SCHWEIZERISCHE NATIONALBANK
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SWISS NATIONAL BANK

Berne, 19 June 2014
Jean-Pierre Danthine

Introductory remarks by Jean-Pierre Danthine

As my colleague Thomas Jordan has explained, economic and financial conditions continue to be challenging. Against this background, I would like to examine the situation at Swiss banks from a financial stability perspective, looking first at the big banks and then moving on to a discussion of domestically focused banks.

Big banks: Strengthening resilience

Over the past year, the Swiss big banks have further improved their capital situation. In terms of loss-absorbing capital – defined as Common Equity Tier 1 capital plus high-trigger contingent capital instruments – their risk-weighted capital ratio either already exceeds or is close to the 13% requirement that will apply from 2019. They also meet or are very close to meeting the corresponding leverage ratio requirement of 3.1%. In terms of total capital, both big banks have also substantially improved their ratios. However, they have yet to meet the corresponding requirements applicable from 2019.[1]

The SNB welcomes the significant progress made by the big banks in improving their capital situation and their compliance with some of the requirements applicable from 2019. The SNB recommends that they continue to improve their resilience and, in particular, their leverage ratios. This is important for two reasons.

First, the loss potential for the Swiss big banks – estimated under the different adverse scenarios considered – continues to be substantial relative to their capitalisation. These adverse scenarios are not forecasts. They represent unlikely, highly unfavourable but coherent developments in economic and financial conditions. For financial stability in Switzerland, it is important that the big banks remain adequately capitalised in the event of such scenarios

[1] Total capital comprises going-concern loss-absorbing capital (Common Equity Tier 1 capital plus high-trigger contingent capital instruments) and low-trigger contingent capital instruments. The latter are primarily aimed at ensuring the maintenance of systemically important functions and the orderly resolution of the residual bank, and are therefore important in a ‘gone concern’ perspective.

occurring. In addition, irrespective of the scenario considered, substantial losses can also result from operational and legal risks, as recent experience has shown.

Second, an international comparison reveals an uneven picture of the Swiss big banks' capitalisation, depending on which capital measure one examines. Although their risk-weighted ratios are above average for large globally active banks, the same cannot be said for their leverage ratios, as calculated according to various common definitions. Leverage ratios are gaining in importance as a measure of banks' resilience. Experience shows that these ratios quickly become the focus of market attention during a crisis. Moreover, the international requirement, effective from the beginning of 2015, to disclose the Basel III leverage ratio will enable a direct comparison between large globally active banks. This is why it is essential for banks to have a solid leverage ratio.

Increasing the credibility of model-based risk-weighted assets

Increasing the credibility of risk-weighted assets (RWA) based on banks' internal models remains an important goal. As discussed in the 2013 *Financial Stability Report*, model-based RWA are being called into question by market participants, analysts and authorities worldwide. This is particularly significant as RWA are at the heart of the capital regulations for banks. It is widely accepted that a bank's risks can, in principle, be more accurately quantified using the model-based approach than using the standardised approach. Yet banks' internal models are highly complex and can vary widely between institutions, thus making it difficult to accurately assess a bank's resilience and compare one bank with another.

The SNB welcomes the efforts by the Swiss big banks to increase transparency with regard to their risks. For example, both institutions recently started to disclose changes in their RWA, broken down by cause. Of particular interest is the proportion of the reduction in RWA which is attributable to model adjustments. In addition, Credit Suisse has been publishing a statistical measure of total loss potential for some time now, and UBS recently started to publish a statistical measure of loss potential by business division and a scenario-based post-stress capital ratio.

The SNB encourages the big banks to further increase transparency with regard to their risks. It continues to recommend that the big banks disclose RWA according to both the model-based approach and the model-independent standardised approach. This recommendation is in line with increasing efforts being made at international level. Disclosing RWA according to the standardised approach would provide market participants with additional information for assessing the level of, and changes in, model-based RWA.

In this context, the analysis of RWA being carried out by FINMA with the support of the SNB will play an important role. The big banks have already provided the necessary data by calculating RWA based on the standardised approach. Now the analysis will focus on the question of whether, and why, RWA based on the banks' internal models differ from those based on the model-independent standardised approach. Differences must be well explained and have a sound economic rationale. If the analysis does not reveal any substantial and

inexplicable differences, this would strengthen the credibility of the model-based approach. Conversely, if substantial differences cannot be explained, corrective measures would need to be considered.

Domestically focused commercial banks

I would now like to turn to the domestically focused commercial banks. In 2013, these banks further increased their already high exposure to mortgage and real estate market risk. First, growth in domestically focused banks’ mortgage lending was almost unchanged from the previous year. By contrast, the big banks’ lending growth decreased significantly in 2013. Second, domestically focused banks’ risk appetite in mortgage lending remained high overall. While there has been a decline in the share of new mortgage loans with a high loan-to-value (LTV) ratio since the last *Financial Stability Report*, no trend towards lower affordability risks is discernible. Third, they continued to carry a historically high level of interest rate risk in the banking book. As a result, these banks are particularly vulnerable to adverse scenarios which assume a significant interest rate increase coupled with a price correction on the residential real estate market.

While domestically focused banks’ exposure to risk is high, their current capital ratios are also significantly above the regulatory minimum. As a consequence, substantial capital buffers are available in the system to absorb losses from negative developments in the economic and financial environment. Nonetheless, from a financial stability perspective, the banks’ high exposure to risk, coupled with the imbalances on the mortgage and real estate markets, is a source of concern. The situation calls for a prudent lending policy, both to limit banks’ future loss potential and to help prevent a further build-up of imbalances.

Regarding the latter, the different measures taken thus far by the authorities appear to have had some positive impact. Measures such as the revision of the self-regulation rules in July 2012 and the activation of the countercyclical capital buffer (CCB) in early 2013, which contributed to strengthening banking sector resilience, seem to have helped contain market momentum. Nonetheless, imbalances built up further in 2013, thereby justifying the increase in the level of the CCB, decided by the Federal Council in January 2014.

Since then, imbalances have remained almost unchanged. On the one hand, momentum on the mortgage market slowed somewhat during the first quarter of 2014. On the other, during the same period, the rate of real estate price growth remained similar to that observed over the last few quarters, only slightly exceeding the growth of fundamental factors. From a financial stability perspective, these are welcome developments.

Experience shows, however, that short-term changes in momentum do not necessarily imply a change in trend. Given the persistence of the low interest rate environment, banks and authorities should remain alert and take the necessary steps to keep risks for financial stability in check.

First, measures giving banks stronger incentives to pursue a more cautious mortgage lending policy should be considered. Such measures should target both the owner-occupied residential property and the residential investment property segments. Efforts should now be directed towards preparing regulatory measures that could be implemented swiftly should momentum pick up again on the mortgage and residential real estate markets.

Second, interest rate risk exposure in the banking book should be appropriately backed with capital. Under the aegis of the Basel Committee on Banking Supervision, international standards on capital requirements for interest rate risk are currently being developed. Given the significance of this risk factor, domestically focused banks should ensure they adopt a prudent stance towards measuring and managing this risk. In this context, the SNB fully supports FINMA's efforts to ensure that risk-taking by individual banks is reduced or backed by specific capital charges whenever the risk exposure is deemed exceptionally large by historical or industry standards.

In parallel with these measures, the SNB will continue to monitor developments on the mortgage and real estate markets closely, and will reassess the need for an adjustment to the CCB on a regular basis.