Niklaus Blattner: Developments in the Swiss banking sector

Introductory remarks by Mr Niklaus Blattner, Vice-Chairman of the Governing Board of the Swiss National Bank, at the half-yearly media news conference, Berne, 16 June 2005.

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With its Financial Stability Report, the Swiss National Bank (SNB) informs the public of the state of the financial system and presents its assessment of system stability. Moreover, the Bank provides indicators that may be used for an in-depth analysis.

The SNB tracks developments in the banking sector from a macroprudential, i.e. a system-wide perspective. In so doing, it complements the task of the Swiss Federal Banking Commission (SFBC), which is responsible for microprudential oversight, i.e. for individual institutions.

The part of the report that focuses on the banking sector mainly highlights strains or imbalances which could pose a threat to system stability in the short or longer term. In addition, the SNB reports on its activities in connection with the oversight of payment and securities settlement systems. This year it also provides information on the “Business Continuity Planning” (BCP) project, i.e. on preventive measures to overcome disruptions, thus strengthening the operational resistance of the Swiss financial centre.

Banking sector

The banking sector is currently stable. The stress index developed by SNB – an indicator which combines comprehensive information on potential stress symptoms in the banking industry – shows that the strains on the Swiss banking industry were extraordinarily low compared with the historical average. This is mainly attributable to three factors.

Firstly, the Swiss banking industry found itself in a predominantly positive environment: economic activity and the stock markets exhibited favourable development, interest rates remained low, and the credit standing of borrowers tended to improve. Consequently, profits in the banking sector not only remained high, but in most cases had increased over the previous period. While the satisfactory results achieved already in 2003 were mainly due to cost-cutting measures, the figures during the period under review can be ascribed to higher operative earnings.

Secondly, the banks’ reinforced capital resources improved the sector’s resilience. The majority of banks took advantage of the favourable environment to strengthen their capital base. Excess capital at the end of 2004 significantly exceeded the historical average. One exception, however, are the big banks, which – despite better profits – hardly increased their capital base at all. The *risk-weighted capital ratio* is relevant for regulation. The big banks are quite well placed by international standards in this regard. However, if the *unweighted capital ratio* is used as a benchmark (in Switzerland, it is not subject to any minimum requirements), the capital levels of the big banks are more modest when viewed internationally. The reasons for this discrepancy are the comparatively low proportion of off-balance-sheet business at the Swiss big banks on the one hand, and the low average weighting of trading and loan books on the other hand.

Thirdly, there is no indication – from our perspective – that the risks entered into in the banking industry have risen: market and interest rate risk have only increased slightly on an aggregate level, and credit risk even seems to have fallen.

Consequently, the banking sector is in good shape at the moment. As far as prospects for the near future are concerned, we believe that the macroeconomic environment and financial market conditions pose no major threat to the stability of the Swiss banking system. The outlook for 2005 indicates that economic growth in most regions will only slow down at a moderate pace. In addition, the available indicators suggest that there is currently little risk of contagion effects causing a crisis in the Swiss banking sector.

Nevertheless, there are still potential sources of risk. They pertain to credit risks in particular. Firstly, an unexpectedly sharp economic downturn could have a serious impact on the quality of the loan portfolios and the stock market. Secondly, should we witness a swift economic recovery, however, a sharp rise in the still very low interest rates could also result in a deterioration of the loan portfolio. This is because the growing interest burden would suddenly put considerable pressure on households and companies with mortgages to pay off. Banks would also be directly affected by the steep interest rate hike, as the interest rates on their assets tend to be fixed for a longer period than those on their liabilities. In view of the interest rate risks taken and the now extremely low provisions in the Swiss banking sector, the negative consequences of an unexpectedly sharp interest rate increase could be relatively far-reaching. The Swiss banking sector should nevertheless have sufficient capital to bear up, even under such circumstances.

Hedge funds might pose an indirect threat to stability in that their failure affects systemically important banks. In our opinion, this is an unlikely scenario, however. Hedge fund risk management at Swiss big banks is adequate. The SFBC supervises the big banks' hedge fund activities. Their exposure to hedge funds must be backed by capital as in the case of any other market and credit risks. It is, however, undisputable that, given the rapid developments in the hedge fund industry, activities must be monitored closely.

System oversight

In December, we reported on the situation with regard to the oversight of systemically important payment and securities settlement systems. In the meantime, the "systemically important" classifications of the interbank payment system Swiss Interbank Clearing (SIC), the securities settlement system SECOM, the central counterparty SIS x-clear and the multi-currency payment system Continuous Linked Settlement (CLS) have become definitive, and the preparations for the oversight measures stipulated in the National Bank Ordinance are going ahead as scheduled. In particular, detailed guidelines were drawn up in order to examine whether or not the regulatory minimum requirements are complied with. With these guidelines, the different systems can be monitored consistently, while at the same time keeping the administrative effort of the operators at an acceptable level.

Business Continuity Planning (BCP)

Different experiences in the recent past – from the 9/11 terrorist attacks in the United States to minor local technical difficulties – suggest that measures to strengthen the operational resistance of the Swiss financial sector must be taken. During the past year and a half, the SNB has headed a sectoral working group in cooperation with the SFBC secretariat. The group consists of representatives from infrastructure providers, financial institutions and the authorities and has conducted an in-depth analysis of the business continuity plans of the major players in the financial markets. The Business Continuity Planning (BCP) project focuses on precautionary measures to prevent the likelihood of disruptions. In addition, measures are taken to help cope as efficiently as possible with disruptions, once they have occurred.

In its analysis, the working group focused on the two business processes which were considered to be especially critical for system stability and which must be maintained without fail even in exceptional circumstances. Firstly, the supply of liquidity to the financial system with central bank money by means of repos and, secondly, large-value payment transactions between the commercial banks in Swiss Interbank Clearing (SIC).

The analysis began with the following scenario: a severe disruption causing the failure of an important operational centre and incapacitating its staff. Requirements were defined with regard to the maximum tolerable downtime before the resumption of normal operations. A distinction was made between critical and non-critical business processes, activities and participants. Business processes were deemed to be critical if their functioning is absolutely vital for the system-wide provision of liquidity.

- The central infrastructures (SNB, SIS, Telekurs), which are crucial for the critical business processes, must be able to resume critical business activities within two hours without losing any confirmed transactions.
- Critical system participants must be able to resume defined critical business activities within four hours.
- The other system participants must be able to resume operations within 24 hours.

The results of the analysis show that adequate preparations have been made both for central infrastructures and the major system participants. Nevertheless, areas in which there is room for improvement were identified. For instance, existing precautionary measures should not only be tailored to cater for the failure of physical components (such as buildings or hardware), but particularly to events that interfere with staff availability.

The final report of the working group will be completed in the second half of 2005. It will not be limited to issuing specific recommendations, but also to showing how they can be implemented.

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