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Global credit crisis – consequences for banking supervision

Investment banks as (main) drivers and main victims of the crisis

The causes and impact of the credit crisis driven by the US subprime retail mortgage sector have already been described and analysed in detail many times. In summary I refer to only one of these, the soon-to-be-published report of the Financial Stability Forum. Philipp Hildebrand, Vice-Chairman of the Governing Board of the Swiss National Bank (SNB), was actively involved in the Forum's working group[1]. I would just like to highlight some important points from the perspective of the Swiss Federal Banking Commission (SFBC):

- Not for the first time in the history of the financial markets, the current crisis originated from a **speculative bubble in the real estate sector**, this time in the US. In such boom times, the due diligence standards for the granting of loans are usually relaxed or just simply ignored. The Swiss banking sector saw the same thing happening not too long ago, when the losses on domestic loans **in the 1990s** reached between 50 and 60 billion francs as a result of the real estate speculation in the second half of the 1980s. In the US, however, the problems were exacerbated by the fact that the majority of the subprime loans were granted or negotiated by unregulated or hardly regulated non-banks.

- In our globalised world the crisis did not remain contained in the US. For this we can thank the **investment banks**, which also include the relevant business divisions of our two large banks UBS and Credit Suisse. Although the investment banks did not grant the subprime mortgages themselves, they bought up these loans, transferred them to special-purpose entities, tranched them into differently ranked loan notes, sometimes even securitised and sliced them up a second time (resecuritisation through collateralised debt obligations (CDOs) on asset-backed securities (ABS) and sold them to profit-greedy institutional investors, hedge funds and banks within and outside the US with the support of the rating agencies who handed out top rat-

[1] Financial Stability Forum, Working Group on Market and Institutional Resilience.

ings. With the help of the **securitisation process** used by the investment banks – which involved not only subprime mortgages but also alt-A and prime retail mortgages, commercial mortgages, student loans, car loans and credit card advances – the US exported and **globalised** its credit bubble. The only good news for the Swiss banking sector is that, apart from the two large banks, none of our medium-sized or small banks invested directly in these structured credit products, although a few of their investment funds might be affected by the crisis.

- The new business model adopted by the investment banks – **originate to distribute**[2] instead of the traditional practice of holding a loan on the bank's balance sheet until maturity – was designed to better divide the risk among those investors who were willing to go along and who were best able to bear the risk. The dispersion of credit risk was meant to lessen the burden of the banks, strengthen the financial system by improving risk diversification and tradability, and drive economic growth with innovative products and wide-spread distribution. However, the undeniable theoretic advantages of this business model were perverted into their opposite by the liquidity crisis and the crisis of confidence on the capital markets. The **risk** is again or still almost exclusively **concentrated in the banking system, and mainly with the investment banks.** Securitised assets ready for sale gathered dust in the banks' warehouses or were held in the trading book. Loan-financed takeovers of companies (leveraged buy-outs, syndicated finance) could no longer be placed with other investors. For reasons of reputation or due to legal obligations, off-balance sheet vehicles such as structured investment vehicles (SIV) or conduits for asset-backed commercial paper had to be returned to the banks' balance sheets; the large Swiss banks, however, are hardly affected by such off-balance sheet vehicles. Protection bought for securitised assets or bonds became ineffecitve as the bond insurers (monoline insurers) lost their top-ratings; the insured banks are now even expected to help recapitalise the monoline insurers. As is usual in the US, the banks are also confronted by claims for damages from clients and shareholders. However, the biggest risks and write-downs were incurred by some investment banks, including UBS, on the uppermost tranches of resecuritised paper, the so-called super senior CDOs, deliberately retained on their balance sheets. These complex securities were regarded as particularly safe investments before the crisis, as they are serviced before all other categories of paper, even paper that had already been rated AAA by the rating agencies. As the default risk on this paper was allegedly very small, it earned only a moderate rate of interest and was not very attractive to third-party investors. The issuing bank therefore had to keep this paper itself if it wanted to profitably sell the lower categories of paper that earned more interest. **The main victims of the crisis** are therefore without a doubt the **investment banks and their shareholders**.

- The crisis was not triggered by the **hedge funds**, which until recently mostly managed to stay out of the firing line with surprising success. The main problem did not lie with these funds, but rather in the heart of the regulated banking sector and with the most sophisticated market players. The SFBC therefore does not find it necessary to change its arguments regarding hedge funds presented in its position paper

[2] see SFBC Annual Report 2007 (German version), page 98.

of September 2007[3]. This applies in particular to the indirect supervision approach, which emphasises the supervision of the interfaces to the hedge funds, the (large) banks. When downward pressure on the financial markets is forcing hedge funds to reduce their level of debt, it also impacts their prime brokerage counterparties, i.e. the investment banks.

Why did the supervisory authorities fail to prevent the crisis?

The supervisory authorities and central banks did in fact issue more than one warning about the speculative bubble on the financial markets, the too low risk premiums, the unpredictable conduct and feedback mechanism of complex financial instruments under stress, as well as the consequences of a sudden shortage of liquidity on the capital markets. The Basel Committee on Banking Supervision correctly identified the weaknesses of the "originate-to-distribute" business model shortly before the crisis struck. However, it was already too late to react, and under the impression of the debate on overregulation some regulatory projects initiated earlier were relatively slow[4]. The entire supervisory community, including the SFBC, was taken by surprise by the issue that triggered the crisis – the subprime mortgages – as well as the scope of the problem and the speed with which things worsened. The supervisory authorities are not responsible for the crisis, but unfortunately we also did not prevent it. There are several explanations for this which at the same time can also serve as an answer to the criticism levelled against the SFBC and its supervision of the large banks in Switzerland.

- The globally active **investment banks** handled the crisis **very differently** . The Senior Supervisors Group set up by the supervisory authorities of five countries (US, UK, Switzerland, Germany and France) investigated the reasons for the success or failure of the risk management practices of 11 investment banks under their supervision and published an anonymised report[5]. The strengths and weaknesses of the investigated banks were divided quite evenly between the supervisory authorities and countries involved, and apparently have little to do with the quality of the supervision. This also applies to the SFBC, where UBS and Credit Suisse differ substantially as regards risk exposure and the mistakes in risk management in the time leading up to the crisis, although both are supervised by the SFBC in the same manner and using the same resources in terms of quality and quantity. It is clearly also not connected to the size of the supervisory authority; the SFBC did not fare better or worse than its much larger Anglo-Saxon sisters. Cynics could conclude from this that the influence of the supervisory authorities was negligible and that everything depended on whether the bank in question applied skill, prudence and intuition in its handling of the risks and also had some luck. However, without supervision the investment banks would certainly have taken even greater risks and would have had an even thinner capital base.

[3] SFBC Annual Report 2007 (German version), p. 74 et seq.

[4] SFBC Annual Report 2007 (German version), p. 21et seq.

[5] Senior Supervisors Group, Observations on Risk Management Practices during the Recent Market Turbulence. See http://www.ebk.admin.ch/e/aktuell/, article of 03/06/2006.

- Our two large banks also did not suffer from a lack of **international cooperation** between the most important investment banking supervisory authorities. The ever closer **trilateral cooperation** developed over many years between the SFBC as the parent supervisory authority in the country of origin and its main partners in the US (Federal Reserve Bank of New York) and the UK (Financial Services Authority) is regarded as a showcase model worldwide and is absolutely vital for our supervision of the investment banking business mainly managed out of these two host countries. We coordinate our control activities, have access to the same information on the banks, continuously exchange information and also receive a benchmark from our colleagues regarding other institutions active in their markets.

- The SFBC department responsible for the large banks regularly discussed their exposure to the US real estate market with UBS and Credit Suisse, and in the winter of 2006/2007 also used publicly accessible sources to **investigate and report on the risks associated with subprime mortgages**. At the beginning of March 2007, UBS reassuringly answered the SFBC's question regarding its exposure to the risks of the subprime market by stating that the investment bank is fully hedged, yes, even overhedged (short). This answer subsequently proved to be wrong, because UBS did not correctly capture its actual risk exposure and seriously overestimated its hedges. With hindsight it becomes clear that it would have been worthwhile to investigate this answer and to request a report on the exact composition of the individual positions. However, it cannot be accepted as par for the course that every answer provided by the bank could be wrong and must therefore be investigated in depth, because the supervisory authority regularly asks many questions.

- Given the immense size of the global investment banks, every supervisory authority is to a large extent **dependent on the banks' own data and risk measurement systems**. The supervisory authority can check the basic structure of the risk measurement systems and risk management processes and analyse compliance reports by the internal and external auditors, but even if it multiplied its staff it would never be able to check everything on site. The politicians sitting on the Council of State's Committee for Economic Affairs and Taxation (CEAT) seemed shocked or disillusioned that we use the same radar screens as the bank and that what does not appear there also remains hidden to us. We can and also did ask questions about the things that are hidden away, but the answers are again based on the data contained in the bank's own systems. We can also tell the bank to change the angle of its reports, but again the bank must collect the required data itself and might even have to adjust its data systems, which for cost reasons will only be considered if the reasons are very convincing.

- The **banks' internal risk control systems** are actually impressively big and consist of various levels. UBS Investment Bank has 22,000 employees, of whom 11,000 work in the front (traders) and back offices. It employsaround 3,400 persons in risk control of the Investment Bank (including at the group corporate center), and they can hardly be described as unqualified or underpaid. These internal controllers basically have the same task as the supervisory authority, i.e. to protect the bank against unacceptable risks. Why such a well-developed control system failed and what should be done to remediate the situation are part of the SFBC's investigation into the causes and responsibility for the exceptionally large losses. However, it cannot be denied that not only the top management but partly also the supervisory authority were lulled into a false sense of security by a process-driven and maybe even excessively structured control system.

- As supervisors we can also not deny that we, like the banks, had a little too much **faith in models**; otherwise we could not have approved the value-at-risk models to calculate the regulatory capital adequacy requirements for market risks. We were all aware of the limits of such models, which use only past volatility data – which was very favourable before the crisis – and only factor in a loss-probability of 99% over a holding period of 10 days. This is why we correctly required supplementary stress tests, but hindsight shows that these tests were inadequate. The Basel Committee also realised that the investment banks' trading books contain ever more credit risk – like the securitised loans that have proved so fatal – and that the market risk models do not take sufficient account of these risks. The project regarding the requirement for additional capital to cover default risks has been expanded to also include event risks such as unexpected rating downgrades or a liquidity shortage (incremental event risk charge) and was launched to supplement Basel II as far back as 2005, but was only supposed to be implemented in 2010.

- Finally, with Basel II the Basel Committee gave the **external rating agencies supervisory recognition** for banks' use external of ratings to calculate capital adequacy requirements, thereby indirectly boosting their credibility. This is not meant as criticism of Basel II, which caputures the complex trading activities of the investment banks and the rapid innovation in this area much better than its static predecessor Basel I. But we may also not complain that Basel II enhanced a certain **faith in ratings** which must now be put into perspective.

- On the other hand, the criticism levelled at the **SFBC department responsible for the large banks** is unfair. This department employs 25 people, including the Risk Management team which also works for other departments. Around 10 people are responsible for each of the two large banks, with line supervision in the hands of an experienced group manager and four additional employees, two each per investment bank. Our people are well qualified and highly motivated and do their work with great commitment, and in the current crisis they are also under a lot of pressure. Although the team is small compared to the size and complexity of the large global banking institutions that have to be monitored, they do a good job. We do not need better people but we certainly need more staff who can provide ongoing assessments of potential risks in the area of investment banking in particular and who can follow up on the problems that have been identified. In addition to finding more staff, the SFBC should concentrate on retaining its good employees. For this we need working conditions that can compete with those offered by the private sector.

- The **mandate of the supervisory authorities**, including the mandate of the SFBC, has been met in full to date, i.e. to protect the banks' creditors and clients against a loss of their assets and, together with the central banks, to maintain a fully functioning bank system. However, it is not the task of supervisors to manage banks, nor to even approve their strategy, business model, risk appetite or financial products. In a free economy this remains the sole responsibility of a bank's board of directors and top management, despite regulation and supervision.

Crisis management takes precedence

Since the outbreak of the crisis in August 2007 UBS and Credit Suisse have been monitored closely by the SFBC and the SNB, with more effort concentrated on UBS which is more exposed. The focus falls on the level of capital, the available liquidity, the difficult valuation of complex, illiquid financial instruments, the identification of areas that could also be contaminated by the crisis, the reduction of problematic investments, crisis-specific stress scenarios, the disclosure of risks as demanded by the current situation, and public communication. An exchange of information and analysis of the situation with bothlarge banks and among SFBC and SNB happen at high frequency. International cooperation between the supervisory authorities and central banks, in particular of those countries housing global investment banks, has also intensified. Extremely sensitive and confidential data can only be shared with a relatively small circle of experts.

The crisis has proven all too clearly why a **high level of capital** is central in shoring up confidence in the banks. Impairment of the contaminated positions has reached a level at some banks such as UBS which far outstrips all earlier stress scenarios prepared by the banks as well as the by nature more pessimistic assessments of supervisory authorities. In the current climate of uncertainty the banks and supervisory authorities must ensure that a capital buffer in excess of the minimum requirements is created by share capital increases and that all doubts about the banks' solvency are removed. When disclosing enormous write-downs and losses, the banks must ideally also announce compensatory recapitalisation measures in order to regain the confidence of their worried clients, employees, counterparties and the market. This has been successful to date, and the first phase was even quite painless thanks to highly welcome investments by sovereign wealth funds. Recapitalisation during the second phase is made via rights issues firmly underwritten by bank consortiums at a substantial discount on the current share price or, in the case of the US investment bank Bear Stearns, with the government supporting a takeover by a competitor. Even banks which to date were spared from substantial losses will be well advised in such an environment to maintain their capital base well above the regulatory minimum and to delay share buyback programmes.

The **cautious supervisory policy of the SFBC** – fully supported by the SNB – and its Swiss finish capital adequacy requirements **which are higher than the international minimum standards** have proved their worth in the current crisis. The demand for more capital under Pillar 1 (minimum capital requirements) and Pillar 2 (additional buffer) of Basel II has now become **internationally acceptable again** and is no longer contested by our large banks. At the end of August 2007 the SFBC set the target Pillar 2 additional capital buffer for the two large banks – and only for these two banks due to the investment banking risks – higher than the 120% minimum requirement for all other banks in Switzerland. At the moment, however, we cannot and do not want to increase this target further, because such a measure would be procyclical in the current crisis and would be very difficult to implement in the current unstable economic environment. The crisis must first be resolved. How long this will take depends mainly on conditions on the US real estate market and the state of the US economy.

Regulatory consequences

The main beneficiaries of the lessons learned from the crisis must be the investment banks themselves and, at an **international level**, the organisations responsible for financial market issues. Numerous projects are under way, some of which were launched before the crisis broke out, and as these projects were subjected to a real and not just a simulated stress test they have become a testing ground which also enjoys political support. I do not wish to discuss the long list of pending or planned regulatory improvement measures, but would like to refer to the soon-to-be-published report by the **Financial Stability Forum** and the recommendations contained in this report. In our Annual Report we also discuss various initiatives started by the international supervisory organisations in which the SFBC is actively involved, i.e. the **Basel Committee on Banking Supervision** (together with the SNB), **IOSCO** for securities regulation and the cross-sector **Joint Forum**[6]. The Basel Committee will also release its updated work programme with a media release shortly. In summary, however, we can say that the aim is not to radically reform the supervisory system, but rather to **finetune** and **adjust** the system and to **close the existing gaps**. Sometimes a measure is simply designed to remind the stakeholders of the basic principles of sound risk management and the need to apply these principles to new financial products and business models. As usual, but this time with a better chance of success, the SFBC and SNB will insist that the Basel Committee tightens Basel II, especially as regards the capital backing for market risks and an internationally coordinated strengthening of the capital buffer required under Pillar 2. The proposed measures **do not** – at least not in the flexible legislatory framework in use in Switzerland – require any **legislative changes**, but can be implemented in the practice of the supervisory authorities, and if necessary at a lower regulatory level.

At the **national level** the SFBC and SNB will implement the new international standards and also finalise the project started earlier to introduce a special liquidity regime for the two large banks. The SFBC will review the organisation and structure of its department in charge of the large banks in the light of the experience gained from the crisis and any future conclusions from its investigation of the causes of and responsibility for the losses suffered by UBS.

However, we may not labour under the **illusion** that the improvement measures formulated in all seriousness and with much energy by the banks and the authorities will totally exclude a new crisis of the same dimensions in the future. The history of financing is riddled with many counterexamples. Investment banking is a cyclical business and will from time to time fall victim to new exaggeration and speculative bubbles. Other

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[6] SFBC Annual Report 2007 (German version), p. 97 et seq.

people will make the same or new mistakes. We might be able to avoid the known risks but will be surprised from another corner. The acceptance and management of risks is a natural part of the banking business, because without risk there can be no returns. All we can do is to try to reduce the probability of an event and the size of damage caused by system-endangering risks, but we can never totally exclude these risks.

Switzerland with its two globally active large banks is a **special case**: a small albeit wealthy country with limited state funds with two domestically dominant banking institutions that mainly operate abroad and whose main risk exposure is taken via the global investment banking business. The collapse of such banking giants would have devastating consequences for the national economy of this small country and its important financial centre. This systemic risk will remain substantial for as long as the two large banks are involved in investment banking and risky proprietary trading transactions, and must therefore be hedged by radical measures. The best **insurance** against the totally unacceptable risk of a collapse of the large banks is for these banks to have a **capital base** far in excess of the international minimum requirements. The current crisis has opened up new dimensions of potential loss in the investment banking business and has also set a new benchmark for the capital buffer in excess of the minimum which a large bank will need in future. This has been an extreme but very real stress test. In addition to complying with the sophisticated risk-weighted capital adequacy requirements, the large banks should thus also have a primitive but robust cache of additional capital to the amount of x billion francs in order to be able to absorb even large losses without endangering their creditors and the entire banking system. Another option would be to combine risk-weighted requirements with a leverage ratio – as is usual in the US – which prescribes a minimum ratio between equity and balance sheet total as a backstopper. This would all still be the liberal alternative to a total ban on or restriction of the investment banking business, especially as the supervisory authority should not interfere in a bank's strategy or business model. We would simply set the price or metaphorically speaking the insurance premium for system-relevant activities, and this will certainly not be cheap. At the moment, however, these are just utopic dreams, as such a plan cannot be implemented in the middle of the current crisis. It can only be considered once the banks have successfully weathered the crisis and found their way back to their old earning power.