth annual report on financial stability today. My comments are based on this report. I will begin with a brief assessment of the current state of the financial system. Then I will present the most important lessons which the Swiss National Bank has learned from the credit market turmoil.

As you know, the situation in the Swiss banking sector worsened significantly in 2007 as a result of the correction in the US real estate market. In the second half of the year, profits fell at the Swiss big banks and there was a substantial deterioration in their capital base. The other Swiss banks, by contrast, were hardly affected by the turmoil. Most of them were able to benefit from the buoyant Swiss economy and surpass the good results they had achieved the previous year.

Since the beginning of 2008, developments at the big banks have been mixed. On the one hand, in the first quarter of 2008, they suffered losses in the international credit markets due to further deterioration in the international credit markets. On the other hand, they strengthened their capital bases and partially reduced their risk positions.

In the past few months, the overall market environment has calmed somewhat. Nonetheless, it is too early to sound the all-clear. The ongoing price corrections on the US real estate market will probably continue to put a strain on the US economy. Ultimately, this will spill over to countries outside the US, although according to our assessment the affects will be limited. Consequently, although the SNB expects a slowing in momentum in the coming quarters, it expects the decline in economic growth to be less pronounced than in the US.

However, there is considerable uncertainty attached to the current forecast. This means that market participants, and in particular the banks, also need to take less favourable scenarios into account. A clear escalation of the crisis in the US real estate market would heavily depress economic growth in the US and this, in turn, would leave a more pronounced mark on Switzerland. Moreover, real estate prices have risen appreciably in recent years in the US, as in other countries. Price corrections can already be observed here and there in the real estate markets of other countries. Further developments of this kind cannot be ruled out. We do not see any greater risks for the Swiss real estate market at the present time.

As already mentioned, the Swiss big banks have reduced some of their risk positions in recent months. However, they remain exposed with regard to international developments. So far, the financial market turmoil has mainly affected the trading portfolios of the big banks, and hardly any losses have been recorded in traditional lending business. This could change. Should the general economic situation indeed deteriorate further, the solvency of borrowers would also worsen. This would result in losses in the big banks' lending portfolios. The effect on banks with a domestic business focus would depend on the extent of the deterioration in the international environment.

Entering into risk is a bank's core business and, as such, is desirable. What is important is that these risks can be both calculated and carried. However, experience shows that is not always the case. In each of the three most recent international financial crises, a Swiss big bank was particularly hard hit. Each time a crisis occurred an increasing amount of equity was wiped out. This should serve as a warning. If the wheels are not set in motion now, the impact of the next crisis could be even more severe.

Should a big bank collapse, the consequences for Switzerland would be dire. Therefore, measures need to be taken now in order to ensure that the Swiss big banks are sufficiently resilient in the future. The SNB and the Swiss Federal Banking Commission recognise a need for action in – basically – four areas: capital, liquidity, monitoring and crisis management. In our stability report we discuss measures in all four areas. Today I would like to focus on the most important measures in the area of capital.

It is in the nature of the financial markets that there will always be crises. Even with the best risk management, banks can be hit suddenly by unexpected events or developments. I am convinced that managements will continue to misjudge situations in the future. This is something we have to live with. The financial system therefore needs to be made more resilient to possible shocks. This means the buffers in the financial system have to be increased. Fine-tuning of the current regulations is necessary in many respects. However, in my view it is an insufficient response to the steadily increasing complexity of financial markets. It is therefore questionable whether the current regulatory approach, with its increasingly complex provisions that intervene at an ever deeper level in the daily business of banks, is the right one. The authorities are, by nature, always a step behind the latest developments. Even the most complex models will never be infallible. In the current crisis, the model-based form of risk measurement failed. The SNB therefore believes that two fundamental adjustments need to be made to the capital requirements for the Swiss big banks.

First, the risk-weighted capital requirements for the Swiss big banks need to be tightened. One way of achieving this would be by using an appropriate multiplier to increase the capital requirements under Basel 2.

Second, a limit on leverage – often referred to as 'leverage ratio' – needs to be introduced for the big banks as a complement to the risk-weighted capital requirements. As clearly outlined in our *Financial Stability Report,* leverage at the Swiss big banks is very high, and since the mid-1990s, average indebtedness at the two big banks has risen from 90% to

over 97%. That means over CHF 97 of borrowed capital for every CHF 3 of equity. This ratio is also very high by international standards. In terms of return on equity, high leverage may appear attractive. In terms of financial stability, however, it is also a source of risk. Thus, in the current crisis, losses arose on Swiss big bank risk positions which are relatively small in comparison to total assets. However, because leverage was high, in the case of UBS these losses destroyed almost half the bank's equity.

The two measures mentioned above have a complementary effect. The risk-based requirements ensure the best possible risk-sensitivity for capital adequacy purposes. Alongside this, a leverage ratio would guarantee a minimum safety buffer which does not depend on complex models. Thus, the leverage ratio would be a protection against unexpected shocks that are not sufficiently covered by the risk-weighted requirements. This limitation set on the degree of indebtedness would mean that capital requirements would increase for activities based on large amounts of borrowed funds, such as proprietary trading. In the US, banks have long been subject to a leverage ratio. They have to comply with a capital-to-assets ratio of at least 5% in order to be considered as well capitalised.

The Swiss Federal Banking Commission (SFBC) – as the authority with responsibility for this area – is currently in the process of spelling out in detail what measures will be needed in the area of capital adequacy requirements. Careful planning will be particularly important with respect to implementation of the new measures. First of all, the current crisis has to be seen through. The appropriate measures then need to be introduced progressively over a number of years. In this project, the SFBC can count on the full support of the SNB, in the interests of securing a long-term strengthening of the Swiss financial system.