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2012 Financial Stability Report

Executive summary

Economic and financial conditions for the Swiss banking sector have deteriorated since June 2011. The European debt crisis deepened in the second half of 2011, global economic growth lost momentum, tensions grew in the international banking system, and imbalances on the Swiss real estate and mortgage markets increased. Early signs of a possible recovery in the euro area, which had emerged at the beginning of 2012, have vanished again. Even though the SNB expects a gradual improvement of the situation over the next 12 months, the risk of a rapid and marked deterioration in conditions for the Swiss banking sector remains high.

Despite progress achieved, the big banks' loss-absorbing capital is still below the level needed to ensure sufficient resilience given the high risks in the environment. The big banks' importance for the Swiss economy and for financial stability requires that they further strengthen their resilience. The SNB therefore recommends that UBS continue with this process – including, in particular, a policy of dividend restraint – and that Credit Suisse significantly expand its loss-absorbing capital during the current year. An improvement in capitalisation is not only necessary from a financial stability perspective; it also benefits the banks, in that it bolsters their competitive position in the core business of wealth management, and boosts general market confidence. In addition, to avoid unfavourable market assessments during periods of stress, the big banks should also increase their transparency with regard to resilience.

A strength of the big banks is that they are only moderately exposed to the peripheral euro area countries. This may be one reason why the market assessment of their creditworthiness is currently favourable compared to other international banks. In addition, since June 2011 they have reduced their risk-weighted assets and expanded their loss-absorbing capital. Their weaknesses, however, include that the level of their loss-absorbing capital, measured according to the Basel III regulations, is below average in an international comparison. This is particularly true for Credit Suisse. Moreover, in the event of a renewed escalation of the euro area crisis, although losses on direct exposures to the peripheral countries would be relatively small, the accompanying general deterioration in economic conditions would bring with it substantial

losses compared to the banks' loss-absorbing capital. Furthermore, the leverage of both banks remains very high, despite the reduction of risk-weighted assets; accordingly, it is uncertain to what extent the reduction of risk-weighted assets is matched by an effective reduction of economic risks. Finally, the above-average market assessment is partly based on the continuing expectation of state support in the event of a crisis.

Regarding domestically focused commercial banks, average capitalisation relative to regulatory requirements is at a historically high level. However, the resilience of some of these banks – including some larger ones – should be further strengthened, in view of their risk exposures. In addition, given the growing cyclical risks in the Swiss real estate and mortgage markets, a temporary adjustment of system-wide capital requirements may have to be considered.

To limit these medium-term risks to financial stability, self-regulation measures and microprudential supervision can be combined with macroprudential policies. The SNB therefore welcomes the measures aimed at reducing risks in the mortgage market announced on 1 June 2012. These measures include: a further revision of the self-regulation rules for mortgage lending; a permanent adjustment of risk weights for high loan-to-value mortgage loans; and a macroprudential instrument in the form of a countercyclical capital buffer.

In the short run, the assessment of the necessity to activate the countercyclical capital buffer will focus on developments in the real estate and mortgage markets. When activated, the buffer should help to protect the banking sector against the consequences of excessive credit growth by increasing its loss-absorbing capacity. Moreover, it should help to lean against the build-up of such excesses. The activation of this instrument would be a temporary measure.

1 Overall assessment

Economic and financial conditions for the Swiss banking sector have deteriorated since the June 2011 *Financial Stability Report*. The sovereign debt crisis in the peripheral euro area countries escalated in the second half of 2011 and threatened to spill over to the core countries of the euro area. The crisis had a particularly negative effect on the European banking sector, which is heavily exposed to these countries. The problems in the banking sector in turn weighed on economic growth, in that European banks became more cautious in their lending practices. The weak economic activity further hampered efforts by the affected countries to restructure their budgets. All these developments resulted in a sharp rise in credit risk premia in the financial markets. At the same time, global economic growth lost momentum. Early signs of a possible recovery in the euro area, which had emerged at the beginning of 2012, have vanished again.

Economic growth also slowed in Switzerland, although, in an international comparison, economic conditions continued to be favourable. This, together with historically low interest rates, further stimulated the strong momentum observed in real estate prices over the last few years. SNB estimates on apartment prices indicate that they already exceed values justified by fundamentals.

Under the baseline scenario, the SNB expects the moderate recovery of the Swiss and international economies to continue. As a consequence, economic and financial conditions for the Swiss banking sector are expected to improve. Under this scenario, the strong momentum in the real estate and mortgage markets continues, due to relatively good domestic economic conditions and a low interest rate environment. In the medium term, this is associated with an increase in both the risk and the magnitude of a potential residential real estate price correction.

Even though the SNB currently expects global economic and financial conditions to improve, the risk of a rapid and marked deterioration remains high in the next 12 months. Hence, in order to assess banks' capital adequacy, the SNB is using an adverse scenario which reflects these risks. This very severe but possible scenario assumes a further escalation of the European debt crisis, leading European countries – including Switzerland – and the US to slip into a deep recession, while econom-

ic growth in the emerging markets declines sharply. Under this scenario, the global banking sector is hit by a serious crisis, thereby further exacerbating the economic situation. Furthermore, share and real estate prices fall in most countries, including Switzerland.

Improving the resilience of the big banks

Under the baseline scenario, a gradual improvement in the resilience of the big banks is to be expected in the short term. In the medium term, however, this scenario sees the risks in the Swiss real estate and mortgage markets – and therefore the loss potential in connection with Swiss mortgages – increasing. Due to their diversified business models, however, the effects of a possible real estate price correction would be smaller for the big banks than for most domestically focused commercial banks.

Under the adverse scenario, the loss potential for the big banks would be substantial, due to their large credit and trading positions. The exposure of Credit Suisse and UBS to the peripheral euro area countries is moderate, both in absolute terms and in comparison to other international commercial banks. As a result, direct losses in the case of debt restructuring measures in these countries would be relatively small. However, indirectly, both big banks are heavily exposed to the European banking sector, which is why a European banking crisis would lead to substantial losses. Further significant losses under this adverse scenario would occur due to credit defaults in Switzerland and the US, as well as to the slump in global stock markets.

Despite progress achieved, the SNB considers that, in view of the loss potential under this scenario, the big banks' loss-absorbing capital is still below the level needed to ensure sufficient resilience. At the end of March 2012, risk-weighted capital ratios calculated using loss-absorbing capital¹ and risk-weighted assets under the new regulations, i.e. Basel III and Swiss 'too big to fail' regulations, came to about 5.9% for Credit Suisse² and 7.5% for UBS.³ Relative to the net balance sheet total,⁴ however, loss-absorbing capital only amounted to around 1.7% at Credit Suisse and 2.7% at UBS. This capital would, for example, be insufficient to absorb losses such as those experienced by UBS in the recent crisis (over 3% of the net balance sheet total).

In addition, when measured according to Basel III definitions, the capitalisation of both big banks – in particular Credit Suisse – is below

1 The SNB defines loss-absorbing capital as comprising Common Equity Tier 1 capital (CET1 capital) under full Basel III implementation, plus high-trigger contingent capital instruments as set out in the Swiss 'too big to fail' legislation. Under the Swiss regulations, the banks must hold additional, low-trigger contingent capital instruments. These are mainly intended for the Swiss emergency plan and the restructuring or wind-down of the remaining bank units, and are therefore not considered in this 'going concern' perspective. For details, cf. chapter 4 on p. 20.

2 Source: SNB calculations based on Credit Suisse's quarterly report for Q1 2012.

3 UBS presentation on the results for Q1 2012.

4 In order to take differences in accounting standards into consideration, UBS's balance sheet total is adjusted. The adjustment includes the impact of netting agreements (including cash collateral) in accordance with Swiss banking law, based on the IFRS scope of consolidation; Credit Suisse's balance sheet total is not adjusted. From 2019 onwards, under the Swiss 'too big to fail' regulations, the

average in an international comparison. Given the importance of the big banks for the Swiss economy and for financial stability, an above-average capitalisation level would be appropriate. Although full compliance with Basel III is not required until the beginning of 2019, from an economic standpoint – and, since the latest financial crisis, increasingly from a market perspective as well – it is already the relevant benchmark for assessing resilience. While international comparisons should always be interpreted with caution, the SNB considers that, in this specific case, the results of this comparison are sufficiently reliable and relevant.

The SNB is therefore of the view that both big banks should further expand their loss-absorbing capital. For UBS, this implies a continuation of its capital strengthening process; and for Credit Suisse, an acceleration of the process, with a marked increase during the current year. Strengthening resilience is necessary from a financial stability perspective. However, it is also in the banks' own interest, as a sound capital base constitutes a competitive advantage in the core business of wealth management. Moreover, the banks would also reduce their risk of having to recapitalise under adverse conditions in a stress situation.

In addition, the SNB recommends that the big banks increase their transparency with regard to resilience. Greater transparency fosters market confidence and, in a crisis, prevents erroneous and unfavourable market assessments being made due to a lack of clarity, which could potentially further exacerbate the stress situation. In concrete terms, both institutions should report each quarter on the new regulatory indicators under full Basel III implementation – as, indeed, UBS has done in the two most recent presentations of its quarterly results. To transparently demonstrate their ongoing progress in risk reduction, they should calculate and disclose their risk-weighted assets not just according to internal models, but also according to the Basel standardised approach.

Imbalances in the Swiss real estate and mortgage markets as primary risks for domestically focused commercial banks

Under the baseline scenario, medium-term risks increase for domestically focused commercial banks in connection with a possible correction of imbalances in the Swiss real estate and mortgage markets. If the strong momentum in these markets persists, not only does the likelihood of a price cor-

rection grow, but its consequences also become more serious. A decline in real estate prices to the extent experienced in the 1990s – triggered, for example, by an increase in interest rates – would result in substantial losses for domestically focused banks. Furthermore, a rise in interest rates would likely lead to some banks experiencing significant losses in earnings, due to their high direct interest rate risk exposure.

The average capitalisation – based on the regulatory requirements – of domestically focused banks remains at a historically high level, measured relative to both risk-weighted assets and balance sheet total. Moreover, in contrast to the big banks, a large proportion of domestically focused banks' reported capital under Basel II is also loss-absorbing.

However, in the current situation, the resilience of these banks, as measured by the regulatory capital indicators, is overestimated. First, certain risks are not captured by the capital requirements. This applies to interest rate exposure in the banking book.⁵ Second, the existing capital requirements have a procyclical effect. Through their impact on loan-to-value ratios, rising real estate prices can lead to lower capital requirements. The higher real estate prices rise above levels that are justified by fundamentals, the more the regulatory capital indicators overestimate the resilience of these banks.

In addition, there is quite a wide distribution of capital ratios and risk appetite for domestically focused banks. A number of these banks – including some larger ones – have, alongside relatively low capital buffers, high interest and credit risk exposure.

Against this backdrop, and in view of the growing risks in the Swiss real estate and mortgage markets, the SNB considers that there is a need for corrective measures. To date, neither last year's revision of the self-regulation rules by the Swiss Bankers Association⁶ nor the strengthening of microprudential supervision by FINMA⁷ have been sufficient to prevent a further increase in systemic risk on the Swiss real estate and mortgage markets.

In this context, the SNB welcomes the measures aimed at reducing risks in the mortgage market announced on 1 June 2012. These measures include: a further revision of the self-regulation rules for mortgage lending, which restricts the use of pension savings as collateral for borrowers, effective from July 2012; a permanent adjustment of risk weights for high loan-to-value mortgage

big banks will have to comply with a leverage ratio of at least 4.5%. However, this is not fully comparable with the capital ratios discussed here. First, the banks will be able to include all capital, rather than only their loss-absorbing capital. Second, the applicable balance sheet total figure will include additional items (e.g. certain off-balance-sheet items), and would thus – according to current estimates – be around 50% larger than the net balance sheet total. Source: UBS report for Q1 2012.

5 In contrast to interest rate risk in the trading book, under Pillar 1 rules interest rate risk in the banking book does not need to be backed with capital.

6 Swiss Banking, *Guidelines governing the examination, valuation and treatment of mortgage-backed loans*, October 2011.

7 FINMA, *Annual Report*, 2010.

loans, effective from January 2013; and a macroprudential instrument in the form of a countercyclical capital buffer, which will be available to the Swiss authorities from July 2012.

In the short run, the assessment of the necessity to activate the countercyclical capital buffer will focus on developments in the real estate and mortgage markets. When activated, the buffer should help to protect the banking sector against the consequences of excessive credit growth by increasing its loss-absorbing capacity. Moreover, it should help to lean against the build-up of such excesses. The activation of this instrument would be a temporary measure.

For some domestically focused banks, there is a need for corrective measures not just in the medium term, but also in the short term, since the environment could deteriorate rapidly, as projected under the adverse scenario. SNB estimates indicate that some of these banks' capital buffers would be insufficient to absorb the credit losses associated with such an adverse scenario. These short-term risks should be addressed with microprudential measures.

2 Key risks to the Swiss banking system

Economic and financial conditions for the Swiss banking sector have deteriorated since June 2011. With the escalation of the sovereign debt crisis in Europe, global credit risk and market uncertainty increased substantially, while economic growth slowed (cf. chart 1). Peripheral euro area countries were particularly affected as the process of fiscal consolidation weighed on growth. Sovereign bond risk premia have risen again in the most vulnerable countries. Furthermore, tensions in the international banking system remain.

In Switzerland, credit risk has risen slightly. While corporates have proved relatively resilient to deteriorating conditions in Europe and to the persistently strong Swiss franc, households' credit quality has been affected by less favourable labour market conditions. At the same time, risks stemming from the domestic housing market have increased as price imbalances in certain segments and regions, already apparent 12 months ago, have developed further.

At the beginning of 2012, signs of a possible recovery emerged, particularly in the core euro area countries. Financial market conditions and, in particular, sovereign bond risk premia have responded positively to the additional measures announced by central banks. Since May 2012, however, concerns about sovereign defaults in Europe have increased again, and sovereign bond risk premia for some peripheral euro area countries have returned to very high levels. Bond risk premia for Italy matched their peak of 2011, while those for Spain even exceeded their 2011 peak.

General increase in credit risk

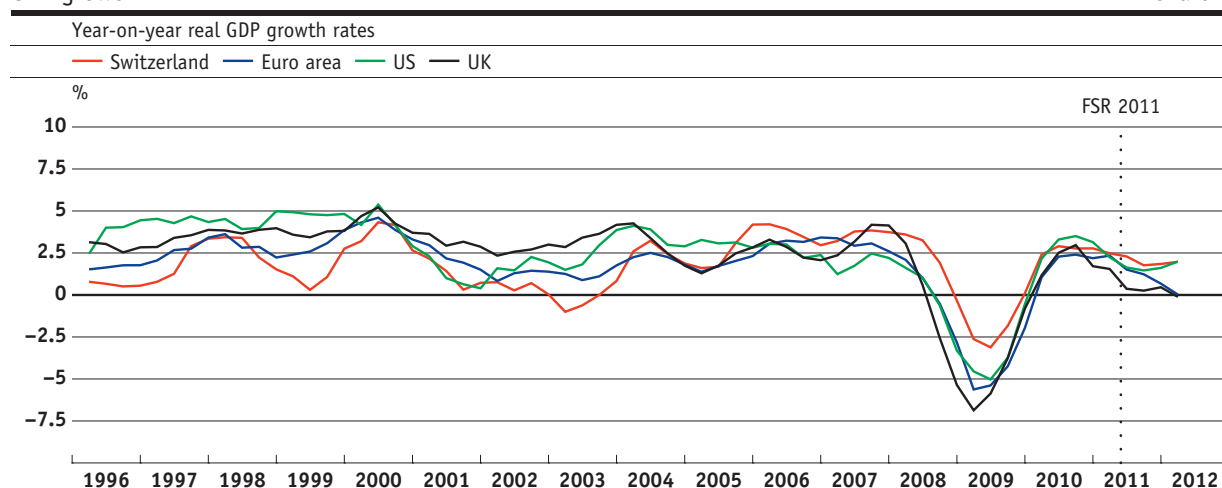
There has been a general increase in credit risk over the last 12 months. This has been observed across all sectors – sovereigns, banks, corporates, as well as households – and in most countries.

Sovereign credit quality has again deteriorated over the past 12 months. This mainly reflects the difficulties faced by some countries – notably those of the peripheral euro area – in managing the process of deleveraging while dealing with a contracting economy. Consequently, these countries' CDS premia have either increased to extremely high levels by historical standards, or have stayed at high levels (cf. chart 2). In many cases, this has been coupled with a downgrade of these countries' sovereign debt ratings. In contrast, CDS premia have remained fairly stable at low levels in the US, despite the first-ever downgrade of the federal government's rating by a major rating agency.

The general increase in sovereign credit risk has weighed heavily on the quality of *banks'* credit portfolios, particularly in the euro area periphery. Several European banks appear inadequately capitalised given their sovereign exposures, lower credit quality in their home markets and the adverse capital market conditions.⁸ Moreover, sovereigns' willingness and ability to support their banks has become more uncertain. These factors have led to increased counterparty risk for the Swiss banking system. This is reflected in higher credit risk premia and credit rating downgrades of their counterparties. In this context, the risk of a major bank failure remains substantial.

GDP growth

Chart 1



Source: SNB

⁸ The European Banking Authority has calculated a total capital shortfall of EUR 115 billion as at December 2011.

Corporate credit quality has declined in Europe and is low in a historical comparison, as reflected in the level and evolution of corporate bond spreads (cf. chart 3) and the rating downgrade-to-upgrade ratio (cf. chart 4). The deterioration has especially affected the peripheral euro area, where corporates face negative growth prospects and severe funding constraints.

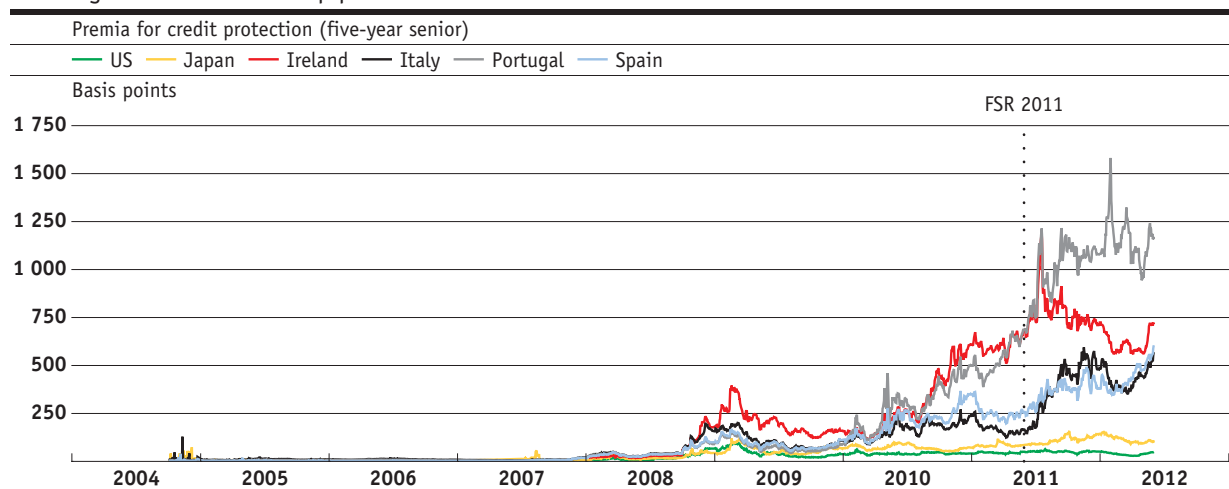
The picture is mixed for corporates in the US. On the one hand, corporate bond spreads (cf. chart 3) suggest that credit quality is historically low and has deteriorated further. On the other hand, the ratio of rating downgrades to upgrades in the US is low in a historical comparison, in spite of its recent increase. Delinquency rates on business loans have also decreased significantly over the

past 12 months (cf. chart 5) and are well below their peak of 2009.

In Switzerland, the corporate sector has so far been relatively resilient. The number of domestic corporate insolvencies has remained fairly stable over the past 12 months and, on average, credit ratings have remained unchanged. At the same time, domestic bond spreads have increased somewhat but remain low in an international comparison. However, ongoing pressure related to the strength of the Swiss franc is likely to negatively affect corporate credit quality. One indication of an impending decrease in credit quality might be the slight tightening of lending conditions for firms reported by some banks over the past few quarters in the SNB bank lending survey.

Sovereign credit default swap premia

Chart 2



Bond spreads

Chart 3

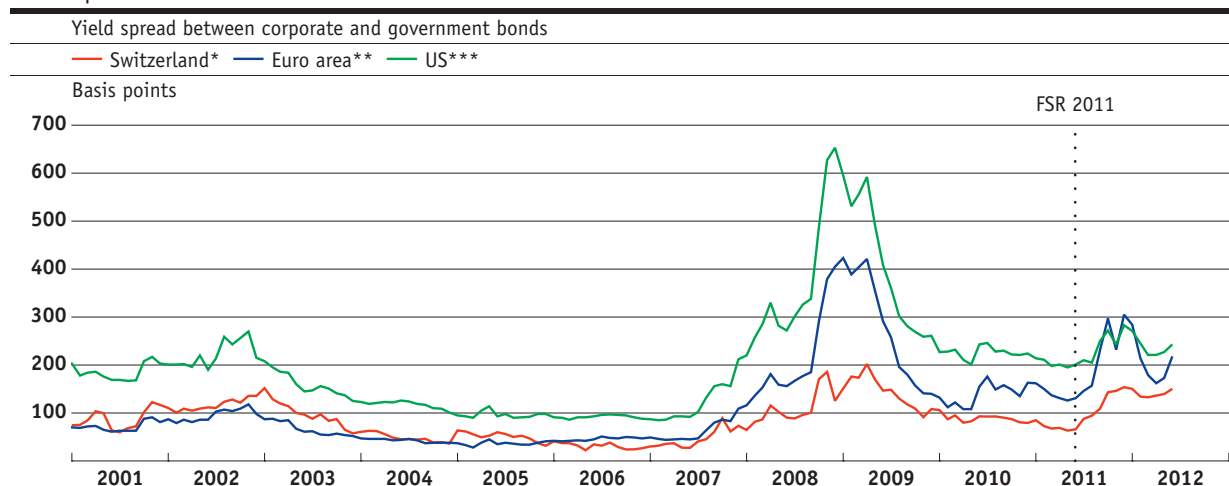


Chart 2: Source: Bloomberg

Chart 3: Sources: SNB, Thomson Datastream

* Yields (spot rates) for Swiss investment grade corporate bonds and for Swiss Confederation bonds, calculated by the SNB.

** Euro-Aggregate Corporate (investment grade, EUR-denominated) and Euro-Aggregate Government AAA indices, Barclays Capital.

*** US Corporate (investment grade, USD-denominated) and US Treasury indices, Barclays Capital.

Similarly to the corporate sector, the *household sector's* credit quality is vulnerable to a slower economic growth trajectory and to bank deleveraging, particularly in those countries directly affected by the sovereign debt crisis. Nevertheless, there have been signs of an improvement in the overall credit quality of households in Europe since June 2011. In the US, delinquency rates on real estate and consumer loans have fallen, but the former remain at exceptionally high levels (cf. chart 5).

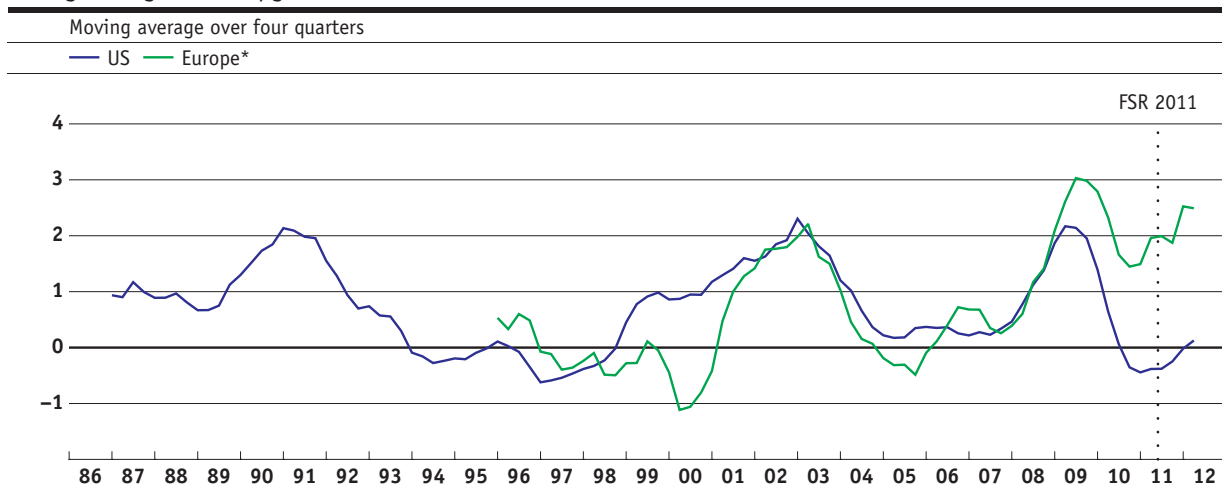
In Switzerland, the number of private insolvencies has risen over the last few months. Furthermore, the Swiss household sector's rising debt relative to GDP – reflecting the strong growth in mortgages over the past few years – makes it vulnerable to potential macro-economic shocks.

Imbalances in some real estate markets

Over the past few years, real estate markets in most countries have experienced substantial corrections. In the UK and the US, the correction has brought prices back broadly into line with fundamentals. In other countries – in particular France and Spain – imbalances seem to persist (cf. chart 6).⁹ Countries undergoing severe deleveraging are experiencing downward pressure on real estate prices, even if there are no signs of overvaluation.

Rating downgrade-to-upgrade ratio

Chart 4



US delinquency rates

Chart 5

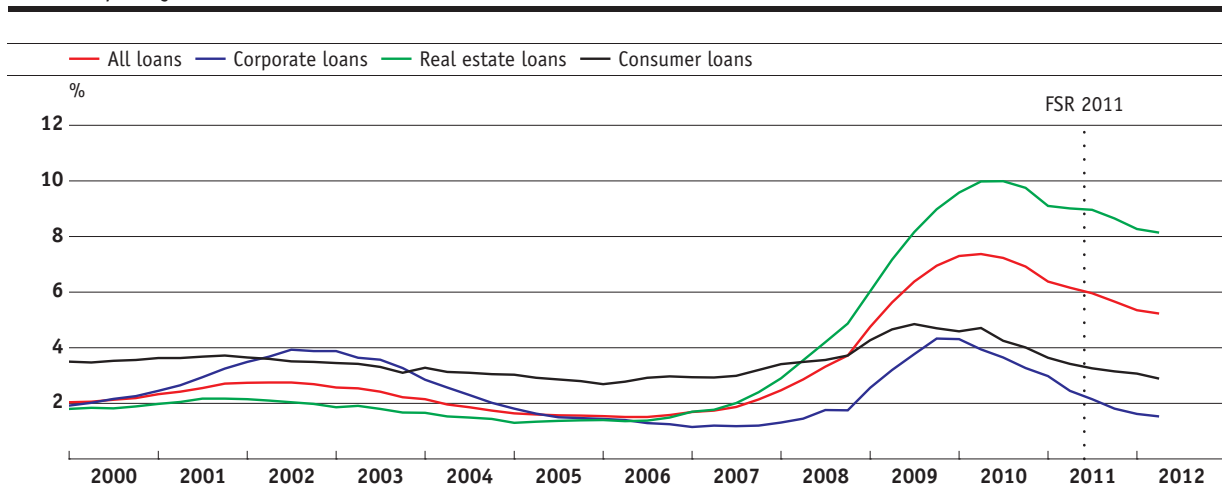


Chart 4: Source: Moody's

* EU-17 countries plus Switzerland, Norway and Iceland.

Chart 5: Source: Federal Reserve

⁹ The European Central Bank (ECB) also concludes that house prices in some countries of the euro area remain high relative to fundamentals.

In Switzerland, a strong positive dynamic has prevailed in the domestic residential real estate market over the past few years. In the context of historically low interest rates, apartment and single-family house price growth has been persistently stronger than what can be explained by fundamental factors, such as economic and population growth. As a consequence, imbalances in the apartment segment – already highlighted in the June 2011 *Financial Stability Report* – continued to develop (cf. chart 6). Similarly, in some regions such as Lake Geneva, Lake Zurich, Lake Zug and some tourist areas, signs of an overvaluation of residential properties in all segments have strengthened. This increases the risk of a significant price correction in the Swiss residential real estate market.

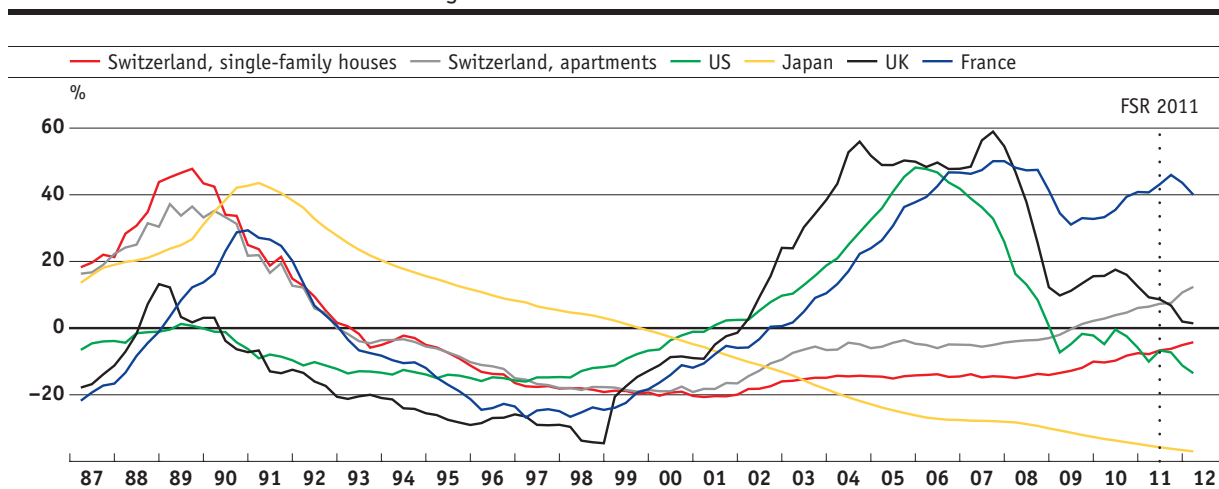
Increased global market risk

International stock markets have been highly volatile over the last 12 months (cf. chart 7). Following a substantial price correction in the second half of 2011, stock markets in the US, the UK and Switzerland have recovered, while those in the euro area remain significantly below mid-2011 levels. Overall, stock market prices currently seem to be in line with, or below, fundamental levels (cf. chart 8).

The increase in market uncertainty has shifted investor demand towards assets perceived as safe, such as government bonds and currencies of countries with the soundest fiscal situation. As a result, the prices of these assets may have risen to levels that are no longer in line with fundamentals. These

Price-to-rent ratio: deviation from average*

Chart 6



Stock market indices

Chart 7

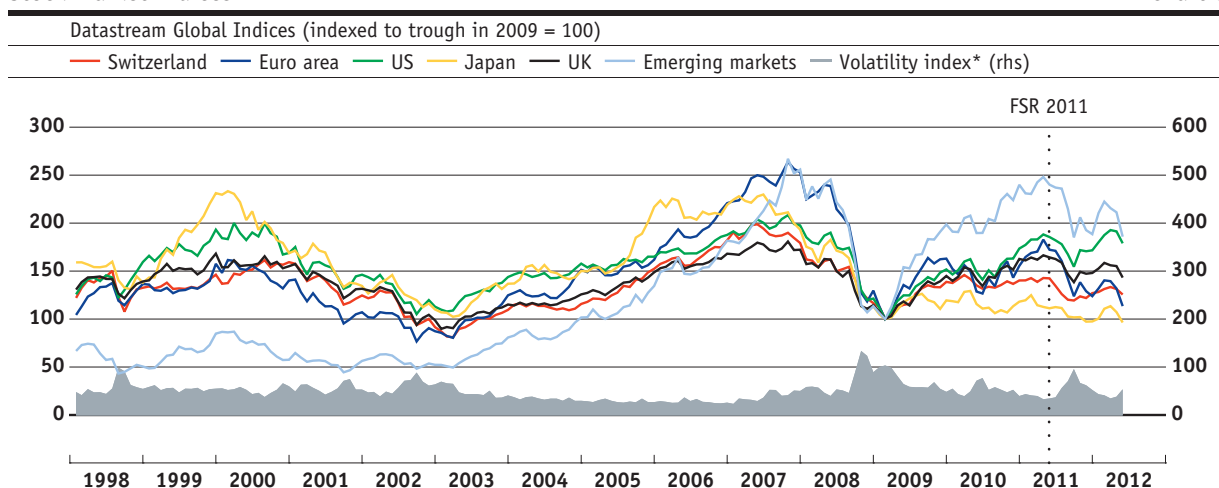


Chart 6: Sources: BIS, IMF, OECD, SNB, Thomson Datastream, Wüest & Partner

* The average is calculated over the depicted sample period.

Chart 7: Source: Thomson Datastream

* The index used is the Chicago Board Options Exchange Market Volatility Index (VIX), which measures the implied volatility of index options on the S&P 500.

prices may be subject to corrections as economic conditions improve and market confidence returns.

Increased funding difficulties

Amid uncertainty about the solvency of banks, global bank wholesale funding has come under severe strain. The problem became particularly acute towards the end of 2011, when the long-term unsecured funding markets virtually dried up and tensions in short-term funding were high (cf. chart 9).

In order to alleviate funding tensions, central banks intervened. The European Central Bank (ECB) offered two 3-year Long Term Refinancing Operations (LTROs) and relaxed its lending criteria. Several central banks – including the SNB – also lowered the price and extended the availability of US

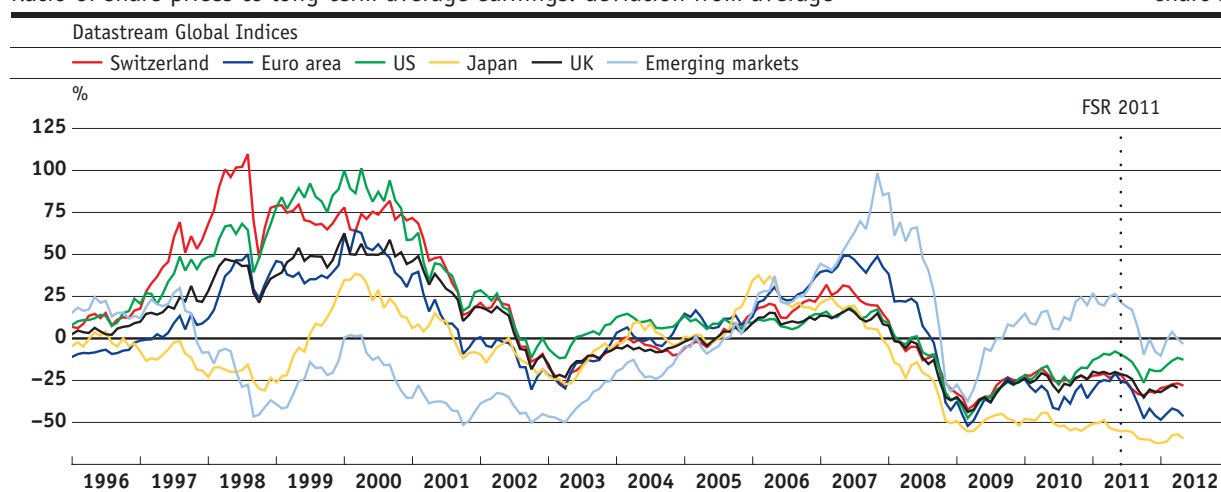
dollar funding to non-US banks. These policy measures have been effective. Historical experience shows, however, that as long as underlying vulnerabilities in the banking and sovereign sectors persist, there is a significant risk that funding tensions will re-emerge.

Interest rates at historically low levels

In most countries, both short and long-term interest rates have been at very low levels by historical standards for several years now (cf. chart 10). Over the past 12 months, expansionary monetary policy, coupled with persistently low expectations regarding economic growth and inflation, has even resulted in a further decline in interest rates in many countries. Notable exceptions are countries

Ratio of share prices to long-term average earnings: deviation from average*

Chart 8



Libor-OIS spreads

Chart 9

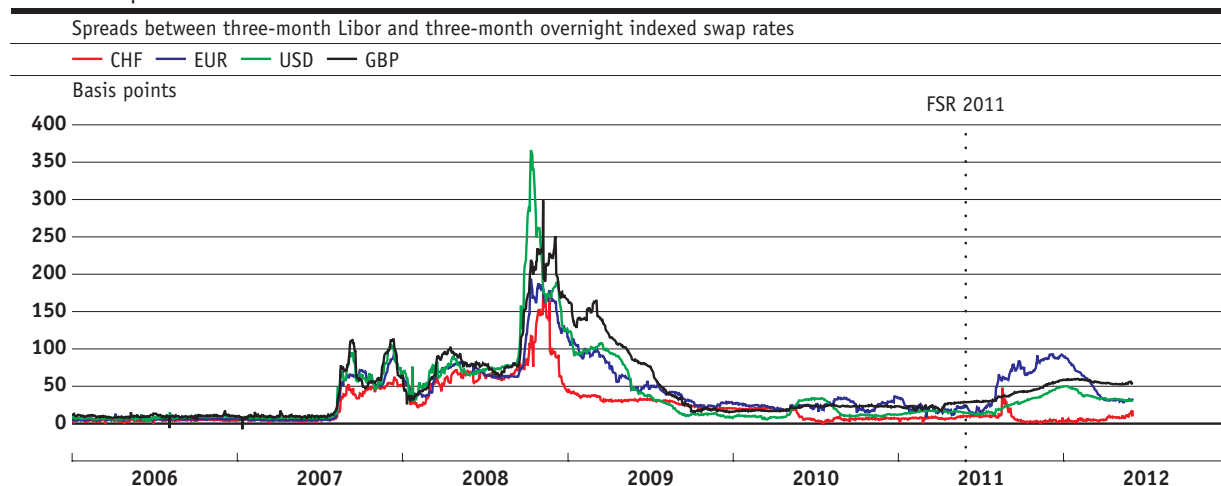


Chart 8: Source: Thomson Datastream

* The average is calculated over the depicted sample period.

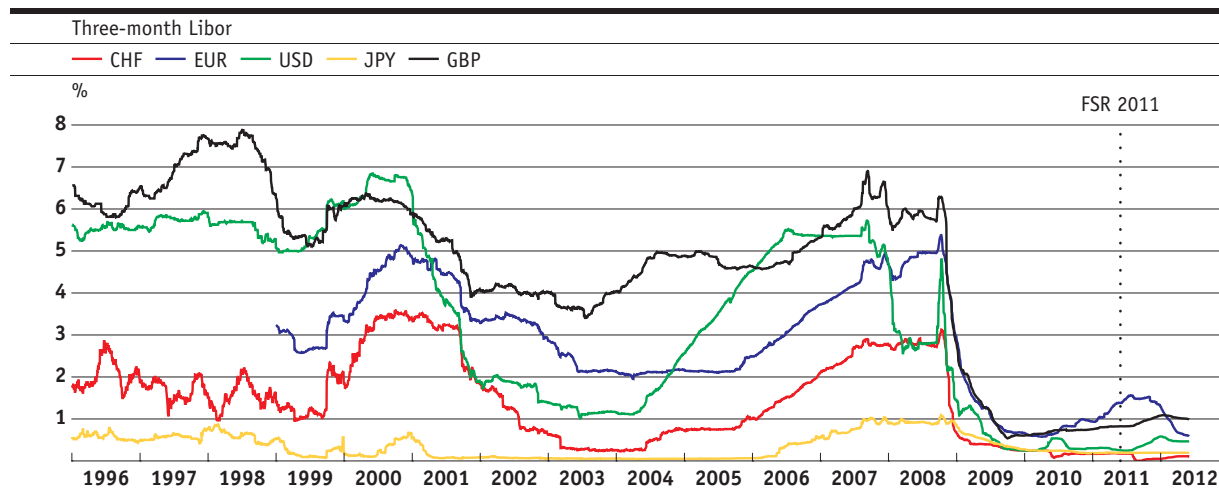
Chart 9: Sources: Bloomberg, Reuters

with sovereign debt problems, where strong increases in risk premia more than offset the overall decrease in risk-free rates, and caused a general rise in interest rates.

In the medium term, the level of interest rates should normalise as monetary policies become less expansionary and economic conditions improve. Historical experience shows that the normalisation of interest rates can occur very quickly. Furthermore, both short and long-term interest rates may significantly overshoot long-term averages during the normalisation process.

Short-term interest rates

Chart 10



Source: SNB

3 Scenarios, exposures and impact on banks

Banking intermediation involves risk-taking. Risks can materialise, in particular, when economic and financial conditions deteriorate. The resulting loss potential depends on the economic scenario and on banks' exposures.

In the light of the risk factors mentioned above, we present two scenarios for the evolution of economic and financial conditions, and discuss their impact on the Swiss banking sector in terms of loss potential. The baseline scenario represents the most likely outcome given the current environment, while the adverse scenario describes a very severe but possible development.

From a financial stability perspective, it is essential that banks hold enough capital to absorb the potential losses implied by their activities, even under a very adverse scenario. The corresponding assessment of banks' resilience is presented in chapter 4.

Baseline scenario

Under the baseline scenario, economic conditions improve gradually over the next 12 months as international growth gathers pace and the recovery of the Swiss economy continues. In the medium term, imbalances in the Swiss real estate market continue to build up.

In Europe, policy measures and central bank support succeed in avoiding a further escalation of the debt crisis. The debt of the most vulnerable countries is restructured in an orderly manner and EU banks manage to restore an adequate capital base. In the core euro area countries and the UK, consumption and investment growth remains weak but positive. Unemployment increases slightly and the credit quality of households and corporates stabilises. Peripheral euro area countries suffer a recession as their economies deleverage and austerity measures weigh on short-term growth. In those economies real estate prices decline, credit quality deteriorates and unemployment rises further. Inflation in the euro area slows down.

In the US, the modest recovery continues and growth gradually gains momentum. Inflation levels remain moderate. While share prices continue to rise, real estate prices remain stable. Household and corporate credit quality strengthens and banking sector soundness improves gradually. In emerging markets, growth picks up speed again and share prices recover.

In Switzerland, exports and investment growth gather pace only gradually. Unemployment inches up over the next few quarters. In this context, the rate of household and corporate defaults increases somewhat.

In the medium term, the continued real estate price growth in Switzerland leads to a general overvaluation of residential property in all segments. This development is fuelled by the persistence of historically low interest rates and by strong competition in the banking sector. As a consequence, the risk of large price corrections increases. Such corrections can, for instance, be triggered by a normalisation of the interest rate level.

Loss potential for Swiss banking sector not significant under baseline scenario; yet risks building up in the medium term

Under the baseline scenario, the SNB does not consider the loss potential for Swiss banks to be significant in the next 12 months. The Swiss banking sector is only moderately exposed to the peripheral euro area countries. Consequently, no major write-downs or losses are expected on either credit or trading positions.

Risks in the Swiss real estate and mortgage markets build up further in the medium term, however. Already now, there are clear signs of such a build-up of risk among domestically focused commercial banks in particular.

– *Continued strong growth in mortgage lending:* As in the previous year, mortgage volume growth at these banks was once again considerably stronger than GDP growth. This is also reflected at the system level, with a further substantial rise in the credit-to-GDP ratio. On average, mortgage volumes at domestically focused banks grew by roughly 6.5% in 2011 (cf. chart 11). The variation in growth rates between the individual institutions is considerable, however. In 2011, domestically focused banks – excluding the 10th and 90th deciles – registered mortgage growth ranging between –0.2% and 9.2%. Chart 11 also shows that, since the weighted average is above the median, larger domestically focused banks generally exhibit higher growth rates than smaller institutions. In addition, high growth rates were recorded, in particular, by banks whose mortgage portfolios were focused on regions already showing signs of overvaluation.

– *High risk appetite in lending:* According to the SNB’s mortgage lending survey, more than one-fifth of new mortgages for owner-occupied residential property have a loan-to-value ratio of over 80%. In the case of mortgages for residential investment property, it amounts to roughly one-fifth. The survey also reveals signs of stretched affordability for a significant proportion of new mortgages. In the case of 40% of new mortgages granted for the financing of owner-occupied residential property, the imputed costs would exceed one-third of gross income at a mortgage interest rate of 5%.¹⁰ For 15% of new mortgages, this threshold would be breached at an interest rate of just 3%.¹¹ The situation with regard to mortgages for residential investment property is similar. In the case of roughly one-third of new mortgages,

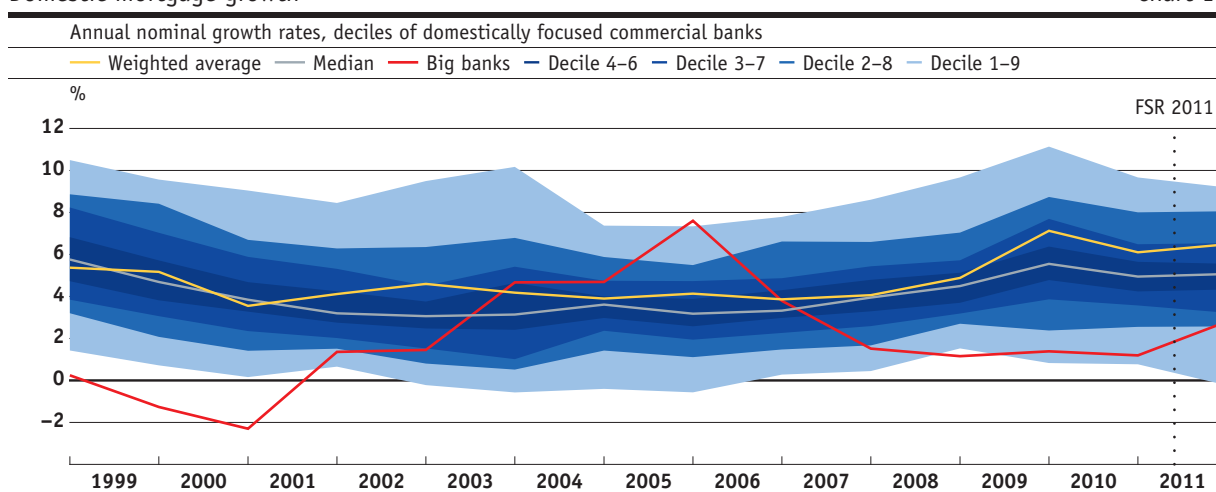
the net rental income does not cover the imputed costs of the mortgage at an interest rate of 5%.

– *Narrowing interest rate margins:* Interest rate margins have narrowed by around 35 basis points since 2007.¹² At the same time, interest rate risk has risen sharply. Combined, these developments point to increased competition among banks. While competition is an important prerequisite for a market economy to function efficiently, pressure on interest rate margins can restrict the ability of banks to cover expected future credit losses out of current earnings.

– *Interest rate risk stable at historically high levels:* If the general level of interest rates were to rise by 200 basis points, the net present value of domestically focused commercial banks would decline on average by 14.2% of their eligible cap-

Domestic mortgage growth

Chart 11



Interest rate risk of domestically focused commercial banks

Chart 12

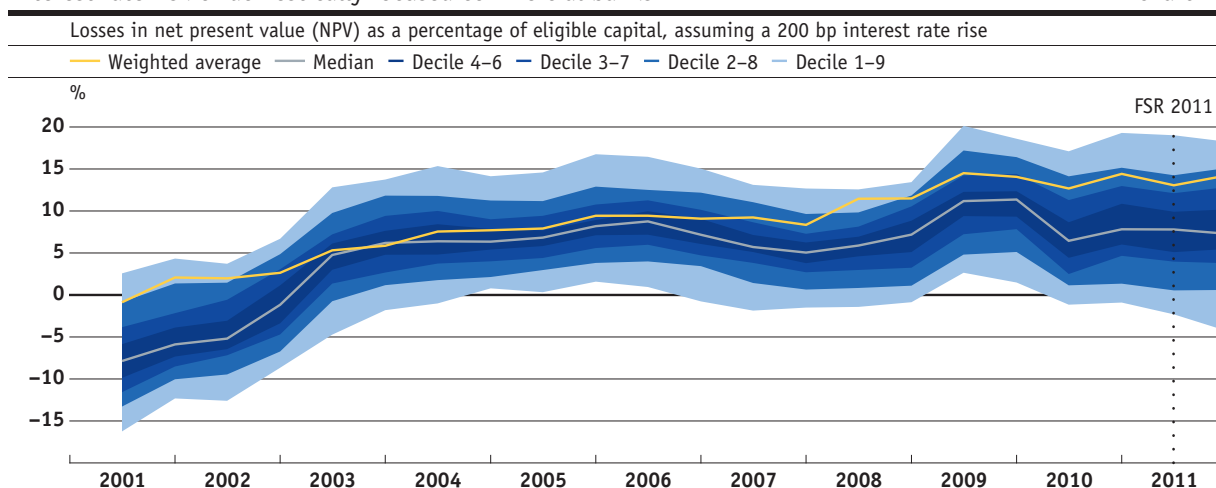


Chart 11: Source: SNB

Chart 12: Sources: FINMA, SNB

10 The imputed costs used for this estimate comprise the imputed interest rate (5% or 3%) plus maintenance and amortisation costs (1% each). The average mortgage rate over the last 50 years is just under 5%.

11 When interpreting these figures, it should be noted that they are based only on the borrower’s gross income from employment. Other elements affecting affordability positively (such as bonuses and wealth) or negatively (such as leasing or interest payments on other bank loans) are disregarded.

12 Interest rate margins are approximated as net interest income divided by total credits.

ital (cf. chart 12). The variation in interest rate risk among these banks is considerable. Excluding the 10th and 90th deciles, the impact ranges from an increase of 4.3% in the net present value of their eligible capital¹³ to a decline of 18.2%. Larger domestically focused banks generally exhibit higher interest rate risk than smaller banks.

As the build-up of imbalances in the real estate and mortgage markets increases, so too does the risk of a substantial price correction, triggered for instance by a normalisation of interest rates. The greater the divergence of prices from their fundamental levels and the higher the possible rise in interest rates, the greater the potential magnitude of the price correction and the larger the increase in borrower defaults. As a consequence of lower collateralisation and higher delinquency rates, losses on mortgage loans would rise substantially at both domestically focused banks and big banks. The impact on the former would be particularly pronounced, for two reasons:

- *Low diversification*: The ratio of mortgage loans to total credit has been increasing steadily. While in 1990 mortgage loans accounted, on average, for less than 80% of total credit, today they make up close to 90%. With mortgage loans accounting for an average of roughly 70% of the balance sheet, the mortgage market constitutes a significant risk concentration for domestically focused banks.
- *Significant shift in banks' risk profile*: The risk appetite of several domestically focused banks – in particular some larger ones – increased significantly between 2007 and 2011. This assessment is based on the banks' risk scores, which sum-

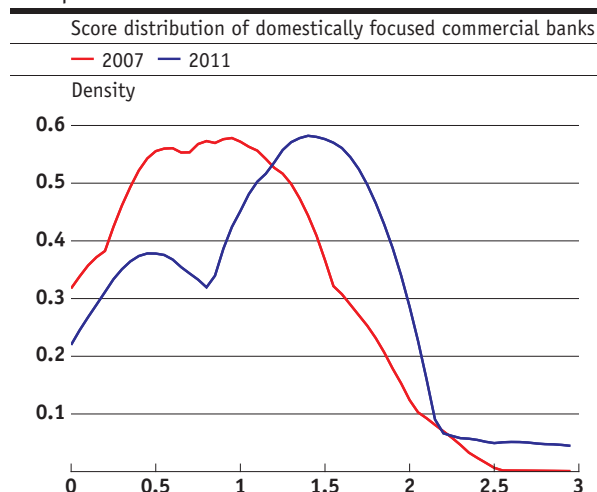
marise indicators covering different aspects of the banks' risk-taking, such as credit growth, mortgage exposure in regions showing signs of overvaluation of residential properties, and sensitivity to interest rate shocks. Chart 13 shows the distribution of these risk scores for 2007 and 2011, whereby banks are weighted according to their market share in the Swiss mortgage market. As can be seen from the rightward shift of the curve, the overall risk appetite among domestically focused banks has increased significantly over the last few years.

Adverse scenario

Under the adverse scenario, economic and financial conditions for the Swiss banking sector deteriorate sharply over the next 12 months. Policy measures cannot prevent a further escalation of the European debt crisis. The euro area falls into a deep recession, which spreads to other European countries, including Switzerland, and also to the US. Growth in emerging markets declines sharply. The adverse scenario could be triggered by a disorderly default of several smaller peripheral euro area countries, leading to a significant loss of confidence.

In the euro area, peripheral countries are particularly affected and suffer an even more severe recession as fiscal tightening results in a negative spiral of slower growth and missed deficit targets. For the core euro area countries, attempts to stabilise the situation come at a high cost in terms of fiscal transfers. This leads to an increase in sovereign and corporate risk premia in these countries. Under these adverse conditions, concerns about the soundness of the European banking system

Risk profile* Chart 13



Sources: FINMA, SNB

13 Eligible capital under Basel II.

* Distribution of scores for individual risk profiles of domestically focused commercial banks, weighted according to their market share in the Swiss mortgage market; the higher the score, the more pronounced the risk profile. The score for each bank summarises indicators covering different aspects of the banks' risk-taking. The overall risk appetite of domestically focused commercial banks increased significantly between 2007 and 2011, as reflected in the shift of the curve to the right.

are heightened. Banks deleverage abruptly by cutting credit to households and firms. This has a further negative impact on growth and leads to a higher rate of household and corporate defaults. Share and real estate prices collapse, especially in overvalued market segments.

The crisis spreads to the US and emerging markets through banking and trade linkages. In the US, real estate and share prices fall, stress in the banking system grows, and banks tighten lending standards. Household and corporate credit quality deteriorates significantly. Emerging markets experience rapid capital outflows, causing stock prices to fall and corporate bond spreads to widen.

As foreign demand collapses, the Swiss economy also falls into a deep recession. Investment and consumption slump and unemployment rises markedly. Moreover, real estate and share prices fall. The correction in real estate prices is more substantial in regions showing signs of property overvaluation. The rate of household and corporate defaults increases strongly. Interest rates remain at historically low levels.

High loss potential for Swiss banks under adverse scenario

Both the big banks and domestically focused commercial banks would suffer significant losses under the adverse scenario. From a financial stability perspective, such losses can be problematic if they are high relative to the banks' resilience (cf. chapter 4). This section discusses the asset classes that would be particularly affected under the adverse scenario, and on which losses could consequently occur.

Big banks

For both big banks, potential losses under the adverse scenario would be substantial, owing to their large credit and trading positions. As an indication of total loss potential, Credit Suisse reports position risk at end-March 2012 of CHF 19.5 billion as part of its economic capital calculations.¹⁴ The SNB considers that the main risks lie in an escalation of the euro area crisis, a deterioration in credit quality related to mortgage and corporate loans in Switzerland and the US, and a slump in the global stock market:

– *Moderate direct, but high indirect impact of an escalation of the euro area crisis:* The escalation of the euro area crisis described under the adverse scenario would cause only moderate

direct losses for the big banks, as their exposures to smaller, peripheral euro area countries affected by restructuring are limited.¹⁵ Indirect losses, however, would be substantial as, under the adverse scenario, the escalation of the euro area crisis would trigger a banking crisis, and the Swiss big banks are strongly interconnected with the European banking sector.

– *Substantial losses on mortgage-based products:*

The big banks would suffer major losses on real-estate-related exposures, especially in Switzerland and the US. In Switzerland, the big banks would have to take substantial write-downs as a result of an increase in loan defaults combined with falling collateralisation levels. Their exposure to the domestic mortgage market is significant. At the end of 2011, their combined domestic mortgage claims outstanding amounted to CHF 241 billion.¹⁶ Just under half of these mortgages were for properties in cantons that are already showing signs of overvaluation in real estate markets. In the US, under the adverse scenario, the big banks would have to accept losses on their asset-backed securities (ABS), as these instruments would lose value following a renewed fall in real estate prices. Although the big banks' holdings of ABS have declined since the onset of the financial crisis in mid-2007 (at end-2011 they amounted to CHF 40 billion for Credit Suisse and CHF 17 billion for UBS),¹⁷ risk exposure is still considerable. For example, Credit Suisse reports position risk on such instruments at around 20% of its entire position risk.¹⁸

– *Increasing write-downs and losses on corporate loans in Switzerland and the US:*

The global recession described under the adverse scenario would cause default rates to rise, and would lead to write-downs and losses on Swiss and US corporate loans, in particular. At the end of 2011, Credit Suisse had outstanding corporate loans totalling CHF 85 billion, while UBS had CHF 54 billion.¹⁹ Losses in this loan category would be comparatively high, because the quality of corporate loans would be severely affected under the adverse scenario, as a result of a deep recession.

– *Losses on equities:*

The sharp fall in global share prices would lead to major losses at both big banks. Credit Suisse, for instance, reports position risk on equities that is around 20% of its total position risk, with the bulk of the risk originating from illiquid investments.²⁰ Despite a considerable reduction compared to 2010, holdings

14 Source: Quarterly report for Q1 2012. Credit Suisse bases its calculation of position risk on its Economic Capital Model. The position risk used here corresponds to the level of unexpected economic losses over a one-year horizon which is only exceeded with a probability of 0.03% (confidence interval of 99.97%). UBS continues to publish only economic loss potential estimates relating to market risk in the trading book in the form of Value-at-Risk measures.

15 Source: Quarterly reports for Q1 2012. Gross claims against Ireland amounted to CHF 2.9 billion (Credit Suisse) and CHF 1.3 billion (UBS), against Greece to CHF 1 billion and CHF 0.1 billion,

against Portugal to CHF 0.6 billion and CHF 0.3 billion, and against Spain to CHF 4.3 billion and CHF 4.7 billion respectively. Gross claims cover all economic sectors and industries.

16 Source: SNB, *Banks in Switzerland*.

17 Source: Annual reports.

18 Source: Quarterly reports for Q1 2012. Credit Suisse only publishes a breakdown of position risk based on a confidence interval of 99%.

19 Source: Annual reports.

20 Source: Quarterly report for Q1 2012. Credit Suisse only publishes a breakdown of position risk based on a confidence interval of 99%.

of equities at both Credit Suisse (CHF 87 billion) and UBS (CHF 45 billion) were still significant at the end of the first quarter of 2012.²¹

Domestically focused commercial banks

Under the adverse scenario, losses by domestically focused commercial banks would stem almost exclusively from the lending business. Write-downs on both mortgage loans and corporate loans would be substantial.

- *Significant losses on mortgage lending:* Under the adverse scenario, with the drastic economic downturn and the moderate correction of real estate prices, both default rates and loss given default would rise. The main driver of write-downs, which would persist over several years, would be the significant rise in unemployment and the consequent increase in household defaults. Banks whose mortgage portfolios focus heavily on regions showing signs of real estate overvaluation would be especially hard hit. Mortgage loans constitute the most important item on domestically focused banks' balance sheets. Aggregated over all domestically focused banks, they amount to around CHF 540 billion, which is equivalent to approximately 70% of these banks' balance sheet totals.
- *Write-downs on corporate lending rises sharply:* Due to the long and deep recession assumed under the adverse scenario, a sharp increase in write-downs on corporate loans would be expected. Both export-based companies and firms whose main client base is in the domestic market would suffer as a result of the economic downturn. Write-down rates would be high and banks would scale back their lending activity. At the end of 2011, loans to corporations amounted to CHF 78 billion, with 94% of these loans being granted to firms based in Switzerland. Of these corporate loans, 70% were secured and 30% unsecured.
- *Limited loss potential on trading positions:* Due to low exposures, the loss potential on trading positions would be limited for most banks. Trading portfolios aggregated over all domestically focused banks amounted to around CHF 17 billion, which is equivalent to approximately 2% of these banks' balance sheet totals. Average risk-weighted assets for market risk were 2.5% at the end of 2011. Although they have risen compared with the previous year (2.1%), their relative importance remains low.

²¹ Source: Quarterly reports for Q1 2012.

4 Resilience of banks

Overall, Swiss banks have levels of capitalisation that are well above the current regulatory minimum. However, in view of their risk exposure, and focusing on their loss-absorbing capital as measured according to the new regulations,²² the SNB considers that there is a need to further increase the resilience of both the big banks and some domestically focused commercial banks. In addition, given the growing cyclical risks in the Swiss real estate and mortgage markets, a temporary adjustment of system-wide capital requirements may have to be considered.

Resilience of the big banks

Credit Suisse and UBS fulfil all current regulatory capital requirements. However, measured according to the new regulations, i.e. Basel III and Swiss 'too big to fail' regulations, their loss-absorbing capital²³ is still below the level needed to ensure sufficient resilience, given the risks in the environment. Since June 2011, both big banks have made further progress in improving their relevant capital ratios by reducing their risk-weighted assets and increasing their loss-absorbing capital. Nevertheless, the big banks' importance for the Swiss economy and for financial stability requires that they strengthen their resilience beyond these latest efforts. It is also in the banks' own interest to strengthen their resilience, as a sound capital base constitutes a competitive advantage in the core business of wealth management. Moreover, the banks would also be better cushioned against potential losses under the adverse scenario (cf. chapter 3), and would reduce the risk of having to recapitalise under adverse conditions in such a stress situation.

The SNB recommends that UBS continue with the capital strengthening process – including, in particular, a policy of dividend restraint – and that Credit Suisse accelerate its process and expand its loss-absorbing capital base significantly during the current year. In addition, both big banks should increase their transparency with regard to resilience. Greater transparency fosters market confidence and, in a crisis, prevents erroneous and unfavourable market assessments.

Focus on loss-absorbing capital

When assessing the big banks' resilience, the SNB focuses on loss-absorbing capital and risk-weighted assets as measured according to the new regulations. The recent crisis has shown that capital ratios defined under the current regulations overestimate banks' resilience. First, not all eligible capital is loss-absorbing;²⁴ second, risk is not fully captured in the calculation of risk-weighted assets. The new regulations eliminate the main shortcomings in both of these areas.

Although full compliance with the new regulations is not required until the beginning of 2019, from an economic standpoint they are already the relevant benchmark. The market and the authorities are also turning increasingly to estimates of effective loss-absorbing capital in order to assess a bank's solvency. This is because, in the most recent financial crisis, even banks with high capital ratios by current regulatory standards got into difficulty and had to resort to state support.

The difference between capital ratios under the current and the new regulations is particularly pronounced for the Swiss big banks.²⁵ For example, at the end of March 2012, Tier 1 capital ratios under Basel 2.5 were 15.6% for Credit Suisse and 18.7% for UBS, whereas the ratios calculated using loss-absorbing capital and risk-weighted assets under the new regulations came to about 5.9% (Credit Suisse²⁶) and 7.5% (UBS²⁷).

Resilience assessment

To assess the big banks' resilience, the SNB performs comparative assessments using banks' loss potential (cf. chapter 3), their historical loss experience and their resilience relative to other international banks. In addition, the challenges faced by the banks in implementing the regulatory requirements by the beginning of 2019 are assessed.

The three comparative assessments yield the following results:

- First, the risks in the environment – as described under the very severe but possible adverse scenario – and the big banks' exposure to these risks are high, which can result in substantial losses relative to available capital. Credit Suisse publishes potential loss data in the form of a position risk figure.²⁸ This amounts to CHF 19.5 billion (at end-March 2012), which exceeds its loss-absorbing capital of around CHF 17.3 billion. UBS does not publish a comparable risk measure.

22 Basel III and Swiss 'too big to fail' regulations.

23 The SNB defines loss-absorbing capital as comprising Common Equity Tier 1 capital (CET1 capital) using the capital definitions of the Basel III framework once fully implemented, plus high-trigger contingent capital instruments as set out in the Swiss 'too big to fail' legislation. Under the Swiss regulations, the banks must hold additional, low-trigger contingent capital instruments. These are mainly intended for the Swiss emergency plan and the restructuring or wind-down of the remaining bank units, and are therefore not considered in this 'going concern' perspective.

24 Cf. SNB, *Financial Stability Report*, 2011, in particular box 3, 'Regulatory and loss-absorbing capital'.

25 Cf. Basel Committee on Banking Supervision, 'Results of the Basel III monitoring exercise as of 30 June 2011', April 2012.

26 Source: SNB calculations based on Credit Suisse's quarterly report for Q1 2012.

27 UBS presentation on the results for Q1 2012.

28 To a large extent, position risk shapes Credit Suisse's perception of its level of required economic capital. "Economic capital is the estimated capital needed to remain solvent and in business, even under extreme market, business and operational conditions, given our target financial strength (our long-term credit rating)." Credit Suisse, *Annual Report*, 2011, p. 95.

- Second, UBS's losses during the most recent financial crisis amounted to more than 3% of its net balance sheet total. By comparison, the share of loss-absorbing capital in the net balance sheet total at end-March 2012 was around 1.7% at Credit Suisse and 2.7% at UBS.²⁹ This corresponds to a leverage – the ratio of debt to capital – of about 60 and 40 respectively.
- Third, when measured according to the new Basel III regulations, the capitalisation of the Swiss big banks – in particular Credit Suisse – is below average for international big banks. An above-average capitalisation level would be appropriate, given the importance of the big banks for the Swiss economy and for financial stability.

Under the Swiss 'too big to fail' regulations, the big banks will have to increase their ratio of loss-absorbing capital to risk-weighted assets to at least 13% by the beginning of 2019.³⁰ Credit Suisse and UBS have both announced³¹ that they plan to meet these requirements in the medium term through a reduction in risk-weighted assets combined with an organic increase in capital.

This will present a number of challenges. The environment must allow sufficient profits to be generated for an organic increase in capital. At the same time, the reduction of risk-weighted assets could weigh on current earnings and future potential profits. In addition, in the future the big banks will have to comply with enhanced leverage requirements. That goal cannot be achieved solely by cutting risk-weighted assets; it will also require a reduction of the balance sheet.

To improve resilience, a reduction in risk-weighted assets should be accompanied by a reduc-

tion in effective economic risk. To demonstrate this, banks should report their risk exposures in a more transparent way – for example, by calculating and disclosing their risk-weighted assets not only according to internal models, but also according to the Basel standardised approach. Greater transparency fosters market confidence, and will help to dispel potential doubts as to the appropriateness of the level of risk-weighted assets relative to the balance sheet total.³²

Market assessment: positive but fragile

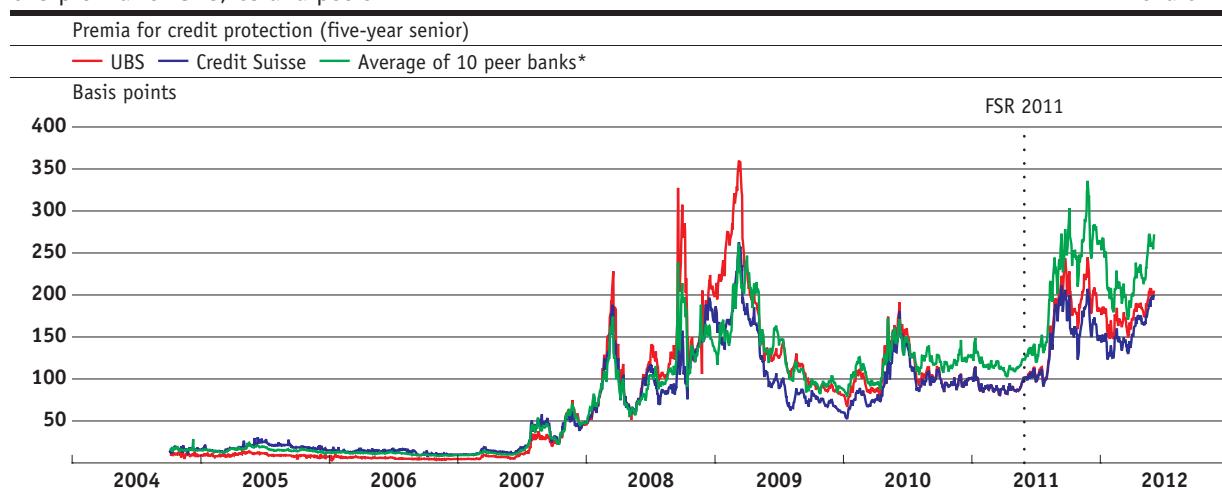
Currently, the market considers the creditworthiness of both big banks to be above average compared to other international banks. By rapidly strengthening their resilience, the big banks can underpin this and prevent a future deterioration in that assessment.

Both Swiss big banks have good long-term credit ratings, despite both having experienced a downgrade compared to the previous year as part of a generally more cautious assessment of the banking sector. Their risk premia, measured in terms of their CDS premia and bond spreads, are some of the lowest among their international peers, although they are markedly higher than in 2007, before the onset of the financial crisis (cf. chart 14). One reason for this might be that, both in absolute terms and compared to other international commercial banks, Credit Suisse and UBS hold only moderate claims against peripheral euro area countries.

However, without a strengthening of their capital base, this positive assessment remains fragile. It is partly based on expectations of state support in the event of a crisis. In addition, the

CDS premia for UBS, CS and peers

Chart 14



Source: Bloomberg

* CDS premia for the peer group represent the unweighted average of the following banks: Citigroup, JP Morgan Chase, Bank of America, Goldman Sachs, BNP Paribas, Société Générale, Royal Bank of Scotland, HSBC, Deutsche Bank, Barclays.

29 Cf. footnote 4.

30 In addition, they will each have to hold some 6% of low-trigger contingent capital instruments. This progressive component of the Swiss 'too big to fail' regulations depends on a bank's size, its

domestic market share and its overall resolvability. Credit Suisse does not yet have any such instruments outstanding; UBS issued USD 2 billion in the first quarter of 2012.

31 Credit Suisse announced plans for reducing its risk-weighted assets at the presentation of its quarterly results in October 2011; UBS announced its own plans during its Investor Day in November 2011.

32 Cf., for example: 'Revisiting Risk-Weighted Assets', IMF Working Paper 12/90, March 2012; Standard & Poor's, Global Credit Portal, Credit Suisse AG, 4 July 2011; and Moody's, Credit Opinion: UBS AG, 28 February 2012.

assessment of the big banks' holdings of loss-absorbing capital and their earnings outlook is becoming increasingly cautious.

Both CDS premia and long-term credit ratings are highly dependent on the market continuing to factor in state support of the Swiss big banks in the event of a crisis. The 'too big to fail' legislation entered into force on 1 March 2012, and it will take time to implement the measures it envisages with regard to resolvability. On that basis, the rating agencies are explicitly giving the Swiss big banks a higher long-term credit rating than would be justified by their resilience. There is currently a rating 'premium' of up to three notches, depending on the agency. If expectations of state support are lowered, the market's assessment may deteriorate accordingly.³³

This is compounded by the danger that the rating agencies will also downgrade the big banks' financial strength ratings. First, the dampening of earnings expectations for the global banking sector has resulted in a less favourable assessment of international big banks' resilience. Second, analysts – as well as, for instance, the IMF³⁴ – are increasingly pointing out that the Swiss big banks' loss-absorbing capital is low in an international comparison. Accordingly, Moody's is contemplating a larger-than-average downgrade of Credit Suisse and UBS.³⁵

The SNB's recommendations

Based on the assessment of resilience described above, and with the aim of increasing financial stability, the SNB has two recommendations for the big banks.

First, the SNB recommends that the big banks further expand their loss-absorbing capital base so that, also according to the definitions in the new regulations, they rank among the best capitalised banks in the world. Strengthening resilience is necessary from a financial stability perspective, and it improves competitiveness in the core business of wealth management. Moreover, the banks would also reduce their risk of having to recapitalise under adverse conditions in a stress situation. For Credit Suisse, given the low starting point and the risks in the environment, it is essential that it already substantially expand its loss-absorbing capital base during the current year. Apart from the planned reduction of risk, these improvements can also be achieved in other ways, such as by suspending dividend payments, or even by raising capital on the market through share issuance.

Second, the SNB recommends that the big banks increase their transparency with regard to resilience. Greater transparency would foster market confidence and, in a crisis, prevent erroneous and unfavourable market assessments being made due to a lack of clarity, which would further exacerbate the stress situation. On the one hand, the big banks should make regular disclosures regarding the new regulatory indicators, in particular loss-absorbing capital and risk-weighted assets under Basel III once fully implemented – as, indeed, UBS has done in the two most recent presentations of its quarterly results.³⁶ On the other hand, the ongoing reduction of risk should be reported transparently. From 1 January 2013, the revised capital ordinance gives FINMA the authority to require a parallel calculation of risk-weighted assets under the Basel standardised approach. The banks should already be doing this voluntarily, to help the market better assess the reduction of risk.³⁷

Resilience of domestically focused commercial banks

Measured against the regulatory requirements, the average capitalisation of domestically focused commercial banks is at a historically high level. However, the resilience of some of these banks – including some larger ones – should be strengthened, in view of their risk exposures. In addition, given the growing cyclical risks in the Swiss real estate and mortgage markets, a temporary adjustment of system-wide capital requirements may have to be considered. To limit these medium-term risks to financial stability, self-regulation measures and microprudential supervision can be combined with macroprudential policies. In this context, the SNB welcomes the fact that, from 1 July 2012, a macroprudential instrument will be available to the Swiss authorities in the form of a countercyclical capital buffer.

33 Already at the end of 2010, Fitch had indicated that rating upgrades based on expectations of state support would come under pressure as resolution regimes were developed for global banks (FitchRatings, 'Resolution Regimes and the Future of Bank Support', 14 December 2010).

34 "(...) we encourage the authorities to: Press large banks to move faster to strengthen the quality of their capital, which remains low in comparison to peers and in light of risks. (...) In light of these risks, the authorities should press systemically important banks to raise the quality of their capital more rapidly." IMF, 2012 Article IV Consultation – Concluding Statement, Berne, 20 March 2012.

35 Moody's, presentation on 2012 Bank Ratings Review, March 2012.

36 The Bank of England's Financial Policy Committee also issued a recommendation that banks should already, as a minimum, report their leverage ratio, as defined under full implementation of the capital definitions in Basel III. 'Record of the interim financial policy committee meeting', March 2012.

37 The Basel Committee on Banking Supervision is proposing that all banks be subject to regular mandatory calculation of capital requirements using the standardised approach for all trading activities. Cf. 'Fundamental review of the trading book', Basel Committee on Banking Supervision, May 2012.

Stable capital situation at domestically focused commercial banks

Average regulatory capital ratios of domestically focused commercial banks are at a historically high level. In contrast to the big banks, a large proportion of their reported capital is also loss-absorbing.

In 2011, the average capitalisation of domestically focused banks hardly changed (cf. charts 15 and 16). At year-end, the ratio of Tier 1 capital to balance sheet total was 6.9% (2010: 7.0%), and to risk-weighted assets it was 13.8% (2010: 14%), or 13.6% (2010: 13.4%) if the rebate for the state guarantee for cantonal banks is disregarded.³⁸

As charts 15 and 16 illustrate, the distribution of capital ratios among domestically focused banks is quite wide. However, they all currently fulfil the regulatory minimum. Furthermore, meeting the new

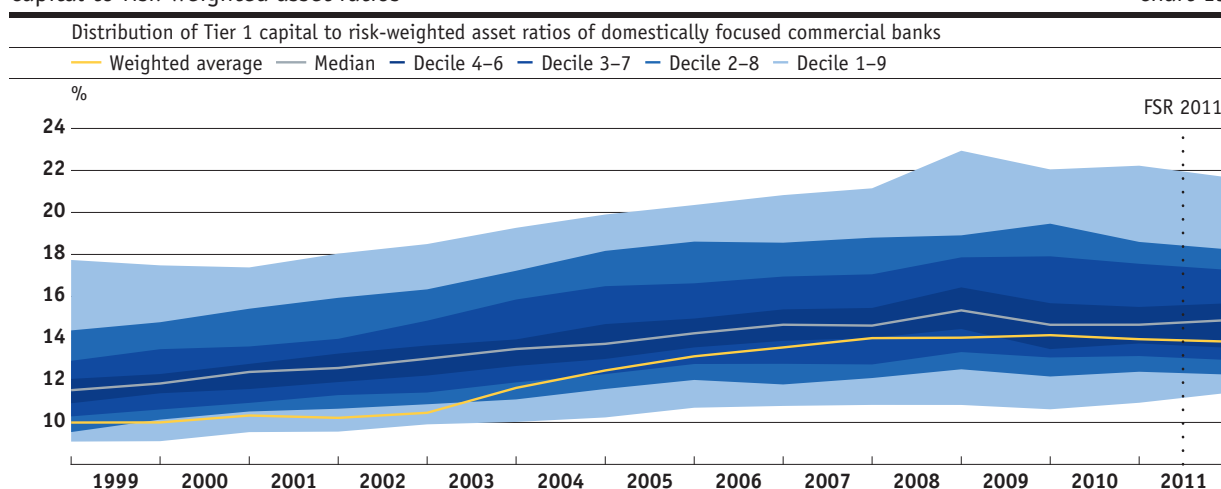
Basel III requirements, as well as FINMA's requirements regarding additional capital buffers depending on the supervisory category, should not present too much of a challenge for most of them.³⁹

In view of the growing risks on the real estate and mortgage markets, resilience should be strengthened further

However, since the last *Financial Stability Report* in June 2011, imbalances in the Swiss real estate and mortgage markets have developed further. To date, neither last year's revision of the self-regulation rules⁴⁰ nor the strengthening of micro-prudential supervision by FINMA⁴¹ have been sufficient to prevent a further increase in systemic risk on the Swiss real estate and mortgage markets.

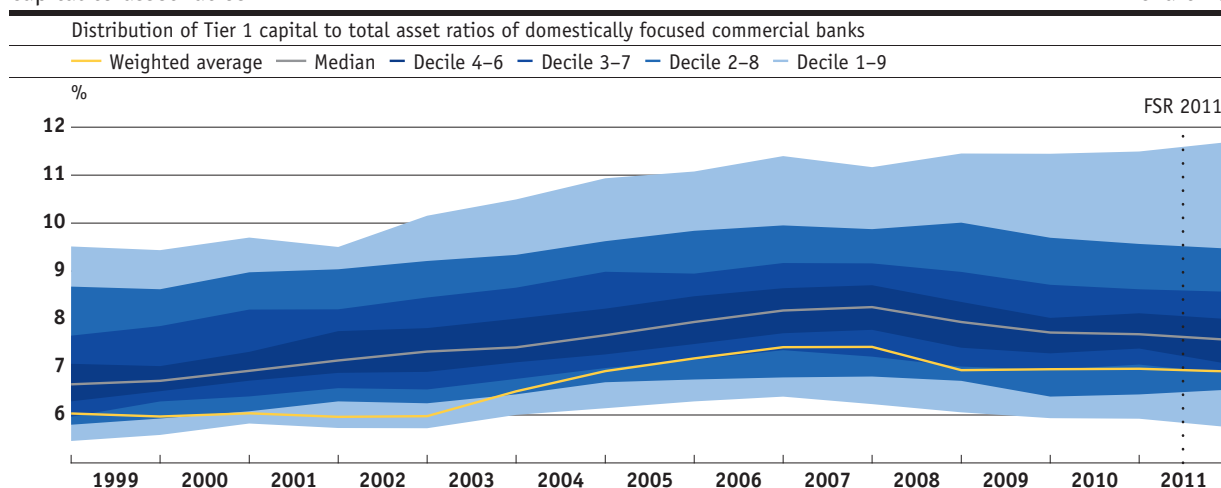
Capital to risk-weighted asset ratios

Chart 15



Capital to asset ratios

Chart 16



Charts 15 and 16: Sources: FINMA, SNB

38 Cantonal banks whose canton fully guarantees their non-subordinated liabilities benefited from reduced capital requirements up to end-2011.

39 Cf. FINMA Circular 2011/2 and explanatory report on the revision of the Capital Adequacy Ordinance and implementing provisions of 21 October 2011.

40 Swiss Banking, *Guidelines governing the examination, valuation and treatment of mortgage-backed loans*, October 2011.

41 FINMA, *Annual Report*, 2010.

In this context, regulatory capital ratios might significantly overestimate banks' resilience. First, through their impact on loan-to-value ratios, rising real estate prices can lead to lower capital requirements, making the latter procyclical. The higher real estate prices rise above levels that are justified by fundamentals, and the higher the turnover in the banks' mortgage portfolios, the more the regulatory capital indicators overestimate the resilience of these banks. In the current situation, this effect may be substantial. Second, the low level of diversification of most of these banks, reflecting in particular their strong focus on the mortgage market, is not taken into account in capital requirements. Finally, many domestically focused commercial banks continue to carry a high level of interest rate risk in their banking books, which is not captured by Pillar 1 capital requirements.

SNB estimates suggest that some banks' capital buffers might not be sufficient to absorb the credit losses that would arise under the adverse scenario. The combined market share of these banks is relatively small. However, experience suggests that, in a critical situation, even small banks may put the banking system as a whole under considerable stress. For banks that are not able to withstand the losses resulting from such an adverse scenario, which is a very severe but possible scenario for the next 12 months, microprudential measures may prove necessary.

In addition, a number of banks with a pronounced risk profile (cf. chapter 3) have relatively thin capital buffers. These banks have a significant market share of all domestically focused banks' assets. Given the continuing build-up of imbalances in the real estate and mortgage markets, and interest rate levels that are unsustainably low in the long term, such banks should review their risk appetite and the appropriateness of their capital buffers, and make adjustments where necessary. They should, in particular, make sure that they are in a position to continue performing their economically important functions even in the event of a large price correction on the residential real estate market coupled with a substantial rise in interest rates and borrower defaults.

Various complementary measures needed to reduce medium-term risks in real estate and mortgage markets

To limit medium-term risks in the real estate and mortgage markets, self-regulation measures and microprudential supervision can be combined with macroprudential policies.

In this context, the SNB welcomes the measures aimed at reducing risks in the mortgage market announced on 1 June 2012. Besides a further revision of the self-regulation rules for mortgage lending, which restricts the use of pension savings as collateral for borrowers (effective from July 2012) and a permanent adjustment of risk weights for high loan-to-value mortgage loans (effective from January 2013), the measures also include a macroprudential instrument in the form of a countercyclical capital buffer, which will be available to the Swiss authorities from July 2012.

When activated, the buffer should help to protect the banking sector against the consequences of excessive credit growth by increasing its loss-absorbing capacity. Moreover, it should help to lean against the build-up of such excesses. It is a temporary measure that will only be activated if imbalances reach a critical level. The institutional responsibilities have been organised such that the Federal Council decides on the activation, level and deactivation of the buffer, at the request of the SNB. The SNB consults FINMA before submitting its request.

