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A macroprudential progress report

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Introduction

Five years ago, the failure of Lehman Brothers sent shockwaves through the global financial system. The failure of a relatively small but highly interconnected institution pushed the entire financial system and, eventually, the global economy to the brink of collapse. This painfully highlighted the fact that policymakers had underestimated systemic risk. Five years later, thanks to substantial efforts, we have a better – but admittedly still incomplete – understanding of what systemic risk is and what we should do about it.

In general terms, systemic risk arises because an optimising financial institution does not fully account for the cost that its behaviour imposes on other financial institutions. Thus, in essence, the origin of systemic risk is a negative externality imposed by individual financial firms on the system. For analytical and regulatory purposes, it is useful to differentiate between structural and cyclical systemic risk. Structural systemic risk stems from institutions that are so large or so interconnected that their failure would threaten the stability of the entire system. These are the institutions that are 'too big to fail' (TBTF) or 'too interconnected to fail'. The cyclical dimension of systemic risk captures the procyclicality of financial agents' behaviour which, if left unchecked, can amplify the financial cycle and increase its instability – a classical collective action problem. Historical evidence shows that the risk of such instability is particularly elevated in situations that combine rising residential prices and dynamic credit growth.[1]

Regulators and policymakers around the world have been working hard on regulatory measures that aim directly at containing these risks. The Lehman anniversary and the papers that have been discussed here this afternoon make this conference a good occasion to reflect on these efforts. In particular, I want to talk about the progress we have made here in Switzerland in devising and implementing regulatory answers to mitigating systemic risk, and also about the work we still have ahead of us in this regard. I will address these two issues in turn.

For a start, let me give you a quick overview of the global reform agenda. On the global scale, the regulatory reform approach (Basel III) sets minimum capital adequacy requirements that are more stringent in both quantitative and qualitative terms, and introduces a global minimum standard on liquidity buffers. At the same time, importantly, the new framework takes explicit account of systemic risk. First, it imposes a capital surcharge for systemically important institutions in order to address the structural TBTF problem. This surcharge amounts to additional loss-absorbing capital of between 1.0% and 2.5% of risk-weighted assets, with the specific requirement depending on the degree to which an institution is systemically important. Second, it introduces a countercyclical buffer ranging between 0.0% and 2.5% of total risk-weighted assets, to increase the system's resilience to cyclical systemic

[1] Cf. for instance Borio, C. (2012) or Schularick, M. and Taylor, A. (2012).

risk. This buffer can be temporarily imposed when credit growth is judged excessive. These new rules are being phased in over several years and will come into full effect in 2019.[2]

Regulation in Switzerland: Framework and progress so far

Switzerland is well advanced in the process of introducing a new regulatory approach in line with this international framework. There was, and still is, an urgent need to proceed faster and to go beyond the global minimum standards.

First, the size of Switzerland's two major banks, Credit Suisse and UBS, relative to GDP is very large by international standards (8:1 in 2007 and 4:1 today). It is worth recalling that, back in October 2008, in order to prevent a breakdown of our financial system, the Swiss authorities had to take measures to strengthen UBS, putting a large amount of public funds – up to USD 60 billion – at considerable risk. Despite the favourable turn of events since then, we have to take all means necessary to avoid such a situation in the future.

Second, on the cyclical front, the sustained momentum in the Swiss mortgage and real estate market over several years has already led to imbalances that pose a risk to financial stability and, ultimately, the Swiss economy.

So, what have we done to address systemic risk in Switzerland up to now?

With respect to the structural dimension of systemic risk – the TBTF issue – Switzerland already adopted a package of measures back in 2011. This package aims at reducing both the likelihood of crisis at a systemically important bank and the costs to the economy in the event of such a crisis.

The package consists of four complementary measures: (1) significantly more capital, and capital of better quality, (2) larger liquidity buffers, (3) rules imposing sufficient diversification to reduce counterparty risk, and (4) organisational measures. Let me briefly outline some key elements of this package.

The new capital adequacy regulations for systemically important banks apply to the risk-weighted capital ratio and the leverage ratio. Furthermore, they are designed to be progressive. Put simply, the bigger the bank, and the greater its systemic importance for the domestic financial system, the higher the requirement. For institutions similar in size to UBS and CS at the time the TBTF package was initially defined, the total capital requirement adds up to 19% of risk-weighted assets (RWA), of which 10% must be held in common equity and 9% can be held in convertible capital (cocos), and the leverage ratio requirement amounts to about 4.6%.[3]

The organisational measures require banks to show convincingly – on the basis of «emergency plans» – that they are organised in such a way as to be able to maintain

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[2] For more detail on the Basel III framework, see Bank for International Settlements (2011).

[3] For the underlying assumptions and principles, see Commission of Experts for limiting the economic risks posed by large companies (2010).

systemically important functions in the event of a crisis, thus reducing the need for a public bail-out. If they are not able to do so, the regulator, FINMA, may impose organisational measures. In March 2012, these new rules came into law and UBS and CS must fully comply by the end of 2018. This transitional period was introduced to mitigate potential unintended side-effects.

Implementation is under way. Specifically, with respect to increasing their risk-weighted capital ratios, both banks have already made substantial progress. If they continue according to the plans they have announced, they will be in a position to fulfil the new regulatory requirements by the end of 2014.[4] At the same time, regulators are working on the establishment of resolution and recovery plans. When finalised, these plans should enable the regulators to secure the orderly resolution of a global bank in the event of a severe crisis and, in doing so, to make sure that systemically important functions can be maintained. As an important step towards this goal, FINMA has been authorised, since November 2012, to order a bail-in of creditors to generate the financial means necessary for restructuring a bank.

Turning to cyclical risk, in June 2012, the Federal Council announced a set of measures consisting of three elements: (1) a permanent increase in risk weights for high loan-to-value mortgage loans,[5] (2) a revision of the banking industry's self-regulation guidelines for mortgage lending,[6] and (3) the legal basis for the activation of a countercyclical capital buffer (CCB), as proposed in the Basel III framework. This instrument allows for a temporary increase in capital requirements when imbalances appear to be building up in the credit markets. It thus aims to increase the resilience of the banking system, and helps to lean against excessive credit growth. In February 2013, following a proposal by the SNB, the Federal Council activated the CCB, requiring banks to hold additional capital amounting to 1% of risk-weighted residential mortgage loan positions. Banks have been obliged to comply with this rule since 30 September 2013.

With the activation of the CCB, Switzerland is among the first countries to implement a tool advocated by the international community as a means for preemptively dealing with cyclical risks to financial stability. While our experience with the CCB may thus be of general interest, we cannot draw conclusive lessons at this point. The CCB took effect only two weeks ago, and was activated while the other two measures I have just outlined were already in place. So we are not conducting a controlled experiment here, which makes disentangling the effect of any single measure very difficult.

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[4] In this respect, both banks are now very well placed in an international peer comparison. At Credit Suisse, the ratio of loss-absorbing capital to risk-weighted assets has more than doubled, from 5.2% in the first quarter of 2012 to 10.8% in the second quarter of 2013, while at UBS it rose from 7.5% to 11.4% over the same period.

[5] Risk weights increase from 75 to 100% for the loan tranche exceeding the 80% LTV ratio.

[6] In particular, the revised guidelines require banks to apply tighter rules regarding mortgage lending, as follows. First, at least 10% of the value of the collateral must be provided in equity from sources other than borrowers' pension assets. Second, the mortgage debt on residential properties has to be repaid such that it amounts to no more than two-thirds of the collateral value after 20 years. A 100% risk-weighting applies for new mortgage loans that do not meet these tighter minimum requirements.

Where should we go from here?

Overall, Switzerland has taken significant steps and substantial progress has been made to better deal with systemic risk, regarding both its cyclical and its structural dimension. Yet, our journey towards a more resilient financial system is far from over. The risk of a systemic crisis of either kind remains. The task has yet to be completed.

Let's start with structural systemic risk. Despite the progress in reducing exposure and strengthening the resilience of the two big banks, the TBTF problem is not fully eliminated as of yet. On the one hand, the capital cushion planned for 2019 is not yet available and, in particular, the leverage ratios of UBS and CS are still low, with their loss-absorbing capital amounting to 2.4% of total exposure.[7] On the other hand, the orderly resolution of a distressed systemically important bank is not yet secured. As a consequence, and given the potentially huge cost of a disorderly collapse of such a bank for financial stability and the economy, we cannot yet exclude the need for a public bail-out in a possible future crisis.

This state of affairs is still unsatisfactory, and has led to renewed debates on how to further regulate global banks. Specifically, voices have been raised in favour of a substantial increase in the minimum non-weighted capital requirement, the leverage ratio. Moreover, demands for an outright separation of investment banking from commercial banking, along the lines of the Glass-Steagall Act, have gained political clout.

While these proposals have merits – and, given the difficulty of the task, one should keep an open mind – qualifying remarks seem appropriate at the current juncture. We are in the midst of implementing a complementary and balanced package of measures. As we have seen, tangible progress has already been made. When it is fully implemented, this package will substantially reduce, and possibly eliminate, the TBTF problem. It is unlikely that a sudden change in strategy would lead to a faster elimination of the underlying risks.

Rather than changing the regulation strategy midway, it is imperative that we press on with the full implementation of the TBTF package. We will then be in a position to assess its effectiveness and decide whether further measures are necessary. Full implementation entails, necessarily, further progress on the following four issues:

First, the big banks must stay on track, and must fully and consistently implement the tighter risk-weighted capital and liquidity requirements as currently planned. This will, importantly, lead to a significant improvement in their leverage ratios.

Second, the quality of the banks' own risk assessment methods must be improved. Increasingly, doubts have been raised on the reliability of the internal models which banks use to compute their risk-weighted assets (RWAs). A stable financial system cannot be based on questionable and opaque risk assessments. To regain confidence in these calculations, banks should make sure that their RWA calculations are transparent and traceable. In particular, they

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[7] As at Q2 2013. Pro memoria: during the crisis, UBS incurred losses of about 2%.

have to ensure that changes in RWAs over time, and differences in published RWAs between institutions, can be explained and economically accounted for.

Third, the ongoing work on recovery and resolution plans should be pursued with total determination. If required for the guaranteed maintenance of systemically important functions, changes in the current organisational structure should be explored and initiated without delay.

Fourth, on the regulatory side, further progress in defining the key elements of a viable resolution and recovery strategy for globally active banks is needed. In the absence of global bank insolvency legislation, this necessitates close coordination among regulators across borders. Specifically, further steps are necessary to guarantee that resolution measures – such as a bail-in – ordered by the home regulator are mutually recognised by foreign authorities. In this regard, it is encouraging that the resolution and recovery plans for our big banks are being developed in close collaboration with the foreign regulatory authorities concerned.

Let me finish with some words regarding the cyclical risks. Mortgage volumes and real estate prices continue to grow at rates significantly above those justified by fundamental factors such as income and population growth. This means that the imbalances, which are already large, are increasing further. At the same time, indications of a possible slowdown in momentum became visible during the course of 2013.[8] Taken together, these developments make it difficult to judge precisely where we are in the credit cycle or the direction in which we are heading. This situation is an example of the fundamental identification difficulty pertaining to the analysis of the financial cycle. Further academic advances in the development of new tools to help identify cyclical risks would be highly welcome.

The lessons are clear, however. In the current environment of significant uncertainty and persistent risk, prudent behaviour on the part of all actors is called for. For banks, this means applying conservative lending criteria in terms of both loan-to-value ratios and affordability. For borrowers, it means bearing in mind that real estate prices are already at elevated levels and ensuring that, even if interest rates were to rise sharply, they could afford to service a loan. And finally, for regulators, it means continuing to monitor the situation very closely and being ready to take further regulatory measures, if the hopes of a soft landing are not fulfilled.

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[8] Nominal growth rates for mortgage claims have slowed to about 4.5% from around 5% in the two preceding years. At the same time, apartment price growth has slowed from 6.8% (average growth rate in 2012) to 5.2% in Q2 2013 (annual growth rates of nominal transactions prices based on quarterly data provided by Wüest&Partner).

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