Current interest rate environment – impact on Swiss Banks

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Switzerland exited the negative interest rate environment in 2022 with a surprisingly strong rate hike. One year later, it appears that the indirect consequences for many banks include a considerable increase in net interest income and, in some cases, even a reduction in interest rate risks. So, the best of both worlds? The uncertain economic development, potential second-round effects with respect to credit risks and the events surrounding the CS and US bank crisis are challenging for bank management.
The article below sheds some light on what board members need to watch out for.

Departure from the negative interest rate environment and absorption of liquidity

In connection with inflation's powerful comeback, the central banks of the key currency zones found themselves forced to raise their policy rates both substantially and at very short intervals. To counteract inflationary pressure in Switzerland, the SNB also tightened its monetary policy and, from June 2022, raised its policy rates by 2.5 percentage points in five interest rate steps, from -0.75 percent to the current rate of 1.75 percent.
The SNB simultaneously introduced a change in the implementation of its monetary policy. To ensure that secured short-term money market rates – specifically the SARON – remain close to the SNB policy rate, interest is now applied to banks' sight deposits with the SNB at the SNB's policy rate and up to a certain limit. In addition, the SNB used open market operations to absorb the vast amount of liquidity available on the Swiss market. As a result, Swiss commercial banks' current account balances at the SNB declined from around CHF 660 billion in June 2022 to just CHF 470 billion in September 2023 (Figure 1, on next page).

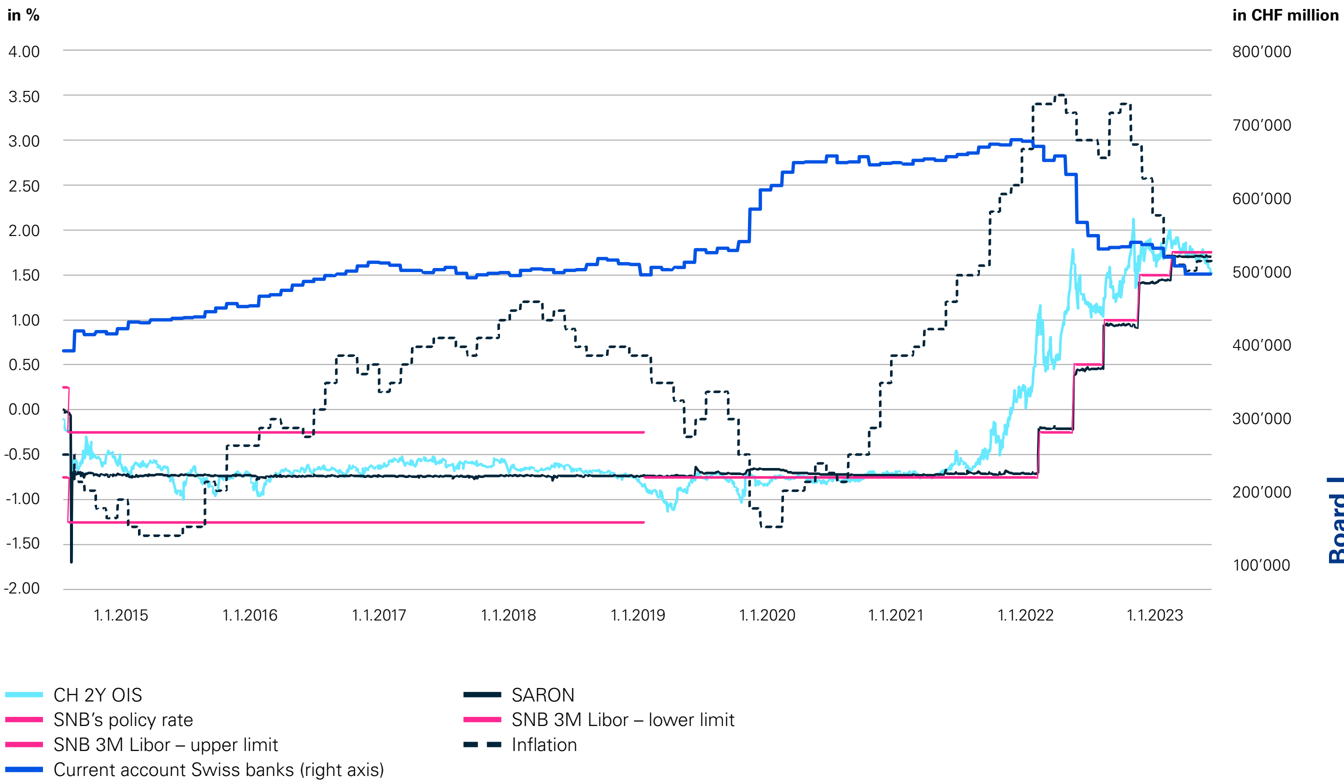

Figure 1: Development of CHF interest rates, inflation and current account deposits of Swiss banks at the SNB. Source: Refinitiv, SNB, Federal Statistical Office

Consequences for Swiss banks

During the negative interest rate phase, voices repeatedly expressed apprehension that a sharp rise in interest rates could cause the real estate market to crash and that interest rate risks could put banks under additional strain. One year after the interest rate turnaround, the real estate market in Switzerland has remained robust so far, even despite negative price expectations.[1] And the banks? The headline of the 27 August 2023 Sonntagszeitung read "Banks are earning billions in interest – clients left out in the cold" and the Sunday newspaper reported that banks focused on Swiss business boosted their net interest income by around 25 percent year on year in the first half of 2023.

The marked increase in net interest income was mainly driven by the passive margin, which – thanks to the increase in interest rates – is no longer negative but back in positive territory, aligning with its typical state in a standard interest rate environment. That became possible because the banks only raised the average interest rate on client deposits from around 0.1 percent to 0.5 percent during the same period, despite an increase in market interest rates of over 2 percent since the start of 2022. This repeatedly exposed banks to accusations in the media of generating profits at their clients' expense.

That effect was expected, however, and had already been described by the SNB in its 2016 report on financial stability. According to the SNB, "(...) an upward interest rate shock would have a significantly positive effect on the passive margin. This margin is currently negative since

[1] For example, see the recently published results of the Swiss Real Estate Index (sresi®) survey, the Swiss Real Estate Sentiment Index - KPMG Switzerland

most interest rates on client deposits did not follow market interest rates into negative territory. That makes it likely that, in the event of a minor or moderate interest rate shock, such as a 200 bps shift in the yield curve, for example, interest on client deposits will rise either less or more slowly than market rates. This would restore banks' passive margins and help move them back into positive territory."

A second driver of net interest income is the newly introduced interest on banks' current account balances at the SNB. While high current account balances at the SNB cost banks enormous amounts of money while interest rates were negative, their new liquidity is earning interest risk-free at a rate of up to 1.75 percent. Not only do banks benefit from additional interest income, but they also always have a profitable, risk-free alternative to higher-risk investments such as client loans.

Unlike sight deposits, interest rates for fixed-rate mortgages are based on daily capital market rates. Accordingly, banks have raised their interest rates on new contracts in sync with the interest rate hikes. The number of SARON mortgages requested by clients rose as a result. With this type of mortgage – unlike with fixed-rate mortgages – clients bear the risk of interest rate changes. As a result of the increase in interest rates, many banks were not only able to generate higher interest income but also reduce the interest rate risks on their balance sheets.

So, the best of both worlds?

Not at all. Central banks' tighter monetary policy and uncertain economic development also bring major challenges.

Low liquidity has made it even tougher for smaller banks without a rating, in particular to obtain refinancing on the money market. That makes liquidity management, specifically controlling and planning the liquidity coverage ratio (LCR), much more challenging. Accordingly, it is important that they adapt their steering instruments to the new circumstances and continue to develop them.

Especially since the events surrounding the CS and US bank crises have demonstrated quite strongly that client inertia with regard to interest rates does not apply in the context of liquidity. Table 1 shows the outflows of client deposits at Silicon Valley Bank, First Republic Bank and Signature Bank, which were hit by bank runs in 2023. These outflows substantially exceeded historical experience and assumptions used in regulatory requirements, one of which is the LCR. In the age of social media and 24/7 mobile payments, negative events and reports are not only capable of having a negative, real-time impact on stock prices, but also on liquidity and can even lead to a bank run. That shortens the response time in a stress scenario and makes it all the more important to take preparatory, risk-mitigating steps going forward. Against this backdrop, banks are well advised to analyze the August 2024 rollout of SIC Instant Payments to ascertain how it could potentially impact their stress scenarios and emergency planning.

Bank	Registered office	Date	Duration	Outflow rate in %
Northern Rock	UK	Sep. 2007	a few weeks	56
IndyMac	USA	Jun. 2008	2 weeks	8,4
Washington Mutual	USA	Sep. 2008 Nov. 2008	16 days 23 days	10,1 4,9
Wachovia	USA	Apr. 2008 Sep. 2008	2 weeks 19 days	3,6 4,4
National City	USA	Mar. 2008 Jul. 2008 Sep. 2008	2 days 5 days 25 days	5,1 4,6 4,6
Dexia	Belgium	Sep. 2011	1 month	8,8
Silvergate Bank	USA	4Q 2022	approx. 7 days	52
Silicon Valley Bank	USA	Mar. 2023	1 day + next day expected	25 + 62*
Silicon Valley Bank UK	UK	Mar. 2023	5 – 6 hours (!)	30
Signature Bank	USA	Mar. 2023	1 day + next day expected	20 + 9*
First Republic Bank	USA	Mar. 2023	7 - 14 days	57
Liquidity coverage ratio (LCR): SMEs and private clients < CHF 1.5 million Private clients > CHF 1.5 million, business clients			30 calendar days 30 calendar days	5 or 10 20 to 40

Table 1: Outflow rates 2008 – 2023. Figures with * correspond to the expected outflow rates for the next day, which did not occur because the banks were closed prior to that. Source: Amamou et al. (2020), Rose (2023), FSB (2023)

Instant Payments will also let clients in Switzerland make payments in nearly real-time, 365 days a year and around the clock.

Banks are advised to validate their stress assumptions not only with respect to liquidity, but also with respect to credit risks. Low interest rates in the past prompted many clients to take out mortgages at long-term fixed rates. As a result, many lenders in Switzerland have so far remained unscathed by the interest rate hike. If the economic situation takes a downturn or further interest rate hikes are needed, this could – subject to a delay – result in increased issues with debt sustainability and, consequently, higher loan defaults. Here, too, banks will have to understand the repercussions of these second-round effects on their loan portfolios and, if necessary, take steps to prepare for them.

Sales management could pose another challenge for banks. While interest rates were negative, various banks geared their sales activities toward growing their assets and reducing or defending themselves against client deposits at 0 percent interest. The interest rate turnaround has resulted in a fundamental about-face. Considered "undesirable" until just recently, sight deposits on private and savings accounts, for example, have regained their status as an affordable and therefore attractive source of refinancing (compared to refinancing on the capital market). This stable refinancing should be used for making targeted investments in loans, which promise a higher return after adjusting for risk than the risk-free rate of 1.75 percent earned on a current account at the SNB. As a result, client advisors need to focus more on attracting stable client deposits and making return-based decisions to grant loans.

That means this is no time to sit back and relax, even in light of the positive financial statements. What do boards of directors have to bear in mind now?

Important questions for boards of directors

According to FINMA Circular 2017/1 "Corporate governance – banks", the board of directors is responsible for monitoring the implementation of risk strategies, ensuring in particular that they are in line with the defined risk tolerance and risk limits. Accordingly, boards of directors should make a conscious effort to examine how the changed interest rate environment will impact their bank. The following questions could help:

- Is the risk positioning appropriate?
  In particular, is it in line with the board's risk appetite?
- Have the risk models been examined to determine whether they are still appropriate in the changed interest rate environment? When were the replication models used for controlling interest rate risk, for example, last validated? And is the board of directors aware of how various interest rate scenarios impact income and risks?
- Is the refinancing strategy, especially the share of capital market refinancing in relation to financing via customer deposits, appropriate and aligned with the planned business development?
- When were the liquidity risk models last reviewed and to which degree were the insights from the CS and US bank crises incorporated into internal stress tests? Were the consequences of possible second-round effects, such as a delayed increase in loan defaults, taken into consideration at that time?
- How robust is the crisis management and, in connection with that, crisis communication?
  When were the emergency plans last tested and what is the role of the board of directors and/or individual board members in the event of a crisis?

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Conclusion

The exit from the unpopular negative interest rate environment made it possible for many banks to start running their conventional interest rate arbitrage business “normally” again and increase their net interest income. However, the decline in liquidity on the money market, events surrounding CS and US banks as well as possible second-round effects with respect to credit risks present challenges for bank management. Banks are well advised to gear their balance sheet management tools, stress tests and emergency plans toward the new conditions and ensure that the risk positioning is in line with the board’s risk appetite.

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