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The Case for More and Higher Quality Capital

Ladies and Gentlemen,

The current debates around bank regulation tend to centre on questions of capital. How much more? By when? What type? Is it fair that somewhere else they are asking for less?

As a cautionary remark, I would first point out that we should not let all the talk about capital distract us from the real risks to the financial system which cannot be addressed that way.

Liquidity risk is more often the cause of bank failure than insolvency, and although we modernized last year our liquidity regime for UBS and Credit Suisse, our other banks are measured against quite out-dated regulatory standards.

As Patrick Raaflaub just pointed out, interest rate risk in the so-called "banking book" has no automatic capital underpinning at all.

And the legal and compliance risks faced especially by banks operating internationally across borders cannot be addressed by increasing capital.

For Swiss banks, today's world of abundant liquidity alongside a rate environment that could rapidly change, plus of course the changing nature of cross-border private banking, pose challenges that mean we tackle multiple issues at once.

That said, regulatory capital will always be the centrepiece of bank regulation and the current financial crisis has taught us that we have three problems, and therefore three calls to action:

- capital charges for many types of trading activities have been way too low;
- minimum levels of capital required for large international banks are insufficient;
- today's non-equity capital instruments, like hybrid capital, do not work as safety buffers.

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The international response is Basel III. The add-on to deal with the specific Swiss situation of having two of the largest international investment banking groups based in a small economy – the "too big to fail" problem – is contained in the legislation about to begin its parliamentary process. I will spend most of my time today talking about the reasons behind these two capital concepts, their consequences, and why they are a necessary and proportionate response to what we have experienced.

But before looking at the details, it is worth reminding ourselves of the function of capital in the banking system.

Banks and other capital market players are the transmission mechanism between macro-economic and monetary conditions on the one hand, and investors and users of credit on the other. Without the judicious build-up of risk in bank balance sheets, transforming, for example, short-term deposits into longer-term credit, there would be no financial engine supporting economic growth. Banks are in the business of taking risk, but because of this so-called maturity transformation, they depend like no other type of industry on the confidence of their depositors and other funders. Shoring up that confidence is only one thing: **capital**. When that capital is consumed, or when confidence in the adequacy of that capital fails, liquidity shortages can kill a bank within weeks or even days.

There is an implied social contract that allows banks to take risk and earn money from that risk-taking as long as they keep the growth engine of the real economy fuelled. The other signatory of that contract is the government, and so it is easy to understand that, if the capital buffers of important banks fail and liquidity dries up, then with the absence of credible resolution arrangements, the state is almost compelled to act.

The current crisis is just the latest reminder that this is not just academic theory, but the painful truth.

You will notice that I refer to the current crisis. That is because I see no real reason to refer to it in the past tense. We may be experiencing a period of relative calm in the markets, but beneath the surface the currents are fast and potentially dangerous. Indeed, governments around the world did stand in front of their banking systems and absorbed much of the financial damage from the first rapid wave of deleveraging. But that has consequences: a flood of cheap money on the one hand, and on the other hand sovereigns either seriously weakened themselves, or at best with little ammunition left in the locker.

The loose money policies around the world have driven widespread asset price increases: safer assets just do not pay, so global equity markets have almost doubled in the last two years, oil has more than doubled, high-yield credit and leverage finance markets are overheating again, and emerging markets have sucked in vast quantities of fast money that can leave as quickly as it arrived. And if you want a much more local example, there is no rational reason why the hotspots in the Swiss real estate market should not continue to get hotter.

With the inflation genie at least straining to get out of the bottle, the danger of discontinuous changes in some of these markets is high.

That is why our message to the large banks is not just: please start to think about how you will meet the new capital standards by 2019, it is "the faster the better".

You may ask why there is any need to act, given the high capital ratios published by our large banks. The answer lies in what is behind those ratios, and how that corresponds to our three calls to action I mentioned earlier: corrections to capital charges, higher minimum requirements, better quality capital instruments.

First, as with all other investment banks, the capital charges for many traded instruments have been simply too low. The so-called Basel 2.5, which we introduced here at the beginning of this year, one year ahead of the international timetable, fixes some of the obvious gaps in the capital charges for instruments whose risk is measured by the statistical “Value at Risk” method, and for securitization products. That has raised total group capital requirements for UBS and Credit Suisse by some 20-30%. Basel III will extend that impact to other insufficiently capitalized risks, such as the risk of counterparties to derivative trades defaulting on their obligations. That should add again around a third to their group totals. More specifically, the capital charges for market risk alone will rise by a multiple of some five to seven times.

That magnitude of changes will force a rethink. Some lines of business may be too expensive in capital terms to be attractive for major banks to pursue in future. That is not an unintended consequence, it is a desired effect.

Second, the minimum quantity of capital. Here Switzerland has traditionally been strong. There has for decades been some kind of “Swiss finish” in place, from the flat 20% surcharge applied to all banks, to the 100% buffer demanded of the large banks in the new capital regime of November 2008. In fact the Swiss tradition has always been to trade-off a relatively light-touch approach to bank regulation in general, with higher capital standards. You will not find here the thousands of pages of rule-making that you can find in say the Dodd-Frank Act in the US to pick just one example.

But in exactly that regime of November 2008 lies also a weakness of the current Swiss system. It expanded the amount of capital that could be held in so-called hybrid instruments significantly beyond the international standards, at just the time when these instruments were proving to be impractical as loss-absorbers in times of crisis. So our large banks do indeed have above the international average levels of capital today, but with lower than the average quality.

That is why the core of the “too big to fail” package’s capital requirement is the need to keep 10% of risk-weighted assets in pure equity – basically paid-in capital plus retained earnings. Together with the strict leverage ratio requirements foreseen in Basel III the amount of top quality capital required will be many times higher than under the previous framework.

We often hear the concern that the international consensus will not follow that lead and will require significantly less capital than Switzerland for large banks, the so-called SIFIs: systemically important financial institutions. All I can say, from what I experience as a member of the Basel Committee is that this is not currently the case. While complete unanimity in a diverse group of 27 nations is impossible, the proposals of the Committee for a SIFI top-up above the 7% equity requirement of Basel III are supportive of a significant surcharge, not just a token amount. In short, the international consensus is hardening, not softening.

Several of my colleagues on the Basel Committee have referred to the Swiss proposals as a "source of inspiration". There is no doubt that in tackling these problems fast, Switzerland has secured a leadership position in the international debate which gives the country a respected voice with disproportionate weight to the size of the country.

That brings us to the third of the calls to action: improving the quality of capital instruments, and again an area where Switzerland has become a trailblazer – the so-called CoCos.

The first thing to say about these kind of contingent instruments is that they are no substitute for equity. They should only take their place as additional shock-absorbers on top of a substantial cushion of pure equity. That said, they are a significant improvement on previous hybrid and subordinated debt capital instruments as with conversion triggers based on both capital ratios and regulatory discretion in case of non-viability; there is no doubt that they will bring their private sector holders into the recovery and resolution process of the respective bank before the state.

What Credit Suisse has gone some way to proving is that there is a market for such instruments. One interesting feature of that market is that it will also distinguish between the quality of regulatory regimes and supervisors. We hear from the market that the success of the Credit Suisse issue was also based on a perception that the Swiss authorities are likely to act responsibly and predictably in difficult times. CoCos issued by banks with less trusted supervisors could be harder to sell at a reasonable price. We have to live up to that implicit trust placed in us.

That is a brief summary of how we are responding to the three calls to action. What about the consequences?

Firstly, the business mix of large investment banks will change. That is to be welcomed.

We also hear a lot about business migrating across jurisdictions. With such significant changes to the regulatory landscape that is probably also to be expected. Trading business in particular is very mobile, has always moved from place to place and always will. Historically, for example, Switzerland was once one of the most important homes for gold trading and had a thriving bond market; now it is one of the world's biggest commodity trading hubs.

Switzerland is not the most logical place from which to conduct international trading or derivatives activities, and indeed there is little such activity based here if you judge by the number of people employed. Of course what we do have is two groups *headquartered* here with very substantial activities located overseas. If that activity is well-controlled, well-capitalized and not directly and irreversibly entwined with the balance sheet of the Swiss banking business itself, then we have no problem with that set-up.

Our responsibility is to set appropriate conditions for banking activities in this country and groups headquartered here, and make them transparent and predictable. The responsibility of business leaders is to assess their options, and take the big decisions in the best interests principally of their shareholders.

Touching briefly on the capitalization of the rest of the Swiss banking landscape, it is little affected by our three calls to action. There are little of the traded instruments on the books that were so wrongly capitalized under Basel II, and the system as a whole is well-capitalized with good quality capital. That is why our upcoming Circular relating to the capitalization of these banks sets a floor for appropriate capitalization which is well below where today's banks lie on average, but also distinguishes in that population between the big domestic players and the small boutiques.

To conclude, reinforcing capital and decreasing leverage are the obvious lessons from the current crisis, and they can only help us with the next one, from wherever that may come. History tells us that banking crises are almost always based on lending too much, too cheap, to the wrong people. Globalized capital markets have brought much good to the world, but have multiplied the ways to spark those crises. For several decades we believed that the greater sophistication of risk management techniques allowed us to tolerate thinner capital cushions. We were wrong.

Basel II pulled capital out of the major banks at just the moment it was most needed. Basel III and the add-on regimes for systemically important banks correct that – an overreaction they are not.