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Financial Stability Working Group

Report

on macroprudential oversight in Switzerland

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Summary

The latest financial crisis has shown that an oversight function geared to the solvency and stability of individual financial market participants, together with a monetary policy strategy of focusing on price stability, is no guarantee for the stability of the financial system. This finding necessitates a review of the macroprudential oversight system, i.e. the oversight of the Swiss financial system as a whole, with a view to eliminating potential weaknesses and providing the Swiss economy with greater protection against the risks of a financial crisis. The Federal Department of Finance (FDF) accordingly created the "Financial Stability" working group in April 2011, and instructed it to draw up proposals on how to eliminate any weaknesses in macroprudential oversight in Switzerland.

The aim of macroprudential oversight is to preserve or restore the stability of the financial system. This involves on the one hand strengthening the resilience of the financial system against the consequences of an economic slump, and on the other countering the build-up of systemic risks in the financial system. If these objectives are to be achieved, relevant and up-to-date information must be available.

National differences in the organisation of financial oversight and the structure of national financial markets make it difficult to assign macroprudential oversight tasks to specific institutions in an internationally standardised way. Both central banks and the supervisory authorities responsible for the prudential oversight of individual institutions play an important role in macroprudential oversight, as the primary areas of responsibility of these institutions (monetary policy and institution-specific oversight) are closely linked to the macroprudential oversight function.

Macroprudential instruments include on the one hand countercyclical instruments, which work to limit the build-up or indeed the abrupt scaling-down of systemic risks over the course of time. On the other hand, structural instruments also need to be taken into account, such as those which limit the concentration of risk in the financial sector and increase the resilience of financial market participants.

On the basis of its analysis, the working group unanimously recommends the following adjustments in order to strengthen macroprudential oversight in Switzerland:

- Enhancement of the macroprudential toolkit with a countercyclical buffer; and
- More stringent capital requirements for the mortgage sector

In addition, the majority of the working group recommends:

- The creation of a right to direct access for the Swiss National Bank (SNB) to information on financial market participants which goes beyond its existing entitlement to statistical data.

By contrast, the working group believes that the current mandates of the SNB and the Swiss Financial Market Supervisory Authority FINMA are sufficiently well-formulated with respect to macroprudential oversight.

1 Background

The latest financial crisis has shown that an oversight function geared to the solvency and stability of individual financial market participants, together with a monetary policy strategy of focusing on price stability, is no guarantee on its own for the stability of the financial system. In the recent crisis, the build-up of systemic risks turned out to have been underestimated, and the existing oversight instruments proved to be insufficient. This finding in turn necessitates a review of the macroprudential oversight structure, i.e. the oversight of the Swiss financial system as a whole, with a view to eliminating potential weaknesses and thus providing the Swiss economy with greater protection against the risks of a financial crisis.

The structure of macroprudential oversight is currently being discussed at international level too. In response to a request from the heads of government of the G20, the International Monetary Fund (IMF), the Financial Stability Board (FSB) and the Bank for International Settlements (BIS) launched a comprehensive working program, and in October 2011 published a report containing an overview of the structure of macroprudential oversight in various countries, together with a list of general recommendations.[1]

At national level, the Control Committees of the National Council and Council of States published a report on 30 May 2010 on the lessons learned from the financial crisis, in which they recommended reviewing legislative changes which would give FINMA and the SNB precise objectives in the oversight of the financial sector and provide them with the corresponding authority.[2]

In April 2011, Federal Department of Finance (FDF) created the "Financial Stability" working group and entrusted it with a corresponding mandate.[3] This gave the working group the task of not just reviewing the current structure of macroprudential oversight in Switzerland, but also drawing up concrete proposals with a view to strengthening it.

In this report, the working group lays out the results of its analysis and the resulting recommendations for action. It starts with a definition of macroprudential oversight and its area of responsibility as distinct from other areas (section 2). Then the current structure of macroprudential oversight in Switzerland is analysed (section 3). This analysis flags up a requirement to strengthen access to information and to enhance the macroprudential toolkit (section 4).

2 Macroprudential oversight

2.1 Definition

First of all, the term macroprudential oversight needs to be defined in order to demarcate the boundaries of the questions that this concept throws up. Macroprudential oversight is characterised by (1) its objective, (2) the assigned institutional responsibilities, (3) its spectrum of analysis, and (4) the available oversight instruments.

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[1] Cf. http://www.financialstabilityboard.org/publications/r_111027b.pdf

[2] Cf. Recommendation 2 in "The Swiss authorities under the pressure of the financial crisis and the disclosure of UBS customer data to the USA", Report of the Control Commissions in the National Council and the Council of States: http://www.parlament.ch/e/dokumentation/berichte/berichte-aufsichtskommissionen/geschaeftspruefungskommission-gpk/berichte-2010/Documents/bericht-gpk-ns-ubs-kundendaten-usa-2010-05-30-res-e.pdf

[3] The working group is made up of the following representatives of the FDF, the Swiss Financial Market Supervisory Authority FINMA and the Swiss National Bank (SNB): Eveline Widmer-Schlumpf, Head of the FDF (Chair); Alexander Karrer, Deputy State Secretary in the State Secretariat for International Financial Matters; Thomas Jordan, Vice-Chairman of the Governing Board of the SNB; Patrick Raaflaub, Director of FINMA; Daniel Roth, Head of FDF Legal Services.

(1) Objective

The aim of macroprudential oversight is the preservation or restoration of the stability of the financial system.[4] On the one hand, this involves strengthening the resilience of the financial system against the consequences of an economic downturn. On the other hand, macroprudential instruments should enable the supervisory authorities to brace themselves against the build-up of systemic risks in the financial system.[5] Systemic risks comprise all risks which threaten the stability of the financial system as a whole and therefore have the potential to wreak serious damage on the real economy.

(2) Institutional responsibility

National differences in the organisation of financial oversight and the structure of national financial markets make it difficult to assign macroprudential oversight tasks to specific institutions in an internationally standardised way. Both central banks and the authorities responsible for the prudential oversight of individual institutions have an important role to play in macroprudential oversight: the central bank because it already has a key role to play in monetary policy (and typically also in payment transactions), which means it can bring its expertise to bear when it comes to the analysis of systemic risks. Furthermore, a deficient level of macroprudential oversight harbours a threat to price stability – which is typically the main priority of the central bank – and increases the probability of a crisis in which the central bank would have to make emergency amounts of liquidity available. The central bank therefore has an intrinsic interest in robust macroprudential oversight.

The argument for the inclusion of the supervisory authorities responsible for the prudential oversight of individual institutions is based above all on the strong overlap of microprudential and macroprudential oversight, and the corresponding overlap of the instruments used in these two areas. The analysis of risks arising from individual institutions, which is the task of these supervisory authorities, forms the basis for the appraisal of risks at the level of the financial system as a whole. At the same time, institution-specific oversight cannot be effective unless systemic risks are taken into account too. The close involvement of the microprudential supervisory authorities also guarantees direct access to the data and information assembled for macroprudential oversight. Moreover, it ensures that the data-gathering process also takes into account macroprudential information requirements.

A clear macroprudential mandate at the legislative level can help to clarify the question of institutional responsibility. However, measures originating in a number of different areas of responsibility (e.g. monetary policy, financial policy, fiscal policy) also contribute to the preservation of financial stability. For this reason, an intensive dialogue between all involved authorities should be promoted so that measures outside the macroprudential mandate can be evaluated in terms of their impact on financial stability.

(3) Spectrum of analysis

The spectrum of analysis is crucial for the effective structuring of macroprudential oversight. In order for systemic risks to be precisely evaluated, the availability of relevant up-to-date information needs to be ensured. At the same time, a definition is needed regarding what risks (or what sources of risk) should be classified as systemic, what data and information

[4] Cf. Galati, G. and R. Moessner (2011), Macroprudential policy – a literature review, BIS Working Papers, No. 337.

[5] Bank for International Settlements (2010), Macroprudential instruments and frameworks: a stocktaking of issues and experiences, CGFS Papers, No. 38.

should be used to identify these risks, and what analytical basis should be used to identify these risks.

Systemic risks can be subdivided into two different dimensions:[6]

- The temporal dimension stresses the emergence of systemic risks over the course of time. Both these risks themselves and their abrupt scaling-down in a crisis can lead to an undesirable pro-cyclical effect on the part of the financial system.
- By contrast, a second dimension looks at the concentration of risks in the financial system at any given time. This includes on the one hand risks arising from parallel behaviours or the open risk positions of numerous financial market players (e.g. towards a specific sector or in a specific foreign currency), and on the other risks that emerge from individual systemically important financial institutions (SIFIs).

The establishment of how precisely a systemic risk is defined also involves identification of potential risk carriers and therefore the market players who need to be supervised. A narrow interpretation which focuses on banks and the providers of financial market infrastructures has the advantage that the parties subject to oversight can be clearly delineated and the data-gathering requirements formulated more easily. By contrast, a broader interpretation encompassing all financial institutions and the shadow banking system facilitates a more comprehensive appraisal of systemic risks. However, this gives rise to additional challenges concerning data procurement and risk evaluation.

(4) Oversight instruments

Macroprudential instruments include all oversight instruments which are specifically designed to contribute to the preservation or restoration of the stability of the financial system. They are focused on the financial sector as a whole, and take into account individual institutions only insofar as these are systemically relevant.

A number of different countercyclical and structural instruments are necessary given the multifaceted nature of systemic risk. Countercyclical instruments can help to restrict the build-up or the abrupt scaling-down of systemic risks over the course of time (by moderating pro-cyclical behaviour). Structural instruments, by contrast, are aimed at limiting concentrations of risk in the financial sector and strengthening the resilience of financial market participants.

2.2 Demarcation from other areas of responsibility

The demarcation of macroprudential instruments from those of other areas of responsibility, in particular the prudential oversight of individual institutions, cannot always be done in a crystal clear way. For example, microprudential instruments such as increased capital requirements for an individual but systemically important bank, or an increase in risk weightings for all banks with certain risk positions, may also contribute to reducing systemic risks in the financial sector as a whole. But macroprudential instruments for their part have an impact on other areas of responsibility too, for example by bringing about a scarcity of supply of credit, with the ensuing repercussions for monetary policy. Furthermore, their impact is always dependent upon the prevailing economic parameters (such as the structure of interest rates or the degree of private sector indebtedness). The classification of a particular instrument is therefore easier if this is undertaken from the viewpoint of the primary objective pursued. This report classifies instruments as macroprudential only if they are largely geared to the preservation of financial stability.

[6] Cf. Financial Stability Board, International Monetary Fund and Bank for International Settlements (2011), Macroprudential policy tools and frameworks – Update to G20 Finance Ministers and Central Bank Governors.

(1) Monetary policy

The aims of monetary policy are different from those of financial stability. The objective of monetary policy is price stability in an economy, whereas that of macroprudential oversight is the reduction of systemic risks in the financial sector. These two objectives are not always mutually compatible. In today's environment, for example, this is illustrated by the combination of major uncertainties in the economic environment and signs of increased risk-taking in the Swiss real estate and mortgage market. Accordingly, financial stability requires its own policy and own instruments.

There are, however, clear areas of overlap between monetary policy and financial stability. The former has an impact on asset prices and the level of credit available in an economy. Both of these factors are also relevant variables for financial stability. As a consequence, financial stability has an impact on these variables and therefore also on the transmission channel of monetary policy. This overlap is particularly apparent in the case of countercyclical macroprudential instruments, i.e. instruments that are designed to counteract the build-up of imbalances in credit and asset markets. In this case, an effect on credit supply that varies over time is explicitly desirable.

Both financial stability and monetary policy require the responsible parties to have a broad perspective of the system as a whole. In both areas, decisions are founded on the analysis of macroeconomic and financial system developments, as well as on the interaction between these two areas. However, the different objectives pursued in each case make it quite clear that financial stability can be no substitute for monetary policy. It should rather be viewed as a complementary area of activity which pursues another target altogether. Monetary policy and financial stability influence similar variables, but in certain situations they will have different interests in the direction those variables take.

(2) Private indebtedness – tax incentives in the real estate area

The current tax regime for residential property in Switzerland provides for the so-called "imputed rental value" – i.e. the equivalent rental value of owner-occupied property – being fully taxable on the one hand, while value-preserving maintenance costs, certain operating costs, value-enhancing energy measures and debit interest are tax-deductible on the other. Thanks to the tax deductibility of mortgage interest, household indebtedness is essentially promoted by the state. Furthermore, due to tax optimisation considerations, the financing and repayment of mortgages on residential properties in Switzerland is typically governed by the requirements of the mortgage creditor, and in combination with an advance withdrawal or pledging of pension assets from the Pillar 2 or Pillar 3a system (including indirect repayment).

As a result of their high degree of indebtedness, households are strongly exposed to certain risks, such as a sharp rise in interest rates. A combination of falling market values and a rising interest rate environment could have a destabilising effect on the real estate market if the indebtedness level of a large number of households were to exceed a certain degree of sustainability. Financial policy incentives that promote excessive household indebtedness should therefore be avoided. A crucial further element here is a cautious and circumspect lending policy on the part of financial market participants. In addition to more rigorous risk weightings for banks (in which affordability is also taken into account), efforts to reduce incentives to take on large amounts of debt should be supported. As an obvious example, the tax deductibility of debit interest could be eschewed. The additional tax burden that such a step would place on households could be offset by the abolition of tax on the imputed rental value.

3 Current structure of macroprudential oversight in Switzerland

3.1 Objective and institutional responsibilities

Swiss legislation does not provide for a specific mandate in which the term macroprudential oversight is explicitly flagged up and its objective defined. Nonetheless, both the SNB and the Swiss Financial Market Supervisory Authority FINMA are entrusted with macroprudential tasks in Switzerland.

According to Article 5 para. 2e of the National Bank Act[7] (NBA), one of the tasks of the SNB is to contribute to the stability of the financial system. This contribution is made in the context of the SNB's monetary and foreign exchange policy. Furthermore, the preservation of financial stability is specifically referred to in Article 19 para. 1 of the NBA, which entrusts to the SNB the task of monitoring the payment and clearing systems.

The involvement of FINMA is provided for in Article 5 of the Financial Market Supervision Act[8] (FINMASA), according to which financial market oversight has the aim of protecting the functioning of the financial markets. In other words, in addition to a preoccupation with the solvency and stability of individually supervised institutions, FINMA's mandate also has a supra-institutional component.

In order to demarcate the respective tasks and to regulate collaboration in the area of financial stability, FINMA and the SNB have additionally signed a *Memorandum of Understanding*[9]. This has been further enhanced by a *Memorandum of Understanding* between the FDF, FINMA and the SNB[10], which is above all designed to strengthen collaboration in the event of a crisis posing a threat to financial stability.

The working group considers the current legally defined mandates with respect to macroprudential oversight to be sufficiently precise for the purposes of effective oversight in Switzerland. Accordingly, it proposes no changes in this area.

3.2 Monitoring of the financial system

The observation and analysis (i.e. monitoring) of developments in the financial system is what forms the basis for the evaluation of systemic risks. An essential prerequisite for this task is timely access to comprehensive information. Accordingly, Article 29 para. 1 of the FINMASA gives FINMA access to all information and documentation that it requires in order to fulfil its tasks. Furthermore, the institutions supervised by FINMA are obliged to report any incidents that arise immediately insofar as they are relevant from an oversight perspective (Art. 29 para. 2 FINMASA).

For its part, the SNB is given comparable access to information in the area of payment and clearing systems (Art. 20 para. 1 NBA). However, the SNB's legal right to information on other financial market participants is limited to the gathering of statistical data according to Articles 14 to 16 of the NBA.[11] Access to further information and documentation of a non-

[7] Federal Act of 3 October 2003 on the National Bank.

[8] Federal Act of 22 June 2007 on Federal Financial Market Supervision.

[9] Memorandum of Understanding regarding financial stability between the Swiss Financial Market Supervisory Authority FINMA and the Swiss National Bank SNB of 23 February 2010.

[10] Memorandum of Understanding regarding financial stability and the exchange of information on financial market regulation between the Federal Department of Finance FDF, the Swiss Financial Market Supervisory Authority FINMA and the Swiss National Bank SNB of January 2011.

[11] The gathering of such data may also be subject to temporal restrictions, as is currently the case with respect to the granting of mortgages.

statistical nature (e.g. for the qualitative risk evaluation of a financial market participant) takes place either on the basis of an exchange of information with FINMA in accordance with Article 23^{bis} para. 3 of the Banking Act[12], or voluntarily on the part of the corresponding financial market participant.

The SNB does conduct its own investigations with respect to the big banks today, and also holds a dialogue with these banks. However, generally speaking, it does not have any legally enforceable direct access to information of a non-statistical nature where financial market participants are concerned. Given the significant role it plays in the area of macroprudential oversight, this can give rise to unsatisfactory situations. FINMA does of course make its existing qualitative risk appraisals with respect to individual financial market participants available to the SNB if the latter requires these for the fulfilment of its macroprudential mandate. Situations may arise, however, in which the required information and data are not held by FINMA, or at least not in the necessary scope. In section 4.1, therefore, the majority of the working group proposes the creation of an independent right to access information for the SNB to cover these kinds of constellations.

In addition to undertaking a comprehensive evaluation of the financial sector data that it assembles, FINMA also conducts additional sensitivity analyses and stress tests for the two big banks in consultation with the SNB. For the sensitivity analyses, the reaction of bank portfolios to the change in individual risk factors (e.g. interest rate structure, share prices, exchange rates) is investigated. This sensitivity analysis is carried out on a portfolio-specific basis so that the dependency of individual business areas can be observed in a differentiated way. This enables conclusions to be drawn as to which activities contribute to the overall risk of the bank, and to what extent. For the stress test (loss potential analysis), a hypothetical overall loss scenario for the bank is investigated against the backdrop of an extremely unfavourable environment. This involves changing several risk factors simultaneously. The description of risk factors is undertaken on the basis of a consistent macroeconomic stress scenario (e.g. recession, stagflation), which allows for the aggregation of losses across different portfolios.

This more stringent oversight of the big banks is explained by their systemic importance for the financial market. Internationally too, SIFIs are classified as potential sources of systemic risks. Accordingly, in November 2011, the Financial Stability Board passed a number of recommendations which envisage addressing the risks posed by SIFIs with higher capital requirements, more rigorous supervision, and the elaboration of legislative frameworks for the recovery and resolution of these institutions. In the case of Switzerland, a key step towards strengthening the regulation of systemically important banks was made when amendments to the Banking Act ("too big to fail") were passed by parliament on 30 September 2011. Experience has shown, however, that the mutually complementary activities of FINMA and the SNB require a large degree of coordination.

FINMA is looking to extend the stress tests to medium-sized banks in the future. Although these banks do not pose systemic risks when viewed individually, the extension of the stress tests could enable potential risks of parallel behaviours to be identified at an earlier stage. This would enable the evaluation of systemic risks in the financial sector to be refined.

Given their significant investment volumes, insurers too are closely interlinked with the rest of the financial sector, which means they are inevitably exposed to contagion risks. Systemic aspects are therefore taken into account in the Swiss Solvency Test for insurers. Furthermore, FINMA takes account of the identification of systemic risks in the insurance

[12] Federal Act of 8 November 1934 on Banks and Savings Banks.

area through its quarterly survey of comprehensive data on certain risk areas (e.g. risk positions vis-à-vis peripheral eurozone states).

3.3 Existing and reviewed oversight instruments

The key instruments of a macroprudential nature which are currently available to the Swiss authorities are listed below. In the area of countercyclical instruments, these are communication policy (1) and in particular the newly designed capital buffer in the banking sector (2). In the area of structural instruments, they include the strengthening of systemically important banks through additional liquidity and capital requirements as well as organisational requirements (3), risk diversification regulations (4) and risk weighting regulations (5). Finally, structural adjustments to clearing and settlement systems (6) also contribute to the stability of the financial system.

(1) Communication policy

A targeted communication policy involving stability reports, media conferences, speeches, etc. can have the effect of amending the behaviour of market participants. However, in the past, this instrument proved insufficiently effective as a way of restraining the pro-cyclical behaviour of market participants. For example, both the SNB and FINMA have recently flagged up the build-up of risks in the Swiss mortgage and real estate market in their different ways, without this resulting in any significant correction to market developments.

(2) Capital buffer in the banking sector

In order to take into account the risks not covered by the minimum requirements ("Pillar 1"), the Capital Adequacy Ordinance[13] (CAO) requires banks to hold additional capital ("Pillar 2"). On 1 July 2011, a differentiated capital regime came into effect, whereby the requirements for the amount of additional capital a financial institution must hold depend on its size, complexity and business activities.[14]

This envisages the surpluses earned by banks in good economic times being available to compensate for losses in an economic downturn, without the ordinary course of business activity being affected. The additional capital therefore has a countercyclical and stabilising effect, as it allows the banks to supply the market with the necessary credit in difficult economic times too, thereby avoiding a further deterioration of economic development.

In the ongoing CAO reform to implement the Basel III framework as of 1 January 2013, the "Pillar 2" concept has been broken down into the "capital buffer" and "additional capital" components. For systemically important banks, the current CAO revision will introduce a capital buffer in the amount of 8.5% of their risk-weighted positions[15] (Art. 123f para. 1 of the draft CAO[16]). Other Swiss banks will have to fulfil a capital buffer of 2.5% of risk-weighted positions under Art. 33a para 1 of the draft CAO[17]. Other capital requirements as part of the above-mentioned capital regime will be laid down by FINMA.

[13] Ordinance of 29 September 2006 on Capital Adequacy and Risk Diversification for Banks and Securities Traders.

[14] Cf. FINMA Circular 2011/2 – Capital buffer and capital planning in the banking sector, version of 30 March 2011. This capital regime does not apply to the big banks, as they are subject to their own separate regime.

[15] The weighted positions comprise institutions' balance-sheet and off-balance-sheet positions, which are weighted as per regulatory guidelines on the basis of the risk they pose.

[16] Cf. CAO hearing draft of 5 December 2011.

[17] Cf. hearing draft on the complete revision of the CAO of 24 October 2011.

(3) Regulation of systemically important banks ("too big to fail" measures)

The measures to strengthen the regulation of systemically important banks have a distinct macroprudential character. In addition to the above-mentioned capital buffer, the likelihood of a systemically important bank ending up in a critical situation is limited by comprehensive liquidity requirements. The organisational requirements, for their part, reduce the potential for damage should a critical situation nonetheless arise. These measures are supplemented by additional capital requirements (progressive component), which help to ensure the maintenance of systemically important functions in the event of a crisis. These measures thus protect the financial system as a whole and substantially strengthen its resilience in the event of a crisis.

(4) Risk diversification regulations

The capital and liquidity requirements that apply to banks are based on the inherent assumption of diversification. If a bank takes on large individual risks in relation to its capital – and indeed in relation to its overall exposure – the diversification effect decreases. The existing CAO therefore also regulates risk diversification and establishes upper limits for cluster risks. The risk diversification regulations are currently being revised and made more stringent. Among other things, they now regulate the risk concentration of other banks vis-à-vis systemically important banks, which often provide central services. The consequences of a collapse on the part of such a service provider are to be limited in the future for the service-procuring banks. In future, they will have to guarantee that they can switch to other providers within a reasonable period of time.

(5) Risk weighting

The intensification of the risk weighting regulations has a varying impact on the individual institutions given the individual view and the way the relevant risk portfolio is structured, particularly the nature and scope of certain risks. Nonetheless, the number of banks concerned is increasing overall. Such measures therefore have a structural impact on risk diversification in the financial market and contribute to financial stability.

As part of Basel III, risk weighting is being redefined and recalibrated in various areas. Furthermore, as a result of developments in the real estate and mortgage market, the Federal Council has resolved to adjust the risk weighting regulations for the financing of owner-occupied properties. This will involve not only revising the maximum lending limits, but also taking into account adherence to affordability principles where the weighting is concerned (cf. section 4.3).

(6) Clearing and settlement systems

Given the high volumes of financial transactions between financial intermediaries, problems in both the clearing and settlement of transactions can give rise to significant financial risks. The problems of one counterparty can spread to other participants in a clearing and settlement system. Measures to strengthen these systems therefore contribute directly to the stability of the financial system. Accordingly, in recent years clearing and settlement systems have been structured in such a way that the level of clearing and settlement risk is reduced.

On the basis of the experience gained from the financial crisis, other measures are now being introduced. Some financial contracts which were previously concluded and settled between two individual counterparties (so-called over-the-counter or OTC transactions) are now standardised, which facilitates the settlement of these contracts through a central counterparty. In addition, transparency and liquidity have been strengthened thanks to trade repositories and expanded trading platforms. In the future, the existence of additional capital requirements will incentivise the banks to favour instruments that are settled centrally over those that are settled bilaterally.

(7) Conclusion

The working group reviewed both the existing and a wide range of further possible macroprudential instruments (such as loan-to-value limits, debt service-to-income limits, and dynamic provisioning), and concluded that the macroprudential toolkit should be enhanced in certain areas.

Where instruments that have a countercyclical effect are concerned, the introduction of a countercyclical buffer is envisaged with a view to limiting the risks of excessive credit growth in certain situations (cf. section 4.2). The existing oversight instruments either cannot respond satisfactorily to certain sudden and extensive negative developments in the credit market, or – as is the case with communication – are not sufficiently binding for financial institutions.

Furthermore, the working group concluded that the currently planned adjustment to risk weighting in the area of mortgage lending represents an effective enhancement to the oversight instruments which have a structural impact (cf. section 4.3).

Beyond these measures, the working group does not currently see any need for further macroprudential instruments in Switzerland.

4 Proposed measures

The measures proposed by the working group are summarised below. A detailed description of the proposed new instruments can be found in the corresponding explanatory reports on the hearing drafts.[18] Macroprudential oversight in Switzerland would be strengthened by these measures.

It should nonetheless be stressed that even an oversight mechanism which is more strongly tailored to systemic risk will not rule out the possibility of future financial crises occurring. For one thing, various areas of financial sector activity are inextricably associated with risk, because the transfer of certain risks from the real economy to the financial sector – for example in the context of transformation of maturities – is one of the *raisons d'être* of the financial sector. In addition, the interconnectedness of the international financial system means that systemic risks may increasingly be transferred to the domestic financial system from elsewhere. International collaboration between oversight authorities is therefore vital. Such collaboration is subject to both practical and legal limits, however.

Moreover, the macroprudential framework must have the necessary flexibility to be adjusted in line with the latest developments in the financial sector. As new financial instruments appear, so too will new oversight requirements. The oversight parameters will therefore have to be reviewed on an ongoing basis.

4.1 Access to information for the SNB

As discussed in section 3.2, the SNB has no direct, legally enforceable access to information of a non-statistical nature vis-à-vis financial market participants. The recent crisis showed, however, that this information can be important for the identification of systemic risks. This

[18] Cf. CAO hearing drafts of 18 November 2011.

includes, for example, quantitative information – which is neither standardised nor aggregable – on the exposure of financial market participants to certain risk factors and their resilience in the face of certain defined risks. Qualitative information can also be valuable for monitoring the financial system, such as the views of financial market participants on market developments, for example.

Under existing law, the SNB can obtain such information only if it is forwarded by FINMA or voluntarily submitted by the financial market participants themselves. This setup may have functioned well in practice so far, but it has its limitations:

- As FINMA and the SNB pursue different supervisory goals, the information requirements of these two institutions can differ from one another. It could therefore come to pass that FINMA does not obtain information relevant to the SNB and is therefore not in a position to forward such information. This problem could be eliminated if the SNB were allowed direct access to information itself. This would involve the SNB having specific access to the information required for the fulfilment of its macroprudential mandate.
- Without a legal entitlement to the disclosure of information, it cannot be guaranteed that financial market participants will supply the relevant amount of information to the SNB in a timely way in all cases.
- Direct access to information would also facilitate a direct dialogue between the SNB and financial market participants. This direct dialogue would give the SNB a better understanding and allow for improved qualitative appraisal of the information it receives.

FINMA considers the existing legal basis and the Memorandum of Understanding to be sufficient for the SNB to acquire the information it requires to fulfil its macroprudential mandate. According to FINMA, creating an additional legal right to information for the SNB could be viewed by financial market participants themselves as a dual form of oversight (given FINMA's existing activity). This in turn would raise questions concerning the division of oversight responsibility between the two institutions. As far as FINMA is concerned, this could lead to confusion and duplication, as well as give the supervised institutions the potential opportunity to play one authority off against the other.

However, the majority of the working group believes the SNB should be given direct access to information of a non-statistical nature through an amendment to the NBA. This access would however be restricted to information which is not already obtained by other authorities – i.e. FINMA – and which clearly serves to fulfil the macroprudential mandate. The additional burden placed on financial market participants in the area providing information should therefore be strictly limited to the necessary scope. In the view of the majority of the working group, the additional legal entitlement to information on the part of the SNB would not lead to dual oversight. The division of authority between the SNB and FINMA would remain unaffected. Only FINMA itself is responsible for the prudential oversight of individual institutions.

In addition, a legal foundation for the exchange of information between the SNB and the FDF should be created. In particular, this would refine and improve collaboration in the context of crisis prevention and crisis management.

4.2 Introduction of a countercyclical buffer

In the area of countercyclical instruments, the working group recommends the introduction of a countercyclical buffer amounting to up to 2.5% of risk-weighted positions in accordance with the CAO.[19] The buffer should be structured in such a way that it can be limited to certain

[19] Cf. CAO hearing draft of 18 November 2011.

credit positions as required. This would enable capital requirements to be increased in a way that is more strongly geared to the development of individual sectors such as the mortgage market (sector-related buffer).

Where the activation of the countercyclical buffer is concerned, the following institutional responsibility is envisaged. If, on the basis of an in-depth analysis of the situation in the Swiss credit market, the SNB concludes that imbalances are manifesting themselves which constitute a threat to financial stability, it would submit to the Federal Council an application to activate the countercyclical buffer after consulting with FINMA. At the same time as FINMA, the FDF would be informed about the application in order for the Federal Council's decision-making process to be prepared. On the basis of the application, the Federal Council would then decide on the activation of the countercyclical buffer. Among other things, the Federal Council would take into account FINMA's opinion. A similar process would apply to the removal of the countercyclical buffer.

Major crises in the financial markets are a recurring feature of modern history, typically as a result of credit markets becoming overheated. The corresponding losses can be so enormous that they threaten the stability of the financial system, and therefore trigger major repercussions for the real economy. The aim of the countercyclical buffer is to strengthen the resilience of the banking sector against such excessive credit growth. The aim here is to force the banks to hold higher levels of capital for a temporary period as a response to the development of credit growth. In this way, the banks would build up the necessary reserves during a phase of strong credit growth to deal with the significant impairments that would affect their loans in a subsequent economic downturn. Consequently, the countercyclical buffer would have the effect of counteracting the pro-cyclical behaviour of financial market participants, thereby limiting the build-up of systemic risks in the financial sector. Furthermore, the countercyclical buffer is a core component of the Basel III framework. Its introduction in Switzerland would therefore correspond to the international regulatory standards.

The countercyclical buffer would be activated only if excessive growth in the Swiss credit market posed a threat to financial stability. The greater the threat, the higher the buffer, and the shorter the deadline set for the banks to build up the necessary capital. Ideally, the countercyclical buffer would be activated and then rescinded on the basis of a straightforward rule. As with fiscal and monetary policy, the establishment of a binding rule can strengthen both transparency and credibility. However, in fiscal and monetary policy too, the complexity of economic developments requires a degree of discretionary freedom of manoeuvre for decision-makers if they are to reach the right decisions in individual cases. Likewise, the deployment of the countercyclical buffer would not work without a certain degree of freedom of manoeuvre for the decision-making parties, as to base such a concept on purely quantitative criteria would be to fail to acknowledge the multifaceted transmission mechanisms of the credit market and uncertainty in the identification of systemic risks in the financial sector. Furthermore, experience in the use of countercyclical macroprudential instruments is limited, particularly with respect to their effect in highly-developed financial markets like that of Switzerland.[20]

Even though the use of quantitative criteria alone is not ideal for the deployment of the countercyclical buffer, economic indicators nonetheless form a basis for decision-making when it comes to activating the buffer. In an initial step, a selection of essentially quantitative indicators is evaluated on a systematic basis. The degree of systematic risk results from the overall picture provided by these indicators. In a second step, other supplementary

[20] Cf. Bank for International Settlements (2010), CGFS Papers, No. 38, Macroprudential instruments and frameworks: a stocktaking of issues and experiences.

quantitative indicators as well as qualitative information are brought into the process: these allow an insight to be gained into specific risks, according to the nature of developments in the credit markets. The overall picture results in a comprehensive evaluation of potential threats to financial stability, on the basis of which the decision to activate the countercyclical buffer may be made.

Current developments in the Swiss mortgage and real estate market suggest that recourse to the countercyclical buffer could well be required even before the entry into force of the Basel III reform on 1 January 2013. Such a step would represent an effective supplement to the announced adjustment to risk weightings in residential mortgage lending limits (cf. section 4.3).

4.3 Increased requirements for the capital underpinning mortgage lending

The current guidelines that apply to the capital required to underpin mortgage lending only reflect the underlying risks in a rudimentary way. As a result of the great significance of the mortgage market in Switzerland and the high level of mortgage indebtedness of Swiss households by international standards, the appropriate containment of risks in this area is crucial for financial stability. A combination of the current low interest rate phase and expansionary monetary policy on the part of the SNB – aimed at limiting the overvaluation of the franc – has provided an additional boost to credit lending in Switzerland. The intense competition in the Swiss mortgage market is putting additional pressure on market participants when it comes to defining affordability and lending limits, which in turn is leading to the assumption of higher risks. In response, on 17 August 2011, the Federal Council drew up the guidelines for a risk-adjusted increase in the capital required to underpin mortgage lending.

As set out in section 3.3, an adjustment of risk weightings can have a structural impact on the diversification and the level of risks in the financial system. The working group therefore believes that capital requirements which are more closely tailored to the prevailing risks would represent an effective macroprudential instrument. The proposals to redesign risk weightings are in line with this approach and envisage a refined differentiation of mortgage lending in keeping with lending limits and affordability.[21] Should excessive credit growth nonetheless manifest itself in Switzerland, despite the more stringent capital requirement, the impact of this instrument could be strengthened in a timely and expedient way through the temporary activation of the countercyclical buffer.

[21] Cf. CAO hearing draft of 18 November 2011.