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Introductory remarks by Thomas Jordan

Introduction

Tension in the global financial markets began to abate this spring, and has continued to do so ever since – though despite all the talk of recovery, they are still far below their pre-crisis levels. Whereas initial price rises were mostly corrections of previous excessive falls, markets are currently being driven mainly by the improving economic outlook, by companies' predominantly positive earnings reports and by expansionary monetary and fiscal policies. However, there is still considerable uncertainty in the financial markets.

In the course of the crisis the Swiss National Bank aggressively relaxed its monetary restraints, sometimes treading new paths in the implementation of monetary policy. I shall now briefly summarise the instruments that we used in connection with the financial crisis, highlighting their effects on the SNB's balance sheet. The risks that exist in the SNB's balance sheet or that the SNB could potentially be required to take onto the balance sheet demonstrate the importance of strengthening our equity capital. I shall therefore, as already indicated by the Chairman of the Governing Board, Jean-Pierre Roth, briefly explain to you the new regulations governing our policy on provisions. One of these monetary policy crisis measures is the SNB's stabilisation fund (StabFund), which I shall deal with later. I shall conclude my remarks by commenting on a change in the terms of admission to the Swiss franc repo system.

Deployment of monetary policy instruments in the crisis and trends in the SNB balance sheet

From October 2008 to March 2009 we carried out a massive reduction in the Libor target range in several steps. The most important instruments for expanding liquidity during this phase were repo transactions and currency swaps. Since the reduction of the repo rate to 5 basis points in December 2008, we have been pursuing a *de facto* zero interest rate policy. Beginning in October 2008, the heavy foreign demand for Swiss francs was influencing the level of the Libor – and this made it necessary to conduct Swiss franc/euro currency swaps. Swap agreements with other central banks gave more foreign banks access to Swiss francs, thus bringing the Libor down faster.

As of March 2009, in order to loosen the monetary reins further when there was no more room for interest rate reductions, we adopted so-called unconventional measures. These took two forms: intervention in the foreign exchange market and purchases of bonds issued by domestic borrowers. In addition we concluded long-term repo transactions with terms of up to 12 months. So far the measures we have taken have achieved the objectives we set ourselves. The three-month Libor has been close to our target range of 25 basis points since the middle of September. Foreign currency purchases prevented the Swiss franc from rising against the euro, and in addition the exchange rate of the euro against the Swiss franc has been significantly less volatile. Chart 1 shows the substantial increase in our holdings of foreign exchange reserves as a result of the interventions. Positive conclusions can also be drawn with regard to the bond purchases, which helped to reduce risk premia in the Swiss capital market. To date, bond purchases have totalled around CHF 3 billion. However, we have hardly made any purchases since mid-September due to the substantial improvement on the Swiss franc bond market.

These measures were accompanied by a substantial expansion of the balance sheet (charts 1 and 2): from around CHF 110 billion before the crisis, the SNB's total assets reached a peak of CHF 245 billion in April of this year. The figure then began to decline, reaching around CHF 210 billion in November. On the asset side of the balance sheet, the fall in foreign currency swaps was mainly responsible for this drop. On the liabilities side, the domestic banks' sight deposits played the most important role. These have fallen from a weekly peak of CHF 81 billion at the end of April to CHF 47 billion at the end of November. However, liquidity in the banking system is still very high. Before the crisis, sight deposits amounted to an average of some CHF 5 billion only.

The use of unconventional measures has also changed the nature of part of the liquidity created. Liquidity resulting from repos and currency swaps is temporary: it flows back automatically when the transactions are not renewed. Liquidity created by acquiring foreign exchange and Swiss franc bonds, conversely, is permanent. We expect to keep the foreign exchange and bonds we have purchased on the SNB's balance sheet for an extended period. As part of the impending normalisation of monetary policy, SNB Bills – introduced a year ago – will therefore play a central role. Liquidity absorption will mainly be conducted through the issuance of SNB Bills. Consequently, part of the balance sheet will in future be funded with interest-bearing debt capital. Moreover, the expansion of the balance sheet will substantially increase the SNB's credit and currency risks.

Strengthening the SNB's provisions

The financial crisis has highlighted how important it is for the SNB to have a solid equity capital buffer. Without it, the SNB would be unable to carry the risks on its currency reserves internally – nor would it be in a position to take the measures to stabilise the financial system that proved essential in the financial crisis. Equity capital, furthermore, is central to the independence and credibility of the SNB.

In spite of the extensive crisis measures we have taken, the SNB's balance sheet is as robust as ever – though its financial stress resistance is heavily dependent on the distribution reserve, which is high at present. Like the provisions, this forms part of the SNB's equity capital. In the short term it helps to absorb any losses, while in the longer term it is transferred to the Confederation and the cantons as a distribution of profits. If it were not for the distribution reserve, the SNB's resilience could only be guaranteed to a limited degree. There are two reasons for this: for one thing, a need for measures to safeguard the system could arise unexpectedly, greatly increasing the risks faced by the SNB suddenly; and for another, these risks are significantly higher because of the permanently expanded balance sheet.

The SNB has therefore decided to additionally strengthen its equity capital, and thus its balance sheet. The SNB's ability in the long term to respond to a crisis must not be dependent on the distribution reserve. This is only possible if the SNB increases its provisions from their current level. In the past, it increased its provisions each year at a rate equal to average nominal GDP growth for the previous five years. The SNB now intends to double this allocation in financial years 2009–2013: instead of approximately CHF 1.5 billion, some CHF 3.0 billion will now be allocated to provisions in 2009.

Strengthening provisions will reduce the potential for future profit distributions to the Confederation and the cantons. On a current view, however, the annual profit distribution of CHF 2.5 billion can be expected to be maintained until 2017, when the current agreement on profit distribution lapses. This view is substantiated, in particular, by the fact that the distribution reserve will increase considerably as a result of the profit expected for the year 2009. A collapse in the gold price or heavy currency losses by the SNB, however, would increase the risk that the profit distribution would have to be adjusted before 2017. The SNB has been pointing out this risk for some considerable time, regardless of the current plan to strengthen its provisions.

The SNB StabFund

It is just over a year since the package of measures to support UBS was announced. Over that period, the risks in the SNB StabFund have been significantly reduced. Two key indicators are in the spotlight: the amount of the SNB's loan to the StabFund, and the SNB's overall risk exposure, including non-funded assets.

The StabFund took over assets of USD 38.6 billion as of 30 September 2008. Of that total, USD 8.8 billion consisted of contingent liabilities that did not need to be funded at the time. The remainder was funded with the equity capital paid in by UBS (10% of total assets, i.e. USD 3.9 billion) and the debt capital advanced by the SNB, which thus initially amounted to USD 25.8 billion. Risk exposure for the SNB, i.e. the total portfolio less the equity capital, was thus equal to USD 34.7 billion as at end-September 2008.

The SNB's loan to the StabFund stood at USD 20.8 billion at end-October 2009, a reduction of USD 5 billion – almost one-fifth – on the initial figure. The funds to repay the loan came from repayments and earnings on the assets, and from proceeds of asset sales. The StabFund came to the market for the first time in June 2009. The market's more positive performance made it possible for occasional sales to a total value of USD 1.5 billion to be conducted by the end of October 2009.

Contingent liabilities declined by USD 4.7 billion, mainly as credit default swaps (CDS) expired or were prematurely terminated. At the end of November 2009, non-funded assets totalled USD 4.1 billion. Total risk exposure fell by USD 10.2 billion to USD 24.5 billion. Changes in the SNB's risk exposure with respect to the StabFund are summarised in table 1.

One effect of the recovery in the financial markets that began this spring was to trigger rises in the market values of most of the investment categories held in the StabFund. This development, together with the results of a comprehensive cash flow projection for the entire portfolio, confirm the SNB in its view that it has unimpaired prospects of receiving repayment of the loan in full. However, these calculations are bedevilled by great uncertainty – and the risk to the SNB remains substantial.

As the StabFund values much of its portfolio at amortised cost, the recovery in the financial markets has only modest effects on its financial reporting. The cumulated loss at the end of the third quarter (since 1 October 2008) was USD 4.4 billion. Equity capital reported thus remains negative, though this loss was entirely covered at the time by the secondary loss protection – the warrant for the purchase of 100 million UBS shares at nominal value.

By the end of the StabFund's first financial year it will have largely completed the build-up of its operating activities. In the last few months, following the asset transfer phase between December 2008 and April 2009, the asset management process was set up, risk monitoring and financial reporting expanded, and an internal control system and operational risk management introduced. These processes will be further improved next year, with asset management taking on a key role. While the intrinsic values of the assets represent a key element in managing the portfolio, the process must not be merely mechanistic. Now that it has been possible to sell off some of the more liquid assets over the last few months, attention will focus more closely on two tasks: minimising the larger concentration risks, and ensuring that – as the portfolio is disposed of – the best possible equilibrium is maintained in various respects, including the degree of liquidity of its holdings.

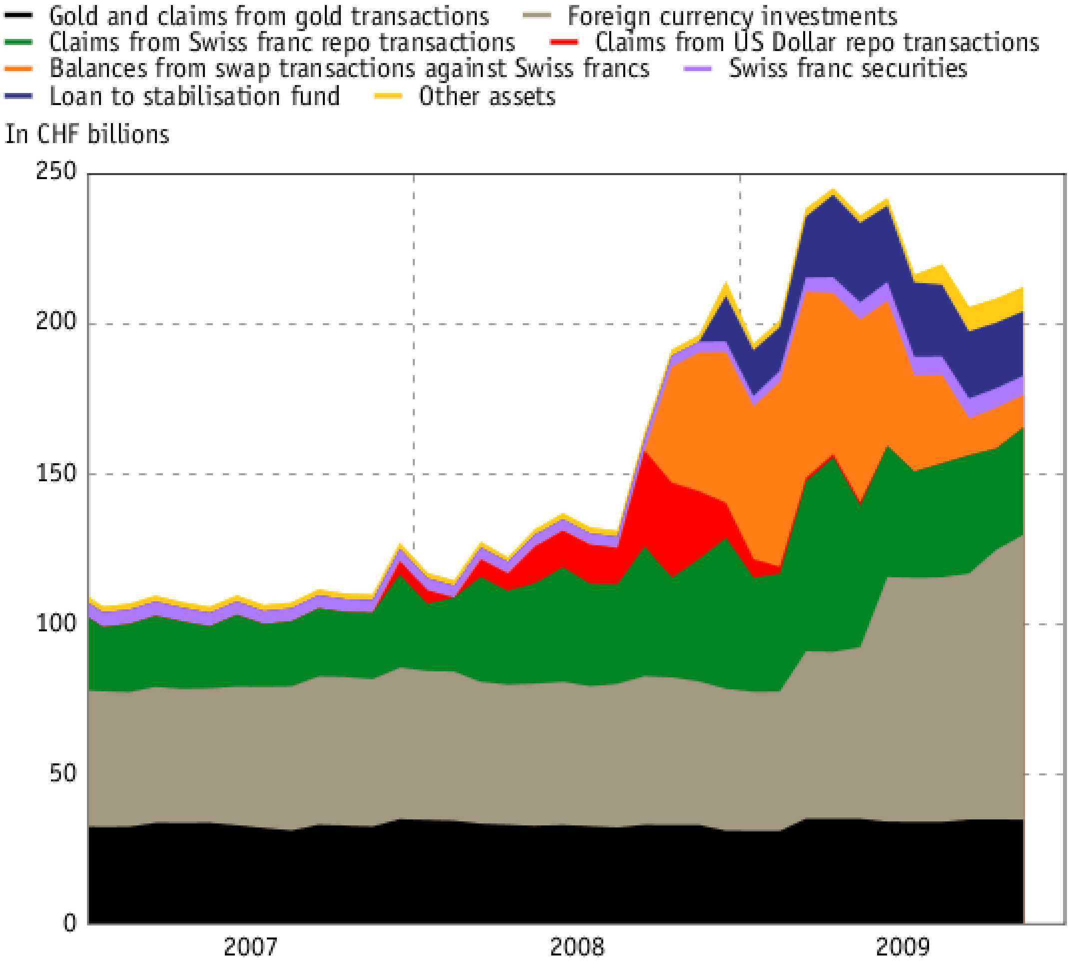
Broadening participation in the Swiss franc repo market

The unsecured money market collapsed when the financial crisis broke out in August 2007 and it has not properly recovered to this day. The repo market, conversely, in which money is lent against securities, has emerged as a crisis-resistant mainstay of the financial system. The efficient Swiss repo system – through which the SNB conducts its normal monetary policy transactions – has proved to be especially robust.

The SNB depends on a liquid Swiss franc money market for the efficient implementation of its monetary policy. This is why, in addition to domestic banks, foreign banks were admitted to the Swiss franc repo market as long as ten years ago. From 2010, the SNB will open the repo market to financial market participants in Switzerland (including Liechtenstein) that do not enjoy the status of banks. However, these new participants will have to be supervised by FINMA (or the regulatory authorities in Liechtenstein), and they must be genuinely active in the Swiss franc money market. Furthermore, they will have to guarantee that business will be transacted in a professional manner. The initial candidates are likely to be insurance companies with significant treasury activities in Swiss francs, and possibly managers of Swiss franc money market funds. In expanding participation in the repo market, the SNB is seeking to further increase the liquidity of the Swiss franc repo market. In this way we plan to further promote the secured money market and increase the stability and crisis resistance of the financial system.

Chart 1. SNB Balance sheet, assets

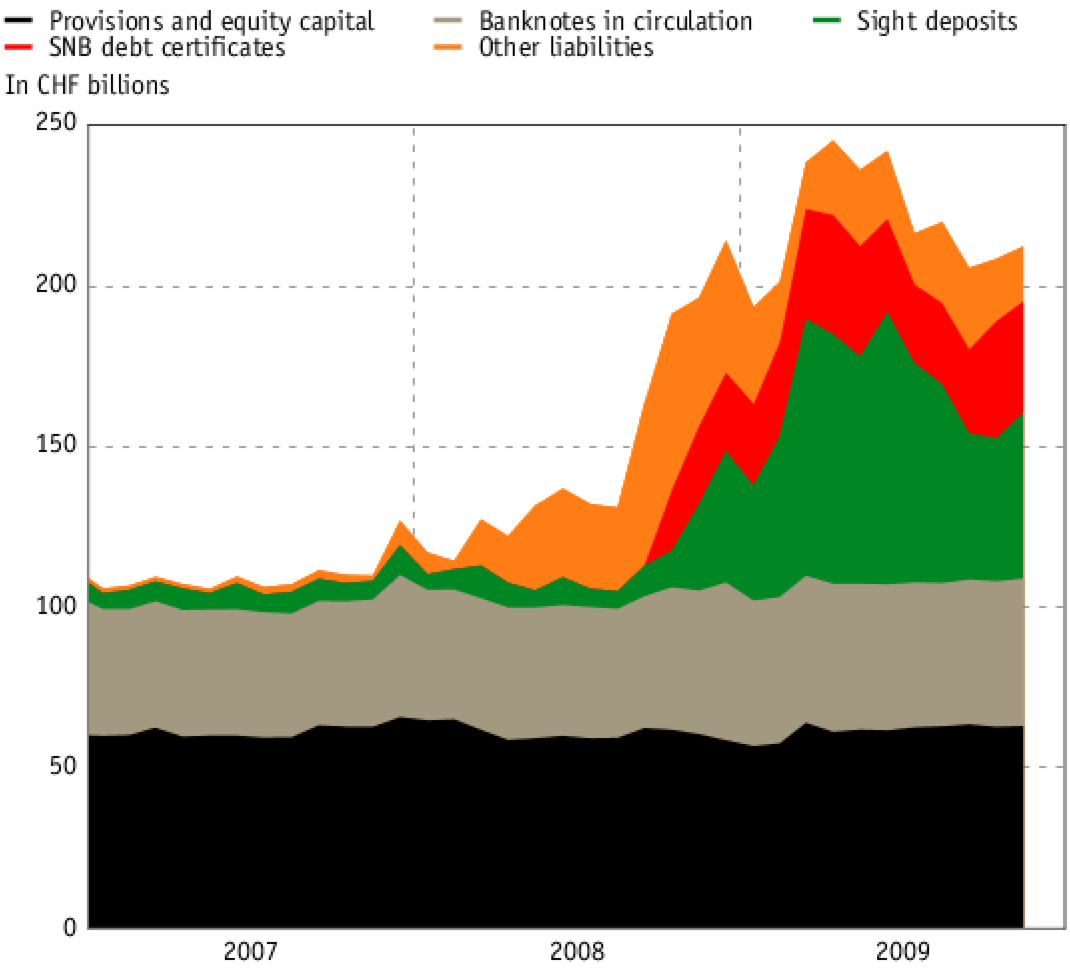
As per end of November 2009



Source: SNB

Chart 2. SNB Balance sheet, liabilities

As per end of November 2009



Source: SNB

Table 1. StabFund: Loan balance and lender exposure

In USD billion	Funded	Unfunded	Total risk
Assets	29.7	8.8	38.6
Equity contribution	-3.9		-3.9
Balance as at 30 September 2008	25.8	8.8	34.7
Interest on SNB loan	0.5		0.5
Sales	-1.5		-1.5
Repayments	-4.5	-0.2	-4.8
Interest income	-1,9		-1.9
Other	2.0	-4.5	-2.5
Balance as at 31 October 2009*	20.4*	4.1	24.5

* Corresponds to the SNB loan minus the liquid funds in the StabFund.