Switzerland—2013 Article for Consultation

Preliminary Conclusions

Bern, March 18, 2013

With the exchange rate floor in place for over a year, the Swiss economy remains stable, though inflation remains negative and very low interest rates fuel risks in the mortgage market. The fiscal position is strong. The financial sector is striving to adjust to the new regulatory environment. Against this background, we encourage the authorities to:

- *Maintain the exchange rate floor for now and return to a freely floating currency if a monetary tightening becomes necessary.*
- *In case of renewed appreciation pressures, consider introducing negative interest rates on excess bank reserves temporarily to discourage inflows.*
- *Continue to build the Swiss National Bank (SNB) capital to ensure it is commensurate with the risks in its balance sheet.*
- *Phase out tax incentives to carry large mortgage debt to reduce risks in the mortgage market.*
- *Pursue progress to make large systemic banks globally resolvable in cooperation with key foreign supervisors.*

Outlook and risks

1. **The economy has responded better than expected to exchange rate appreciation and weak external demand.** While domestic demand remains solid, the slowdown in the global economy (and especially the euro area) is taking a toll on external demand, and the lagged effects of past exchange rate appreciation continue to be felt in some sectors. The same effects are keeping inflation in negative territory despite the rapid expansion of monetary aggregates.

2. **The economy is expected to improve moderately, but risks are still present.** Growth is expected to pick up during the year owing to somewhat more supportive

external conditions, but should remain modest both in 2013 and 2014 as the global recovery will likely be subdued. Inflation should turn positive by early 2014. Although the tail risk of a severe financial crisis and recession in the euro area has been reduced by policy actions, the crisis may be rekindled by policy slippages or adverse economic shocks. Alternatively, an inability to address medium-term fiscal challenges in the U.S. or Japan may undermine confidence in the U.S. dollar or the yen. In either scenario, safe haven capital flows would likely restart, putting the Swiss currency under pressure to appreciate and requiring again large scale foreign exchange market intervention.

Monetary and exchange rate policy

3. **In spite of weak external demand and the still moderately overvalued currency, export-oriented industries have shown resilience.** Real exports continue to grow, market shares are stable relative to those of other countries, and there is an ongoing diversification to new markets. The exchange rate floor provided the economy with a time window to adjust to appreciation, while the ensuing low-inflation environment allows for the moderate competitiveness gap to close over time.

4. **The exchange rate floor should remain in place for now**. Inflation is still well below comfortable levels, growth is modest, and the risk of a resumption in safe haven capital flows remains substantial. Once an economic recovery gets firmly under way, the SNB should exit the floor and return to a free float if inflation threatens to move above comfortable levels. Until then, sustained capital outflows should be used to cautiously unwind past currency interventions, while in case of renewed appreciation pressures the SNB should defend the floor, including by introducing negative interest rates on excess bank reserves as a temporary measure to discourage capital inflows.

5. **While the exchange rate floor policy played a key role in ensuring economic stability, it has expanded the SNB balance sheet to an unprecedented size**. This exposes the bank's net revenue to large fluctuations, and sizable losses could occur if an appreciation of the Swiss franc was to take place before foreign exchange interventions were unwound. The SNB capital is large and growing, reflecting in part

reduced profit distribution to the Confederation and Cantons. However, there is a risk that losses may exceed buffers. In such circumstances, it will be important that the independence of the central bank not be put into question. Also, if balance sheet risks continue to grow, more aggressive profit retention and capital building would be advisable.

Fiscal policy

6. **In current conditions the fiscal stance could be more supportive of the expansionary monetary stance to the extent allowed under the fiscal rule.** The debt brake rule has underpinned remarkable fiscal discipline and public debt is on a firm downward path**.** With conservative budget planning and execution, the federal government has consistently outperformed the rule. In 2013 fiscal policy might again turn out to be tighter than what is needed to fulfill the fiscal rule. With the economy expected to operate below potential, inflation too low, conventional monetary policy instruments exhausted, and fiscal sustainability not in doubt, a more supportive fiscal stance would be warranted.

Mortgage Market

7. **The recent measures to stem risks in the mortgage market are welcome**. With mortgage interest rates falling to new lows, mortgage debt has reached a historic peak, and housing prices are growing well above nominal GDP growth. While so far average prices are not accelerating as in typical bubble episodes, there is evidence of bubble-like dynamics in "hot spots." In 2012, the authorities appropriately moved to cool off the market with several measures, including most recently by increasing capital requirements on mortgage portfolios, stricter repayment requirements, and, importantly, the prohibition to use Pillar II pension fund savings to finance minimum down payments. The recent activation by the Federal Council of the newly-created counter-cyclical capital buffer (CCB) is an important additional step.

8. **However, more interventions may become necessary as the low interest rate environment is likely to persist**. Forceful monitoring and enforcement of the new

minimum regulatory standards and a proactive use of supervisory discretion to ensure prudent lending behavior will be important. If risks continue to build, the authorities should also stand ready to implement new measures or tighten existing ones, including raising the CCB to the maximum of 2.5 percent or introducing minimum affordability ratios.

9. **This would be an appropriate time to phase out existing tax incentives that artificially inflate the mortgage market**. Because mortgage interest payments are tax-deductible, many households carry much more mortgage debt than warranted. In fact, the ratio of residential mortgages to GDP in Switzerland is one of the highest in the world. Phasing out the preferential tax treatment of mortgage interest, while at the same time phasing out taxation of imputed rents, would remove a distortion from the economy and reduce risks in the mortgage market**.**

Financial sector

10. **We welcome Switzerland's rapid progress in upgrading financial sector regulation and supervision both in banking and insurance.** The authorities have moved swiftly to address the gaps exposed by the financial crisis by implementing upgraded regulations for both banks and insurers in line with international initiatives. For example, in banking the Basel III capital and liquidity regulations for banks have been adopted, while in insurance the Swiss Solvency Test (SST) is in place. The reform momentum should continue. Financial firms are adapting their business models to the new frameworks, though lingering uncertainties about the direction of regulatory reforms in other countries are complicating the restructuring process.

11. **While in large banks capital ratios are improving substantially, more rapid progress on the leverage front would be prudent.** Though total assets have declined and capital has been built up**,** a sizable part of the adjustment to new capital regulations has taken place through a reduction in risk-weighted assets. In these circumstances, it is critical to ensure that banks' internal models to calculate risk-weighted assets capture relevant risks, and that banks do not resort (or are not perceived as resorting) to model changes only to reduce capital charges. Measures to enhance

transparency to facilitate peer comparison of risk-weights could reassure investors, while continued strict supervisory scrutiny of models backed up by action as necessary is also important. In this respect, the recent introduction by FINMA of bank-specific multipliers for new Swiss residential mortgages for banks using internal risk models is appropriate. In addition, as the new minimum leverage ratio regulation comes into force, banks will have to more forcefully reduce their balance sheet or build up capital. This regulation will ensure that overly optimistic risk-weighting does not undermine bank resiliency though the phase-in period is long.

12. **Despite significant steps forward in improving the bank resolution framework, further progress is needed along the cross-border dimension.** The introduction of the Bank Insolvency Ordinance and the banks' and authorities' work on resolution and recovery plans are welcome. Still, while the international work on global bank resolution continues, the goal of having a system in which large complex global banks can be resolved without threatening financial stability is yet to be reached both in Switzerland and abroad. Reaching full-fledged cooperation agreements with key foreign supervisors establishing clear principles and procedures to ensure global resolvability is challenging, but we encourage the authorities to forcefully move forward in this direction. In the meantime, the high capital buffers envisaged under the Swiss TBTF legislation provide a key safeguard for taxpayers and financial stability and should remain fully in place. Capital rebates should only be given when global resolvability is credibly established at the end of this process.

We would like to thank the authorities and private sector counterparts for their cooperation and hospitality.