David Benamou
+33 1 84 16 03 61
david.benamou@axiom-ai.com

Jérôme Legras
+33 1 84 17 36 10
Jerome.legras@axiom-ai.com

Philip Hall
+33 1 44 69 43 91
p.hall@axiom-ai.com

Adrian Paturle
+33 1 44 69 43 92
adrian.paturle@axiom-ai.com

January 16, 2015

The Swiss National Bank: Faster than Greece!

Yesterday, in a shocking, unexpected, unprecedented move, the SNB decided to drop its floor (effectively a peg) against the Euro. In a nutshell, the SNB decided to exit the Eurozone, in a very straightforward way. We are not currency experts but would still like to offer a few thoughts on this issue as we believe the rationale and consequences are highly relevant for all markets.

Why?

The first obvious question is why? One month ago the SNB's governor made very clear and definitive remarks on the importance of the currency floor and on the commitments of the SNB. So why the sudden change of mind?

As we all know, the job of an economist is to explain why something that nobody had expected was indeed totally inevitable. So let us give our answer: we believe the rationale is simply "QE". Every policy has a cost and its effectiveness should be compared to its cost. Maintaining the EUR/CHF parity has been costly, but manageable. Recall that even at the peak of the Eurozone crisis, the Euro was fairly stable, mainly because the fall in demand for Drachma Euros was compensated by a rise in demand for Deutsche Mark Euros. The SNB had to buy roughly 175€bn Euros and had to stretched its balance sheet to almost 80% of Swiss GDP – well above other central banks – but it appeared still manageable.

With a potential QE and a Euro in free fall against the USD it is a very different story. Basically, it seems that the SNB had a stop loss embedded in its policy and the stop was triggered by an imminent QE. It seems a rather wise option when one compares the firepower of the ECB with the SNB's.

Another way to put, a bit mischievous maybe, is to argue that in the past the SNB has been able – and willing - to peg its currency to the Deutsche Mark. But pegging it to the Italian Lira is quite a different story. Actually, since 1965, the foreign reserves of the SNB have closely matched the CHF/DEM parity…

What does it mean for central bank policy?

We have heard many people argue that this shocking move means that Central Bank policy cannot be trusted anymore, that forward guidance is dead, *etc*. Presumably these people were all short CHF. There is an old saying in France which goes like this: "*promises only bind those who believe in them*". It is quite clear that the SNB was not going to keep the "peg" (or floor) **forever**. So it had to be stopped, someday, somehow. Considering the importance of the decision, there were two options: slowly, gradually, give hints that the policy could be dropped at some point or stop it straight away. We believe the incredible number of central bank watchers in financial markets makes it almost impossible for a central bank to "preannounce" a new policy smoothly. The tapering tantrum was a good example of that. Any hint at a possible drop of the floor would have triggered massive speculation on the CHF and keeping it would have been extremely costly for the SNB.

One could also point out that, since Lucas published his famous critique in 1976, policymakers worldwide are quite aware that an economic (or monetary) policy is only effective if it is unexpected. Clearly, Mr Jordan had heard of Robert Lucas.

More interestingly, it could mean that what the ECB is preparing is more massive than expected. There is no way to know if Mr. Jordan is aware of the details of a possible QE plan by the ECB, but if he is, a 1tn€ QE should be more frightening than a 500bn€ one. And in case you wonder if central bankers actually do talk to each other about their policies, we note that Mrs Lagarde, perhaps a bit naively, expressed her surprise not only at the move but also at the fact that no one had told her beforehand what was going to happen!

What is the impact for Switzerland?

So the SNB has decided to exit the currency war. Is it bad for the country? Again, we are not macro or currency experts, but the Swiss "way of life" – strong currency, balanced budget, strong savings – does not seem to be working that bad. Since Switzerland moved to floating exchange rates in 1971, the USD went from 4.3 CHF to 0.85 and the GBP from 10.5 CHF to 1.5 CHF. But…but…but industrial production is increasing much more in Switzerland than in the US or in the UK and a current account surplus is the habit rather than the exception. And if you recently went on a ski trip to Switzerland, you probably noticed that the Swiss seem like rather a happy and wealthy people – probably the wealthiest actually, if you exclude micro-tax-haven-states. We wouldn't worry too much for Switzerland.

What is the impact for banks?

Let us now focus on a subject on which we are more familiar: banks. What is the impact of the sharp move of the EUR/CHF parity for European banks? There are four different impacts:

The first and obvious one is profitability. This is mainly an issue for Swiss banks, with a cost base in CHF and revenues often in the currencies of their asset management clients, i.e. EUR or USD. The sensitivity of Swiss banks' profits to the EUR/CHF parity is probably between 1 (international champions such as UBS or Credit Suisse) and 2 (pure domestic players), i.e. a rise of the CHF by 10% could mean a 10%-20% loss in profit before tax. This has mostly an equity impact and the markets reacted rather efficiently with a 10% drop in the share prices. Until the markets find a new equilibrium point for the CHF/EUR parity, FX prices should be a major driver of banks' share price.

For non-Swiss banks, the key issue relates to CHF loans, especially in Eastern Europe. At first sight this could appear a bit odd, but believe it or not CHF loans in Eastern Europe were extremely fashionable before the crisis. Someone came up with the very smart idea to sell to private individuals a FX carry trade embedded in their mortgages and quite unsurprisingly this has backfired. This (mal) practice was especially widespread in Austria, Hungary, Croatia, Romania and Poland. Hungary is both the worse country and also the lowest risk: with so many homeowners being totally unable to repay their loans, FX loans became a true systemic risk. This FX saga led to various laws being passed with the ultimate outcome that all loans were converted into HUF and banks took massive provisions. But this is all the past.

The problem remains in the four other countries and for banks with subsidiaries there (Polish banks, Austrian banks, Unicredit, Santander, Commerzbank, Greek banks). There are four different issues:

- P&L: if the loans are not hedged, the rise in CHF could lead to a profit. We believe this will almost never be the case as most loans are hedged.

- RWA: even if loans are hedged, the credit risk associated with the loans remains in CHF. This implies that RWAs will increase proportionally to the EUR/CHF variation (this would be calculated on a monthly basis) and consequently the CET1 ratio will decrease.

- Liquidity: loans are typically hedged with swaps exchanging the currencies and the two floating rates (e.g. "SwissBOR" vs. EURIBOR). These swaps generally have cash collateral requirement meaning that a sharp increase in the CHF requires them to post collateral. This is generally not an issue for most banks that do not face liquidity issues in a market flooded with cheap liquidity, but it might have contributed to the woes of Greek banks and could explain why two of them had to use the Emergency Liquidity Assistance facility at the ECB yesterday.

- Asset Quality: debtors in CHF could face higher than expected repayment obligations and this could lead to higher credit losses. It is very hard to quantify and the numbers will not necessarily be huge: some debtors might have hedged themselves (corporates) and the issue of CHF loans has been flagged for a very long time.

Looking at various European banks on an individual basis:

- The large Polish banks will probably be the most hit but they benefit from a supportive macro environment (employment, real estate, rates) and the increase in Loan Loss Provision (LLP) should remain reasonable.

- Some European banks have large Polish subsidiaries and could be impacted as well: BCP (65% of *Millennium* with PLN 18bn), Unicredit (50% of PLN 4bn), Santander (70% of PLN 13.1bn), Commerzbank (70% *of mBank*).

- Other European banks have exposures in CHF loans in various countries, directly or in subsidiaries. These include
    - **Erste:** 9.9bn€ with 2.3bn€ in Hungary and a large Austrian exposure which is mostly held by clients who refused to convert)

- **RBI**: 5bn€ with 1.5bn€ in Hungary and the bulk of the rest in Poland. Note that RBI announced the IPO of its Polish unit a couple of hours before the SNB's announcement.

- **Greek banks** have 5% of total lending in CHF loans. **Eurobank** is the most exposed of the Greek banks, with CHF loans at 11%.

Generally speaking, it appears that the impact will be manageable for most banks, including for the Greek banks and for RBI, but obviously for these banks the timing is very poor.