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Financial market stability: are only the banks system-relevant?

SBA discussion paper

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The Swiss National Bank (SNB) has the statutory mandate to contribute to the stability of the financial system. Thus, based on this mandate, it has actively intervened in the market in the financial crisis as well as applied to the Swiss Federal Council to activate the anticyclical buffer. As part of its prevention measures, the SNB additionally publishes its report on the financial stability yearly. In the report, it concentrates on the Swiss banks and justifies this with its experience from the past financial crises. However, this focus is conceived too narrowly in today's environment. In a short time, market shifts and the technological development have led to new sources of systemic risk. This discussion paper argues that non-banks, the cyber threat and crypto currencies are potentially system-relevant in the very spirit of the law. A review of the future embodiment of the SNB's mandate is therefore advisable.

The most important points in brief

- Since 1 May 2004, the Swiss National Banking Act (NBG) has obliged the SNB to contribute to the stability of the financial system. In the exercise of this mandate, the SNB in its financial stability report restricts itself in the case of the market participants to the banks.
- In view of the current reorganisation of the financial system, the question is raised about the advisability of this narrow interpretation of the system stability by the SNB.
- The banking sector has a vital interest in an effective and comprehensive safeguarding of the stability of the financial system. However, analyses show that current developments conceal new risks for the system stability. They must therefore be addressed transparently by the SNB.
- The expansion of the perimeter of the activities for the safeguarding of the system stability suggests itself in two dimensions:
    a. Market developments: entry of non-banks in the production chain of the banking business, for example in the lending and mortgage business
    b. Technological developments: cyber-attacks as a virulent risk for the perfect functioning of the financial systems as well as cryptocurrencies and associated financial products can potentially impair the system stability
- The SNB would promote the reputation of the financial location of Switzerland through the visible inclusion of the current developments in the embodiment of its stability mandate.

In 2004, SNB was legally mandated to make a contribution to the safeguarding of the financial stability. Since then, it has actively intervened in the market in the financial crisis and for example successfully financed the transfer of UBS' illiquid assets to a special purpose vehicle (StabFund). Against this background, it should not be surprising that the SNB in its report on the financial stability every year raises its warning finger regarding the risks in the system-relevant banks and the challenges for the domestically-oriented banks on the mortgage market.

The SNB concentrates in the exercise of its mandate in its report on the financial risks at banks and justifies this with its experience from past financial crises. The recommendations of the committee of experts on the limitation of economic risks through large companies of 30 September 2010 are expected to be formative in this regard. Since then, great progress was achieved in the reduction of the "Too Big To Fail" (TBTF) risks, which is also confirmed in the third evaluation report by the Swiss Federal Council on system-relevant banks of 3 July 2019.

The SNB's narrow focus on banks

This tried and tested exclusive focus on banks as market participants in the past is expected to fall short for two reasons and must be scrutinised in relation to its adequacy of purpose. On the one hand, the banks' resistance is significantly strengthened. Thus, the SNB itself states in its stability report that the TBTF specifications are fulfilled and the banks can also absorb a severe shock on the real estate market with their equity. On the other hand, the rapid changes of market structure and technological possibilities can lead to new systemic risk sources. The fatal consequences of cyber-attacks, the high waves of the announcement of Libra or the widespread market entry of non-banks in the mortgage market, which in isolated cases even results in lending with negative interest rates, in turn are unknown.

These examples show that the look back and the sole mounting of system risks on individual firms are insufficient for the activities for the safeguarding of the financial stability. The presumption is suggested therefore that today significant risk sources regarding the risk for the financial stability are not systematically recorded.

Should the SNB report on the financial stability aim to achieve the holistic recording of the risks for the financial system as the basis for an effective prevention, a reprioritisation of the efforts is required. This should adequately take into account the banks' resistance today and be based on the new risk landscape.[1]

Legal principles

At the statutory level, the National Banking Act (NBG) of 3 October 2003 (in force since 1 May 2004) provides that the SNB as part of the safeguarding of the price stability has the task to contribute to the stability of the financial system. In addition, it monitors the systemically important

[1] According to the final report of the committee of experts on the limitation of economic risks through large companies of 30 September 2010, a company may be classified as system-relevant if it provides (i) services that are indispensable for the national economy and (ii) other market participants cannot replace these services within a period that is bearable for the national economy.

financial market infrastructures. The most effective protection of the system stability consists of ensuring through suitable framework conditions that the foundation pillars of the financial system (currency, banks, settlement systems) are and remain robust.

The systemic risk can also be defined as a risk that financial or operational difficulties of one or several system participants spread out to other participants and the payment or securities settlement system thereby becomes unable to function, so that the stability of the financial system or even the entire economy is put at risk (so-called contagion or domino effect).[2] Correctly, this definition from the Swiss Federal Council Dispatch leaves it up the parliament to decide who the system participants are.

The SNB itself provides for the currently narrow focus on Swiss banks' development as market participants from a macro-economic and macro-prudential perspective in the execution of its mandate. Closely associated with the mandate of the contribution to the financial stability is the mandate to facilitate and safeguard the functioning of cashless payment systems. Consequently, the SNB focuses not only the market participants, but also the markets and the financial infrastructure as stability pillars.

International analyses of new risk sources

A look across the borders shows that in the international boards the work for safeguarding the financial stability extends far beyond the SNB's topic areas and the analysis of potential system risks is running at full speed. In the case of supranational organisations, such as the Financial Stability Board, the BIS or other central banks like the Bank of England, this can be attributed to their broad mandate. In terms of content, however, the work has a pioneering character for the identification of susceptibilities of the financial system and possible preventive measures.

Thus, Randal Quarles, chairman of the Financial Stability Board (FSB), in his letter to the G20 participants of 25 June 2019 with regard to the Osaka summit notes that the risk situation is rapidly changing. The FSB therefore does not monitor like at the time of its foundation in 2010 only the implementation of the reform programme after the financial crisis, which has enabled the impressive progress towards a more stable global financial system. In view of the Swiss banks' efforts, this particularly applies also for the stability of the financial system here, which has recovered more rapidly after the crisis and has implemented the reform agenda earlier.

According to Quarles, new risk sources now demand particular attention. At the same time, he points to the structural transformation in the financial system. In this regard, the shift of the financial intermediary on the non-banks is striking, which today includes almost half of all global financial assets. At the same time, we stand at the beginning of a technological development that manages completely without an intermediary for various transactions. The FSB had an obligation to analyse the resulting risks in a new supervisory framework.

[2] Cf. Swiss Federal Council Dispatch to the parliament on the revision of the National Banking Act of 26 June 2002.

On 20 June 2019, the Future of Finance report on the future of the UK financial system commissioned by the Bank of England (BoE) was published.[3] It recommends the BoE to review its regulatory perimeter in the course of the new risks, for example through crypto assets. It should focus especially on the infrastructure and the cyber risks. In its financial stability report of 19 July 2019, the BoE provides a summary statement on risks that go beyond the classical focus points emerging from the financial crisis. The European Central Bank (ECB) as well exchanges information on the newly emerging risks in connection with the digital transformation with the industry. Up for debate in particular is an extension of the supervisory perimeter to automatic credit worthiness checks, robo-advisory services and cloud banking.

Definition of the system relevance

It is advisable that the SNB does not simply duplicate the work carried out elsewhere, but prioritises risk-based and based on its system protection mandate. In this regard, it is not necessary to create new system definitions (cf. boxes). Rather, a look with a "fresh pair of eyes" off the beaten tracks is necessary.

Systemic relevance in the financial system

In its final report of 30 September 2010 on the Too-big-to-fail problem the committee of experts on the limitation of economic risks through large companies defined the system-relevance with two characteristics:

Too-big-to-fail risks

A company may be classified as system-relevant if it provides (i) services that are indispensable for the national economy and (ii) other market participants cannot replace these services within a period that is bearable for the national economy.

Community risks

Various companies, which are neither especially large nor networked, can get into difficulties at the same time during a crisis situation due to an identical risk profile. The substitution of individual companies by other market participants may thereby be compromised.
As indispensable economic services, network services and the basic supply with vital goods are in the foreground. Examples in the area of the financial sector are the infrastructure for payment transactions (liquidity supply) or the financial intermediation (banking and investment possibilities).

The basic approach for the systemic relevance in the financial system is still correct today. Concerning the operational implementation, network and platform economy requires a comprehensive system view with a reduced value creation depth at the banks resp. with tendencies to disintermediation.

[3] Cf. https://www.bankofengland.co.uk/report/2019/future-of-finance/executive-summary

One will have to depart from a narrow industry consideration, according to which the safeguarding of the resistance of each single banking institution and the infrastructure automatically leads to a stable financial system. Due to the networking of large financial intermediaries with non-industry companies from the IT sector, in particular the substitutability of the services appropriate importance must be attached to a central indicator for system relevance.

Various comments by the SNB provide a clue that such work is actually also ongoing. However, to safeguard the stability in the best manner possible, the market participants require this information for the purpose providing a public good. It is expedient for an effective prevention if the findings on current and potential system risks are systematically comprehensively reviewed in the financial stability report. Where the analyses do not permit any comprehensive evaluation, this is intended to be officially disclosed in a work programme in accordance with good practices.

New main focuses from the perspective of the banking industry

The Swiss Baking Association has been dealing with drivers and the consequences of digital innovation for many years, with the goal to contribute to first-class framework conditions for the Swiss financial centre. According to its priority-setting based on detailed analyses as well as the doctrines from abroad, there are various risk sources that can potentially provoke serious disruptions of the financial stability.

In particular, the following contents must be emphasised

- The acute shift of financial intermediation to non-banks resp. the dis-intermediation with a large number of ROI-seeking market participants in the low interest rate environment,
- The financial infrastructure's susceptibility to cyber-attacks, which have significant systematic risk potential already today, as well as
- technological developments in the area of crypto currencies[4], where Switzerland is a global leader.

Switzerland is not affected to the same extent by further risks that are internationally in focus or it has already addressed these. In addition, the negative interest rates which create incentives for misallocation of the capital and thus massively disrupt the investment and credit award function of the financial system. As a monetary policy measure for safeguarding the price stability, taking into account the economic development, the dimensions go far beyond the SNB's statutory stability mandate in the financial system. An assessment from a partial perspective of the price stability is not opportune at this point.

Potential system risks in detail

Market entry of non-banks

The rapid shift of financial intermediation to non-banks is expressed among other things in the

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[4] The term cryptocurrency is generically used as privately issued currency. The potential system risks considered are of an economic nature.

market entry of insurance companies and pension funds into the mortgage business, which is at the centre of the SNB's attention. Its market share in the mortgage lendings in the meantime is estimated at around 5.5%. The growth of the mortgage lendings of the pension funds was even 16.8% in 2017. Non-banks thus significantly influence the development on the mortgage and real estate market. The question is also raised regarding the risks that "migrate" from the banking sector. However, the SNB deals with these observations in a footnote in the financial stability report.

The automatic transaction triggering in the lending business of so-called BigTech firms are internationally (FSB, BIS) considered to be risks for the financial system. Automatic loan terminations could be the origin of an uncontrolled downward trend on the markets. Certain automatic lending models as well as money creation by BigTechs are considered to be further system risks. Even if such models play a secondary role in Switzerland, already the possibility of a market entry can provoke high-risk competitive behaviour of the current market participants[5].

Through a broader collection of data by market participants not under any obligation to disclose information, the information situation would be improved in view of the early recognition of stability-relevant consequences in the lending activity. The SNB can thereby improve the intensification of the macro-prudential instruments. The inclusion of operational system risks supplements the range of preventive measures. The expansion of the stability focus to non-banks helps eliminate competition policy distortions and disincentives in the market. Overall, a more comprehensive financial system perspective increases the reputation of the Swiss financial centre.

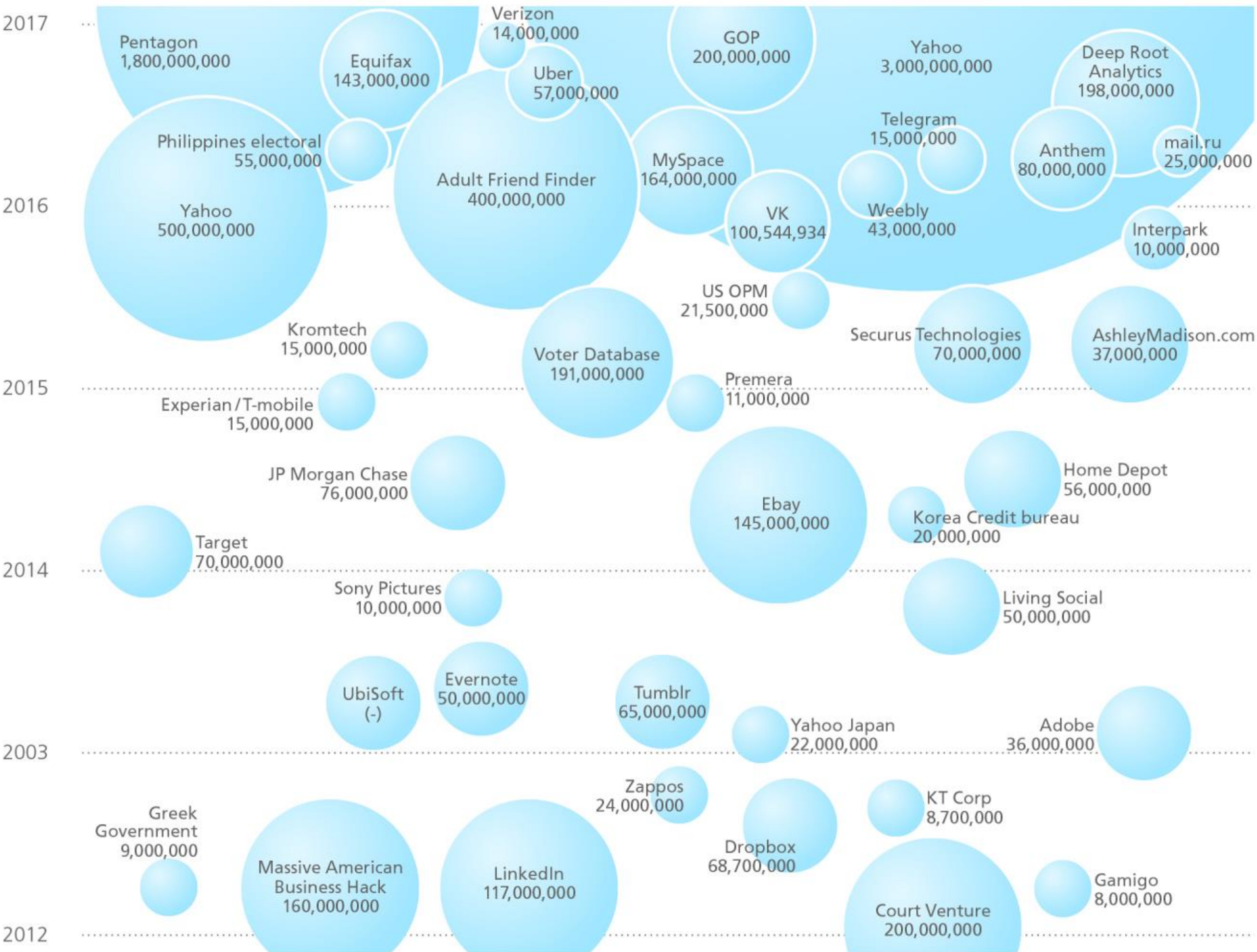
Cyber risks as a threat for the financial system

The functioning of the payment and other information and transaction systems is not safeguarded without operational security. A survey among the participants of the BIS conference meeting of March 2019 shows that the cyber risk is currently by a long way considered to be the greatest risk for the global banking system. The extent and the increase of the cyber-attacks (cf. Fig. 1 from https://www.bankofengland.co.uk/report/2019/future-of-finance/executive-summary) attest to their potential to significantly destabilise lending and investment markets.

[5] Risks in connection with data use were likewise investigated. These touch upon the protection of the consumer and credit differences generated through Artificial Intelligence. However, they are not obviously of a systemic nature.

Fig. 1

Cybersecurity breaches



Note: Size of the bubbles denote the records reported stolen in a selection of publicly acknowledged breaches.

Sources:
Bank of England, Boston Consulting Group (BCG), BCG analysis, DataLossDB.org and informationisbeautiful.net.

As part of its stability mandate the SNB therefore is also assigned a role in the containment of the cyber risks, which goes beyond the safeguarding of the cyber resilience of its own infrastructure and the payment transactions. A central role of the SNB in crisis prevention and suppression in the cyber sector of the entire financial system is a requirement for the safeguarding of the financial stability.

Crypto currencies

Results from the research show that electric national currencies can significantly reduce today's risk with exclusively analogous currency. In private cryptocurrencies, the opposite can occur. Over the long term, the potentially rapidly growing use of private cryptocurrencies and the associated financial products (e.g. stable coins or self-executing smart-contracts) impair the system stability.

In practice, central banks still do not recognise any system risk in cryptocurrencies due to the currently small volumes. The early recognition of stability risks, however, is a permanent task in this sector. Therefore, a declared expansion of the SNB mandate is required for system stability on electronic currencies and a systematic reporting. Transparent early information also allows the banking industry to introduce itself constructively into the discussion and present itself as a pioneer for future-oriented solutions.

Intensification of the discussion on system stability

For the fulfilment of the SNB's mandate for the stability of the financial system, the comprehensive inclusion of all current risk sources foreseeably relevant in the near future is required. The SNB is a member of various international institutions, which deal with system risks more comprehensively than its annual report on the financial stability. There is a need for action at least regarding the communication on the assessment of all potential system risks. The public discussion on the SNB's evaluation and all measures must be intensified. In the future, the financial stability must more than even be the Swiss financial centre's trump card in an increasingly volatile world.

If you are interested in this topic and have an opinion on it? Our experts look forward to your causes for thought and would be delighted to hear from you regarding an exchange of opinions.

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