Bank of England

A Small Open Economy with a Large Banking Sector: Opportunities and Perils

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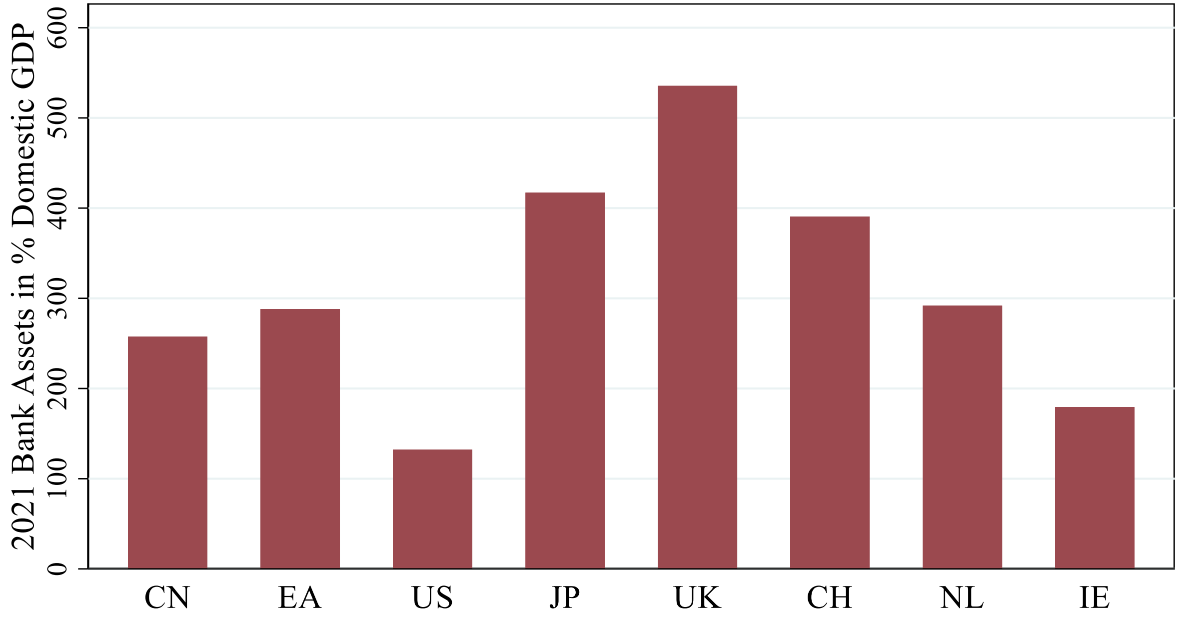
Swiss banking system double-edged sword

- ***Shouldn't lose sight of advantages of a well-developed banking system:***
  - Financial development, sound institutional and legal infrastructure associated with stronger growth (e.g., King and Levine 1993, Beck et al. 2010)
  - Swiss banking sector makes a considerable contribution to the economy – average contribution over 2017 to 2022 nearly 6% of gross value added (Scope Ratings 2023)

- ***Yet, financial stability risks can rise with banking system size*** *(Cecchetti and Kharroubi 2012, Aracand et al. 2015, Kakes and Nijkins 2018)**:***
  - GFC painful demonstration of the costs of TBTF in SOEs with large banking sectors (e.g., Iceland, Switzerland, etc)
  - Switzerland has a safe haven status, which creates separate risks

Bank assets as % of GDP



Source: FSB Global Monitoring Report on Non-Bank Financial Intermediation December 2022

Failure of Credit Suisse biggest test since GFC

Deficiencies in Bank Regs and TBTF motivated many post-GFC reforms

- ❑ Basel III capital, liquidity and leverage rules among other changes
- ❑ GSIB and DSIB regimes
- ❑ Key attributes of effective resolution regimes for financial institutions
- ❑ Bail-in debt
- ❑ Increased cross-border cooperation

✓ Not perfect, but on stronger footing to deal with shocks experienced than when the GFC hit

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Response to CS merits overall passing grade to date

- ❑ The rescue of CS successfully stabilized the situation
  - depositors and other customers could access vital services
  - few spill overs domestically or internationally
- ❑ Cross-border supervisory coordination worked well
  - The Core College and Crisis Management Group met regularly (CS had 3 subsidiaries and branch in the UK)
- ❑ Failure was addressed by shareholders and bond holders taking losses while the firm was sold to UBS
  - some risk to public funds from the transaction, and these have declined over time
- ❑ Ultimate success depends on how well UBS integrates CS
  - This includes how successful they are in strengthening CS's management and risk culture

Issue 1: Resolution regime set out in the post crisis reform is still untested

- ***Swiss authorities' actions solved the problem today***
  - But that same solution may not be possible in the future (UBS is only remaining Swiss GSIB)

- ***The Swiss solution raised questions about their (and by extension, other jurisdiction's) approach to:***
  - The creditor hierarchy, and
  - Resolvability

- ***Swiss government's expert group and FSB post mortem points to:***
  - Closing gaps in the SNB's ability to provide public liquidity backstops
  - Enhancing the degree of strategic optionality for the resolution authority, and working through any possible legal risks (e.g., with the bail-in process)
  - Enhancing cross-border communication and cooperation between the CMG and Core College.

Issue 2: Supervisory powers and approach need more teeth

- ***Supervisory approach/toolkit to deal with long-running management and risk cultural problem***
  - Not uniquely a CS issue, but root of ultimate loss of confidence

- ***Examples of tools that might have been used more extensively on CS Group could include:***
  - Senior managers regime
  - Powers to impose fines
  - Requiring firms to hold additional capital as a mitigant where they are found to have poor risk management and governance, and to provide financial incentive to remediate.
  - Dual supervisory model – FINMA's supervisory model currently places a significant reliance on audit companies to conduct regulatory reviews on FINMA's behalf

- ***Wider lessons for supervisors beyond FINMA too***, to reflect on the need to intervene early and confidently on firms where deep-seated cultural problems exist that can be slow to turn around

Issue 3: “Safe openness” may not be enough

- ***Building a resilient banking sector reduces the risk that comes with a large banking sector, and risks to the taxpayers***
- ***But, shouldn’t expect zero risk to the taxpayer in all cases, especially when dealing with SIBs***
  - At a minimum, some form of CB liquidity will likely be required - these facilities should be designed to limit risk and encourage use (CS had about CHF 40bn of borrowing capacity from pre-positioned collateral going into its stress. The problem was the willingness to draw on this)
- ***Means Governments of SOEs with large banking systems should maintain considerable fiscal space***
- ***For Switzerland, it’s even more complex because of safe haven flows and implications for the franc that can affect macroeconomic stability***
  - The post GFC challenges for monetary policy, exacerbated by the ZLB on interest rates and capital inflows, are a case in point
  - There are a range of tools that can be brought to bear by CBs (e.g., QE, NIP, FX intervention, etc)
  - Still, there remain important questions about how monetary and fiscal authorities should coordinate to respond to shocks, with implications for CB independence and political considerations (not unique to Switzerland)

Thank you