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Editorial

More than 10 years have passed since the outbreak of the financial and economic crisis in 2007. Since then, the monetary policy of the major central banks has been characterized by rather unconventional measures such as negative interest rates and extensive bond purchase programs. While these measures have had the direct, intended effect and the global economy was brought back from the brink of an uncontrolled negative spiral, the unintended, long-term consequences of this development are becoming increasingly apparent: the prices of many assets have reached new highs and concerns are multiplying that a bubble could form in individual asset classes. Global debt continues to grow unabated and has already hit record levels in many areas. Geopolitical tensions also intensified considerably last year, and increasing trade protectionism does not bode well for global economic growth.

This situation poses tremendous challenges for banks. Low interest rate policies have eaten away at margins in the lending business, and interest income has only been kept stable by significantly expanding lending volumes. When it comes to fees and commissions, banks have had to contend with painful income erosion. This is due to several factors, not least the generally higher price sensitivity on the part of investment customers and the increased tax regularization of foreign assets held at Swiss banks seen in recent years.

Even though banks have performed relatively well in the last few years in spite of this challenging market environment and have reinforced their stability through a range of new regulatory provisions, the question arises as to what consequences this development will have for Swiss banks. What is the Swiss banks’ take on these developments – the signs of the times, so to speak – and how optimistic are they about their short and long-term future outlook? How well equipped are the financial institutions to weather fresh market turbulence and market shifts? Will the banks switch their strategic focus going forward in favor of growth and innovation, or will cost management remain at the top of the strategic agenda? How do the banks plan to further develop their business models as they have started to run out of options to create added value in recent years, and what will be their strategic response to the emerging structural change?

The EY Bank Barometer 2019 goes in search of answers to these questions. We hope you enjoying reading this publication and look forward to a lively discussion with you.
1. Study design
Study design

- Survey by EY in November 2018
- Survey of 100 banks in Switzerland¹
- 9th edition since 2010

Breakdown of survey sample

<table>
<thead>
<tr>
<th>Type of bank</th>
<th>2018</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private banks²</td>
<td>33 %</td>
<td>31 %</td>
</tr>
<tr>
<td>Banks under foreign control</td>
<td>28 %</td>
<td>33 %</td>
</tr>
<tr>
<td>Regional banks</td>
<td>18 %</td>
<td>22 %</td>
</tr>
<tr>
<td>Cantonal banks</td>
<td>21 %</td>
<td>14 %</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bank size by customer assets</th>
<th>2018</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 5 billion francs</td>
<td>46 %</td>
<td>52 %</td>
</tr>
<tr>
<td>Between 5 and 1 billion francs</td>
<td>14 %</td>
<td>14 %</td>
</tr>
<tr>
<td>Between 10 and 50 billion francs</td>
<td>26 %</td>
<td>22 %</td>
</tr>
<tr>
<td>Over 50 billion francs</td>
<td>14 %</td>
<td>12 %</td>
</tr>
</tbody>
</table>

¹ The questions were also put to the two big banks in Switzerland and included in the general evaluations but not the evaluations by type of bank
² Including investment banks
2. Market environment
The financial and economic crisis shook the financial world to its core when it hit in 2007. Since then, the monetary policy of the major central banks has been in a state of emergency. While the low interest rate policy and the flooding of the markets with liquidity have had their direct, intended effect and the global economy was brought back from the brink of an uncontrolled negative spiral, the unintended, long-term consequences of this development are becoming increasingly apparent:

- The prices of real assets such as equities, real estate and many other assets have been pushed to greater and greater highs, with records being set on an almost daily basis.
- The global debt tower has risen rapidly in recent years and now accounts for more than 300% of economic output – a truly dizzying figure.
- Insufficient interest earned on pensions and savings.
- More and more, the suspicion is being voiced that the ultra-expansive monetary policy adopted by the central banks has gullied investors into ignoring existing risks, paving the way for a dangerous bubble. This fear is substantiated by the risk premiums on the international bond markets, which for some time have been hovering at historic lows.

The crucial question that needs to be asked in this context is: Is it even realistic that monetary policy can normalize without any upheavals on the financial markets?

These monetary and economic difficulties are compounded by intensifying geopolitical tensions. Expanding trade protectionism coupled with the political resurgence of nationalistic-leaning tendencies in major industrialized nations could pose an additional threat to the global economy.
Money supply, debt and asset prices at peak levels

Included are debts of non-financial corporations, financial corporations, households and the state.

Source: IIF, EY, SIX, STOXX, Cboe

<table>
<thead>
<tr>
<th>Global</th>
<th>Developed countries</th>
<th>Emerging markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute (indexed)</td>
<td>Relative</td>
<td>Absolute (indexed)</td>
</tr>
</tbody>
</table>

### Debt ratio

- **Left axis indexed, 1.1.2000 = 100**

### Shiller-P/E ratio and interest rates

- **Shiller-P/E Ratio S&P 500**
- **Long term interest rates (USD)**

### Volatility

- **VSMI®**
- **EURO STOXX 50® Volatility (VSTOXX®)**
- **Cboe Volatility Index® (VIX®)**

### Table: Money supply, debt and asset prices

<table>
<thead>
<tr>
<th></th>
<th>Switzerland (CHF billion)</th>
<th>EU* (EUR billion)</th>
<th>USA (USD billion)</th>
<th>Japan (in JPY trillion)</th>
<th>UK (in GBP billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money supply</td>
<td>981</td>
<td>11'207</td>
<td>13'920</td>
<td>991</td>
<td>2'346</td>
</tr>
<tr>
<td>GDP</td>
<td>669</td>
<td>11'206</td>
<td>19'391</td>
<td>547</td>
<td>2'044</td>
</tr>
<tr>
<td>Government debt</td>
<td>197</td>
<td>9'732</td>
<td>20'493</td>
<td>1'289</td>
<td>1'783</td>
</tr>
<tr>
<td>M2/GDP</td>
<td>147%</td>
<td>100%</td>
<td>72%</td>
<td>181%</td>
<td>115%</td>
</tr>
<tr>
<td>M2/Government debt</td>
<td>497%</td>
<td>115%</td>
<td>68%</td>
<td>77%</td>
<td>132%</td>
</tr>
<tr>
<td>Government debt/GDP</td>
<td>30%</td>
<td>87%</td>
<td>106%</td>
<td>236%</td>
<td>87%</td>
</tr>
</tbody>
</table>

* = euro zone

Source: SNB, SECO, BIS, ECB, Eurostat u.a.
Global debt has skyrocketed since the outbreak of the financial crisis in 2007, with national debt measured as a percentage of gross domestic product (GDP) in many countries now having reached levels that are unparalleled in an historical context (excluding times of war). The brunt of this development is being borne in particular - but not only - by the emerging markets. The rapid rise in global debt is a direct consequence of government stabilization measures and the expansive monetary policies of central banks initiated in response to the financial crisis. This trend can also be observed in Switzerland; while the government debt ratio is at a very low level in international comparison, money supply - measured in terms of economic output (GDP) - has reached a volume exceeded only by Japan.

The extremely expansive monetary policy has also boosted stock markets worldwide. Measured against the Shiller PE ratio of the S&P 500 index, share prices are dangerously high: Valuations are similar to those immediately prior to the stock market crash in October 1929 and the bursting of the dotcom bubble in March 2000.

In spite of these multiple challenges, the outlook is not all doom and gloom. There are also positive signs. Profits posted by many companies are very strong and earning prospects remain intact, even if general earnings expectations may again be revised downward slightly in the weeks and months ahead. Inflationary pressure is still rather moderate in the major industrialized nations and should not force central banks suddenly to reverse their expansive monetary policies. It is also worth noting that volatility on global markets remains relatively low historically, which is surprising given the developments of recent months.

What does this mean for the Swiss banks? It would be fatal to shut one's eyes to the signs of the times and simply ignore them. Increased caution could therefore be the order of the day. However, opportunities must also be identified and exploited. In turbulent times especially, demand for the traditional strengths of Switzerland and the Swiss financial center - security and asset protection - will only increase. Given their stability and above-average capital resources, their highly regarded expertise worldwide and the political stability of Switzerland as a business location, the Swiss banks have plenty of good arguments on their side to attract international clientele.
Consolidation continues apace, with the number of Swiss banks falling by a further eight in 2017. Since the turn of the millennium, 122 institutions have disappeared (33%). At first glance, employment figures in 2017 fell sharply by nearly 8.6% or 10,425 to 110,425 jobs. However, this figure includes a distorting special effect due to organizational changes at the two major Swiss banks, which in the wake of the too-big-to-fail regulation had to set up new service centers that do not have a banking license and transfer existing staff to these companies.

Swiss banks have increased their aggregate total assets by 53% over the past 10 years. In particular, business with mortgages has been stepped up, and the volume of such loans has almost doubled since the beginning of 2000 (94%). Total customer deposits have also risen by 102% during the same period, while assets under management have increased by a not-insignificant 51%, despite the stock market crash in 2008.
From 2000 to 2017, the aggregate operating income of Swiss banks fell by 9.1% from CHF 68.7 billion to CHF 62.5 billion, while costs rose during the same period from CHF 37.5 billion to CHF 44.0 billion, an increase of 17.4%. Given the differing performance and costs among banks, gross profit from operating activities shrank significantly by 40.9% to CHF 18.5 billion.

The earnings mix of Swiss banks has changed considerably since 2000. Due to the massive growth in mortgage lending business volumes, the interest differential business has become the most important source of income for Swiss banks, despite negative interest rates. Given the significant expansion in the lending business, absolute interest income was only slightly higher than the value seen in 2000, at CHF 24.0 billion versus CHF 23.7 billion. Interest margins have contracted considerably. The commission and service income business has undergone a profound transformation with the transition to tax-compliant cross-border asset management. Commission income remains at CHF 21.7 billion, down 25% on 2000.

Initiatives to boost profitability by the Swiss banks have had a limited effect so far. From 2000 to 2017, the cost/income ratio rose from 54.6% to 70.5%, which is not an encouraging development. While the highs of 82.4% and 76.6% recorded in 2008 and 2009 are still a long way off, banks can hardly be satisfied with this development and should be undertaking additional cost reduction and productivity improvement initiatives.

Bank’s lower operating income since the turn of the millennium is also reflected by the adverse development of value creation, which decreased by CHF 37.9 billion in 2000 to CHF 31.0 billion in 2017. Given this decline, the relative importance of the financial sector for the economy as a whole has declined, with banks’ relative share of the total value added by the Swiss economy falling from 8.6% in 2000 to just 4.8% in 2017.
Margins in traditional banking have been under pressure for some time now, as demonstrated by comparing the long-term growth of business volumes with the corresponding revenue streams. Although the aggregate volume of the balance sheet items mortgage receivables, amounts due from customers, and financial investments has grown by a total of 65.9% from CHF 1,113 billion to CHF 1,847 billion since 2000, net interest income recorded only a slight increase of 1.4% to 24.0 billion. These figures reflect the impact of the low interest rate environment.

The performance of the commission and service income business paints a much less rosy picture. While securities holdings have increased by 70.1% since 2000 to CHF 6,256 billion, income from commission and service fee activities has declined by CHF 7.2 billion or 24.8% to CHF 21.7 billion. This is due to several factors, not least the generally higher price sensitivity on the part of investment customers and the increased tax regularization of foreign assets held at Swiss banks during the period under observation.

Thus the previously very high-margin securities holdings of foreign private customers have decreased significantly since 2000 by CHF 443 billion or 44% to just CHF 553 billion. Assuming an imputed margin of 100 to 150 basis points, this results in declining commission income of an estimated CHF 5-6 billion annually. Meanwhile, the assets of foreign and Swiss institutional investors have seen a major rise since 2000, by 188%. These assets generate much lower margins than those of private individuals, however.
3. Operating business development
Signs of increasing uncertainty?

“How would you assess the current development of your operating business (over the past 6 to 12 months)?”

The Swiss banks are less satisfied with last year’s business performance than they were in the previous year. Only 19% – the lowest figure since 2011 - assess business development in the past financial year as clearly positive (previous year: 32%). While approximately one half of the banks are still cautiously optimistic about business development, one quarter are already recognizing a deterioration (previous year: 18%). Overall it can therefore be said that the optimism of the previous year has decreased.

Last year’s survey showed an extremely positive assessment of business performance. The banks were brimming with optimism at the end of the year because

• a protracted phase of dealing with legacy issues had been brought to an end;
• hope had begun to emerge that the regulatory screw would be loosened;
• the geopolitical risks were deemed manageable;
• the economic recovery underway in many parts of the world and the large volume of money injected by central banks had not quite peaked yet.

This year, however, increased uncertainty is being felt. Geopolitical risks have increased significantly and the downside of the ultra-expansionary monetary policy worldwide is becoming increasingly apparent. It can also be assumed the global economy is probably in the final phase of the economic cycle. In addition, the hope that regulatory provisions would be relaxed going forward has begun to fade.
Increased restraint on the part of cantonal banks and foreign banks

“How would you assess the current development of your operating business (over the past 6 to 12 months)?”

When looking at the various banking groups, it is discernible that the cantonal banks in particular are exercising more restraint than in the previous year. None of the cantonal banks surveyed have rated last year’s business development as clearly positive. In the previous year, a third of the cantonal banks surveyed still said so. A similar trend can be seen among the foreign banks, where only 22% still assess the course of business as positive - down 16 percentage points on the previous year.
Banks are still looking to the future with optimism. Overall 78% expect business performance to improve over the next 6 to 12 months (previous year: 82%). This optimistic tenor increases even further when looking to the medium and long-term future. Thus, the vast majority of the banks expect to be able to improve their results in the medium term (84%) to long term (87%).

Against an overall economic picture of shrinking margins and transformation pressures in the core business coupled with geopolitical tensions and signs of waning growth momentum in the global economy, this optimism is especially remarkable.

Positive outlook for the future despite uncertain environment

“What kind of development do you expect in your organization’s operating business?”

<table>
<thead>
<tr>
<th>Kurzfristig (6-12 Monate)</th>
<th>Mittelfristig (1-3 Jahre)</th>
<th>Langfristig (&gt; 3 Jahre)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3%</td>
<td>1%</td>
<td>13%</td>
</tr>
<tr>
<td>19%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>63%</td>
<td>65%</td>
<td>62%</td>
</tr>
<tr>
<td>15%</td>
<td>19%</td>
<td>25%</td>
</tr>
</tbody>
</table>

Positive (increase in operating income of over 10%)
Somewhat positive (increase in operative income of up to 10%)
Somewhat negative (decrease in operating income of up to 10%)
Negative (decrease in operating income of 10% to 25%)
Very negative (decrease in operating income of over 25%)

This poses the question, therefore, as to whether the banking industry is overly optimistic about the future or whether it can rightly rely on the resilience and adaptability it has demonstrated in recent years. The discernible differences in the future assessments of the asset management banks and the traditional retail banks indicate which direction the journey could take (see next page).
Banking groups assess future outlook differently

“What kind of development do you expect in your organization’s operating business?”

<table>
<thead>
<tr>
<th>Banking Group</th>
<th>Short term (6-12 months)</th>
<th>Medium term (1-3 years)</th>
<th>Long term (&gt; 3 years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cantonal banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Positive</td>
<td>20%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Somewhat positive</td>
<td>80%</td>
<td>70%</td>
<td>65%</td>
</tr>
<tr>
<td>Banks under foreign control</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Positive</td>
<td>4%</td>
<td>15%</td>
<td>7%</td>
</tr>
<tr>
<td>Somewhat positive</td>
<td>59%</td>
<td>71%</td>
<td>48%</td>
</tr>
<tr>
<td>Private banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Positive</td>
<td>6%</td>
<td>6%</td>
<td>3%</td>
</tr>
<tr>
<td>Somewhat positive</td>
<td>22%</td>
<td>17%</td>
<td>21%</td>
</tr>
<tr>
<td>Banks under foreign control</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Positive</td>
<td>3%</td>
<td>21%</td>
<td>15%</td>
</tr>
<tr>
<td>Somewhat positive</td>
<td>52%</td>
<td>50%</td>
<td>59%</td>
</tr>
</tbody>
</table>
| The individual banking groups assess their future prospects very differently. In particular, foreign and private banks, which are primarily active in the asset management business, are very optimistic about the future, with 45% of foreign banks and 29% of private banks forecasting they will be able to increase their earnings by more than 10% in the long term. In the case of the cantonal banks (10%) and regional banks (6%), however, hardly any bank is expecting any major growth on this scale.

What is the cause of these differing outlooks for the future?

The huge growth in the mortgage market in recent years, which has benefited retail banks in particular, is hardly likely to continue in the years ahead. It is also reasonable to assume that the exceptionally long period without any credit defaults cannot last forever. Moreover, the retail banks are faced with an acute pressure to transform in light of the emerging phenomenon of credit brokerage platforms and payment service providers. The final determining factor is that the market potential of the retail banks is restricted to the domestic market.

The asset management banks have already undergone a profound transformation and aligned themselves to the new realities, with the transition to tax-compliant cross-border asset management. In contrast to the retail banks, however, the asset management banks can avail themselves of a global market. Global assets continue to make strong gains, especially in Asia and the US. The number of millionaires worldwide has more than doubled since the financial crisis to 18.1 million, equivalent to an annual rate of growth of approximately 9%. This growing group of customers requires not only appropriate investment products and professional advice for their assets, but increasingly also security and stability to protect the assets they have accumulated, not least in times of exacerbated geopolitical and macroeconomic uncertainty. This development should play into the hands of the Swiss asset management banks, in particular.
The interest rate business has garnered considerable importance in recent years on the back of the massive increase in lending volumes and today constitutes the major source of income for the Swiss banks. Nevertheless, the margins in the traditional interest differential business have also contracted markedly due to the exceptionally low interest rate environment. Additionally, with no indication that the huge growth on the mortgage market seen in recent years will continue going forward, the banks are increasingly on the lookout for new sources of income.

Against this backdrop it is not surprising that the majority of the banks surveyed (56%) now identify the greatest potential for growth for their institution in the investment business (investment advice and asset management). Interestingly, it is the cantonal and regional banks, which are very strongly anchored in the lending business, that have identified the greatest opportunities for growth in the investment business.

The diversification plans of the Swiss banks bode well for their stability and crisis resistance overall, since over-dependence on the mortgage lending business could create problems down the line. The banks therefore want to strengthen their advisory expertise and offer customers comprehensive care and support in all aspects of their finances. For banks that invest today in the right technologies and skills, this diversification strategy shows great promise. It remains to be seen, however, whether for the majority of banks this focus on the investment business will actually bear the fruit they are hoping it will. The sum total of the individual institutions’ goals is greater than the effective market potential, at least for the Swiss business.

This could be a rather rocky road, especially for banks with a strong focus on domestic business and those that mainly serve affluent customers. The growth potential for the investment business in the Swiss market is rather limited and will not be sufficient to satisfy the expansion ambitions of all Swiss banks. It is also be assumed that young, disruptive technologies and business models will further exacerbate the competitive situation.

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**Investment business shifts into focus**

“In which business segment do you expect the biggest growth potential for your organization?”

---

**Credit business**

**Investment business (investment advice, portfolio management)**

**Trading business**

**Asset Management**

**Other**

---

The diversification plans of the Swiss banks bode well for their stability and crisis resistance overall, since over-dependence on the mortgage lending business could create problems down the line. The banks therefore want to strengthen their advisory expertise and offer customers comprehensive care and support in all aspects of their finances. For banks that invest today in the right technologies and skills, this diversification strategy shows great promise. It remains to be seen, however, whether for the majority of banks this focus on the investment business will actually bear the fruit they are hoping it will. The sum total of the individual institutions’ goals is greater than the effective market potential, at least for the Swiss business.

This could be a rather rocky road, especially for banks with a strong focus on domestic business and those that mainly serve affluent customers. The growth potential for the investment business in the Swiss market is rather limited and will not be sufficient to satisfy the expansion ambitions of all Swiss banks. It is also be assumed that young, disruptive technologies and business models will further exacerbate the competitive situation.
The question regarding future personnel development reveals a very disparate picture. Like in the previous year, the majority of the banks (57%) expect headcount to remain relatively constant in the short term (previous year: 56%). Only 13% of the banks surveyed plan to reduce the number of employees by 5% or more (previous year: 14%), while 30% intend to increase their headcount, on a par with the year before.

In the medium to long term, however, banks appear to expect the labor market to become increasingly dynamic. Accordingly, the number of banks that expect headcount to remain constant has fallen from 57% (short term) to 34% (medium term) or as little as 20% (long term). This is an astonishing result, since the trend seen in recent years’ points clearly in the other direction, with headcount declining by around 16% since 2010.

The Swiss banks obviously do not expect to be able to achieve their ambitious growth targets with a constant headcount – despite the increasing use of robots, the ongoing automation of business processes and additional outsourcing agreements. This can partially be explained by the fact that the banks want to grow primarily in the advisory business and to this end will need to develop additional advisory expertise or hire more advisors. Conversely, it also means that the Swiss banks cannot be expected to make any significant productivity enhancements in the future.

A cursory analysis of the various banking groups reveals that the cantonal banks are considerably more sceptical about future employment trends. While among the other banking groups one half up to as much as two thirds expect to increase their headcount, this figure is only 10% among the cantonal banks surveyed. By contrast, 55% of the cantonal banks forecast a reduction in their staffing levels.
4. Negative interest rates
The banks are worried about the persistent negative interest rates, with even more banks (89%) than last year (86%) anticipating negative repercussions for their institution resulting from the SNB’s low interest rate policy. This expectation is evident across all banking groups, not only among the cantonal and regional banks active primarily in the interest differential business.

The persistent negative interest rate environment is squeezing banks’ interest rate margins, and as long as there is no end to the expansionary monetary policy in sight, they will still have to find appropriate answers to this challenge. In the past, banks have responded by massively expanding their loan books and reducing deposit rates to zero. So far this has enabled them largely to offset their disappearing margins in absolute terms, but they have stopped short of passing on negative interest rates to private customers in most cases.

The mortgage market is already showing initial signs of saturation, and the significant volume growth seen in recent years certainly cannot be continued into the future or even be repeated. Deposit interest rates have been at zero for some time and cannot be cut further without far-reaching consequences. This threatens to further exacerbate banks’ profitability problems in the long term. Passing on negative interest rates also to private customers could offer some relief here, but in the long term the only real improvement will be afforded by a change in central banks’ monetary policy.

“In January 2015, the SNB introduced negative interest rates and is expected to keep rates low for some time. How would you assess the situation for your organization?”
The banks are no longer prepared to bear the burden of negative interest rates alone. Whereas in 2015 70% of the banks surveyed categorically ruled out passing on negative interest rates, the figure is now only 34% (previous year: 43%). Only among the regional banks do the vast majority (67%) still completely rule out passing on negative interest rates to their customers.

Retail customers should, however, not be affected by any negative interest charges to their current and savings accounts. Only 13% of banks (previous year: 16%) can envision introducing such a measure for customers with assets of CHF 100,000 or more. The cantonal banks reject such a step across the board, while the regional banks do so with a vast majority of 89%. It would be virtually inconceivable at present for customer assets under CHF 100,000 to be charged negative interest.

However, the results of the survey also show that passing on negative interest rates to wealthy customers is increasingly becoming a reality. The banks are no longer able and willing to shoulder the full extent of these additional burdens.
The banks are increasingly willing to pass on negative interest rates to their customers. This is also reflected in the banks’ response when asked about the future threshold for passing on negative rates, with one third of the banks surveyed stating that they wanted to lower the corresponding threshold in the foreseeable future. If the era of negative interest rates does not come to an end soon, negative interest costs will therefore increasingly also be felt directly by private customers.
Squeeze on margins still the biggest burden

“Which of the following consequences of the sustained low-interest environment do you consider to be the most severe?”

Only one of the banks surveyed (previous year: 3%) does not see any serious consequences from the negative interest rate environment. Although banks have dealt with the negative interest rates surprisingly well so far, the main danger posed by the low interest rate policy for the majority of banks is the erosion of margins in the interest rate business. At the outset, banks were still in the position to compensate for the drop in interest on the assets side by reducing deposit interest rates. Since deposit interest rates are now practically at zero, however, it is no longer possible to offset the burden in this way.

Notwithstanding the adverse impact the negative interest rate policy is having on the banks’ business, they remain convinced that the low interest rate environment will not lead to a softening in lending criteria and excessively risky financing. With that in mind, as in the previous year, only 11% of the banks have detected an increase in risk appetite in the financing business. This assessment is due not only to the stricter regulatory requirements with regard to pledging and portability, but also to the extremely low impairments and losses in the Swiss bank’s lending businesses in recent years.

Pension funds are another serious victim of the persistently low interest rate environment. The long-term repercussions on pension systems can only be estimated at the present time. One thing is certain, however: the negative interest rates are causing misallocations of capital and have driven up the quoted prices of all asset classes in recent years. The risk of bubbles forming in individual asset classes therefore cannot be ruled out.
End to negative interest rates: wishful thinking or reality?

“Do you expect the SNB to increase interest rates into positive territory in: “

The negative interest rates are a fundamental challenge for the banks and are presenting them with a serious profitability problem. For banks active in the lending business, in particular, a normalization of interest rate policy in the form of a gradual rise in interest rates would be a welcome development. It thus goes without saying that an end to the negative interest rate saga is at the top of the wish list of the Swiss banks.

Although the banks do not expect the SNB to change course in the short term, the vast majority of the banks surveyed (72%) expect the SNB to end its expansive monetary policy in the medium term (that is, in one to three years), and interest rates to normalize as a result.

Is this assumption on the part of the Swiss banks justified, or is it just wishful thinking? Even though the US Federal Reserve has already begun to normalize interest policy and has already increased interest rates on four occasions over the past twelve months (the target range for the Fed Funds Rate is now 2.25%-2.5%), there are indications that interest rates in Europe and Switzerland will probably remain very low for a long time to come. Debt has reached record levels worldwide and higher interest rates would put enormous pressure on many of the highly indebted debtors. Especially in the EU, the question arises as to whether a rise in interest rates would be politically feasible at all in view of some highly indebted countries.

Against this backdrop, the SNB would not seem to have much leeway to pursue an independent monetary policy and the low interest rates are likely to persist for the foreseeable future. The most conceivable scenario for a reversal in interest rate policy would be a significant rise in inflation, since the resulting conflicting objectives would require a response from the SNB.
5. Financial market regulation
Following the financial crisis, a massive wave of regulations was unleashed on banks, including continually updated and stricter provisions on sustaining liquidity, capital adequacy and risk management. However, the relevant regulatory provisions only rarely included consideration of the principle of proportionality, which would afford tangible relief for small and mid-sized banks. Many of the small and mid-sized banks have therefore increasingly pointed out in recent years that their competitiveness is being jeopardized by the complex and intertwined mesh of regulations placed on them by the authorities – regulations which are primarily targeted at large, systemically important banks – and they need to be given back more entrepreneurial freedom to secure their long-term success.

In response to this, in fall 2017 FINMA announced within its small bank symposium that it would be examining specific measures to simplify regulation for small banks (i.e. banks belonging to supervisory categories 4 and 5), and in July this year launched the pilot phase of the “small banking regime”. This is geared toward banks with above-average capitalization and very high liquidity. The participating banks enjoy some regulatory relief, for example in relation to the risk-weighted equity ratio, the net stable funding ratio and individual disclosure requirements. No concessions are made concerning the rules of conduct, however (investment suitability, anti-money laundering, market conduct, and cross border).

Smaller banks hope that the small banking regime will make life much easier for them and reduce costs. With that in mind, 82% of all banks with total assets of less than CHF 1 billion believe that the small banking regime is heading in the right direction. Even the banks with total assets of between CHF 1 and 10 billion have a relatively high level of approval, at 60%. Unsurprisingly, this approval decreases as the size of the institution increases. Among the banks with total assets of between CHF 10 billion and CHF 50 billion, the approval rating is just 29%, and among the banks with total assets exceeding CHF 50 billion, it is as low as 17%. Concerning the latter group, however, it should be noted that 49% of the banks surveyed indicate that their institution is not affected by the small bank regime in the first place and therefore they see no advantages or disadvantages from it.

“In 2018, FINMA has introduced the “small banking regime”. Do you consider the respective measures as being meaningful for your organization?

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<td>24%</td>
<td>58%</td>
<td>12%</td>
<td>6%</td>
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</tr>
</tbody>
</table>
Banks want to expand small bank regime

“If the answer to the previous question was “no” or “probably not”: Why?”

Those institutions that reject the small banking regime in its current form (31% of the institutions surveyed) often believe that the small banking regime still does not go far enough and that further measures or simplifications must follow (37%). Many banks with total assets of between CHF 10 billion and CHF 50 billion share this view. In total, 50% of banks of this size explain their disapproving stance toward the small bank regime with this justification. Only in very few cases are these banks in supervisory category 4 or 5 and thus banks which are not yet open to the small banking regime in its current form. The clearly visible desire to extend the small bank regime to include institutions in supervisory category 3 seems to play a role here.

The larger banks reject the small banking regime because they fear that it will lead to different standards within the banking industry with regard to important items of regulation. This unequal treatment is deemed unjust and perceived as a breach of the principle of legal equality.

It remains to be seen whether the regulator will ultimately comply with the sector’s desire for more relief for all banks.
The costs for the risk control and compliance functions will remain high in the future and not see any sustainable decline. This opinion is shared by at least 82% of the banks surveyed, including all of the cantonal banks and more than 80% of the regional banks.

Last year’s clear hope that regulatory efforts and the associated costs have now peaked and will normalize with less regulation and lower costs has not yet materialized. This year, less than one third of the banks surveyed believe that the financial sector will be less regulated in the future (last year, the figure was still 37%).

It should also be noted that the complexity resulting from the flood of regulations following the financial crisis risks consuming the risk control and compliance functions by burdening them with additional responsibilities. The banks are trying hard to simplify these functions in a sensible way without compromising quality. It can also be observed that the individual regulators in various countries increasingly represent national interests and place additional requirements on relevant foreign locations, with the effect of greatly impairing the global management of banking business.

A core problem can be seen in the fact that in recent years – also in the wake of complex new regulatory provisions – many control tasks have been gradually shifted from the front-end departments to the central functions of risk control and compliance. The likely course of action here will be to bring in measures to reinforce controls and responsibilities in the front-line units so as to reduce and simplify again the scope and complexity of the tasks incumbent on the central risk control and compliance functions.

Regulatory costs remain high

“Banks are expecting to see a reduction in the numbers of new regulations in the future and therefore a corresponding reduction in costs, especially related to the risk and compliance functions. Is this true for your organization? Do you expect cost reductions in these functions?”
The financial and economic crisis shook the financial world to its core when it hit in 2007. In the years that followed, the banks had to implement a wide range of new regulations - and absorb the costs that went with this. Despite these considerable regulatory costs, the banks recognize that a lot of the regulations introduced in recent years have made the financial system more stable overall.

However, there are also areas in which the banks surveyed have identified regulatory overzealousness. This applies in particular to the issues of investor protection (67%), fund regulation (60%) and liquidity regulations (55%).

An interesting development is that the approval rating concerning some major areas of regulation has improved compared with a year ago, with the banks identifying less tendencies toward over-regulation that they did the year before in derivatives trading (down 13 percentage points), tax transparency (down 11 percentage points), liquidity requirements (down seven percentage points) and capital adequacy requirements (down six percentage points). This could be related to the fact that, following an initial analysis and implementation phase, which also includes investment in new IT systems and the corresponding parametrizations, compliance costs will gradually start to fall again. Consistent with this, the banks exhibit particular scepticism concerning the largest regulation project of the recent past, namely data protection (54%).

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However, there are also areas in which the banks surveyed have identified regulatory overzealousness. This applies in particular to the issues of investor protection (67%), fund regulation (60%) and liquidity regulations (55%).
The Parliament ratified the Financial Services Act (FIDLEG) in summer 2018. FIDLEG stipulates new rules for providing financial services and offering financial instruments. The overriding goal of the draft legislation is to strengthen customer protection toward financial institutions. A key consideration when drafting FIDLEG was to create equivalent provisions to EU law. Compliance with equivalence requirements is a vital prerequisite for market access in European countries.

As in the previous year, the Swiss banks’ assessment of FIDLEG is mostly negative. This criticism intensified further this year: around three-quarters of banks now fear that FIDLEG will lead to the product range being restricted due to advisory requirements, customer segmentation and mandatory product information. At the same time, 54% of the banks expect that the additional transparency and the advisory and warning obligations will not contribute to an increase in the quality of advisory services. In the short term, FIDLEG will probably raise service costs and increase pressure on margins. In the medium to long term, however, the banks (78%) intend to pass on the additional costs to customers.
The assets under management at the Swiss banks totalled CHF 7,292 billion at the end of 2017, constituting an increase of 51% since the turn of the millennium. Around half of the managed assets originate from international customers. The Swiss financial centre is highly internationalized and export-oriented. With a market share of 27.5% in cross-border asset management business with private customers, Switzerland is the global market leader. Therefore, access to international markets, particularly the European market, is of key importance for the competitiveness of Swiss banks.

Estimates put the total financial assets held by private individuals in Europe at EUR 18 trillion. It is therefore without doubt that the EU is an extremely lucrative market also for Swiss banks. To ensure that the Swiss banks retain access to the EU markets, for some time Swiss policymakers have been in negotiation with the EU to conclude a financial services agreement that lays down the fundamental rules of play for future collaboration. So far, however, this process has been without success, attributable in part to the Brexit negotiations that have been running in parallel between the EU and the UK.

Within the Swiss financial sector, there seems to be some displeasure at the long-drawn-out negotiations with the EU. Three-quarters of the banks surveyed agree with the statement that Swiss politicians currently do too little for the financial centre and securing Swiss banks’ access to the EU market. Not surprisingly, these include in particular the private banks that are strongly anchored in international asset management.
Despite the threat of losing market access to the EU, Swiss banks are keeping a cool head. Almost two thirds of the banks surveyed (62%) do not see any serious consequences for their institution. Nevertheless, 22% forecast a significant decline in earnings and jobs in Switzerland and 16% the outsourcing of at least part of their activities to the EU.

There are major differences within the banking industry, however. While the cantonal and regional banks – which are focused predominantly on the domestic market – perceive almost no negative repercussions (85% and 94%, respectively), the private banks seem much more nervous. Only 27% of these banks do not see any negative consequences for their institution. Under certain circumstances the majority of these banks would have to open new branches abroad and in some cases even relocate important parts of the value chain and thus also attractive jobs to foreign locations. That would inevitably weaken the Swiss financial centre.

A clear difference in opinion is also perceptible depending on how large a bank is. While the large institutions, which already have a strong presence in the EU region, are not worried about any negative consequences for their institution, the smaller banks are exhibiting far more concerns. This is hardly surprising given that such banks often cannot (or do not want to) open any branches abroad and only advise customers domiciled in the EU when they come to Switzerland.

Nevertheless, regardless of the specific consequences for the individual banking institutions, it is clear that from Switzerland’s point of view it would undoubtedly be a loss if some of the Swiss banks had to shift part of their value creation abroad due to additional barriers to entry into the EU.
History has taught us that major financial and economic crises are par for the course. And it is not unreasonable to assume that we will have to face periods of great upheaval again in the future. In recent months more and more voices have been warning about the next crisis on the horizon.

The banks surveyed see the greatest risk of a new potential financial crisis in the consequences of the central banks’ expansionary monetary policy and the unresolved debt problem (33%), followed by increased geopolitical uncertainties due to trade protectionism, and an increasingly nationalist tone in the policies of individual countries (27%). A further 11% see the greatest risk in falling real estate prices.

Only very few expect a financial crisis to be triggered by a stock market crash (7%) or cyber attacks (4%). Given that the ECB recently also warned of a financial crisis triggered by hacker attacks, this assessment is surprising.

The anatomy of previous financial crises in many cases shows that high, rapidly increasing debt - in particular, foreign debt in foreign currencies - was a driving force behind these financial crises. As a consequence, many of the banks surveyed expect that any future crisis will have the same root cause as the crises that have come before it. Indeed, global debt has skyrocketed since the financial crisis since the loose monetary policy of the central banks has encouraged many market participants to take on additional debt. Should their interest burden rise dramatically as a result of a sustained uptick in the yield curve, this could land many borrowers in a tricky situation.
6. Lending business
In recent years, Swiss banks have greatly expanded their mortgage volumes, amounting to CHF 995 billion as of end-2017 – almost double the level in 2000. The Raiffeisen banks (+190% since end-2000) and also the cantonal banks (+97% since end-2000) have especially stepped up the pace here in recent years.

However, the momentum of the mortgage market is showing perceptible signs of slowing. At present, 44% of the banks expect to pursue a more restrictive lending policy for residential property financing in the future. This is a significant increase in comparison to the previous year (34%). By contrast, 55% of the banks intend to continue the lending policy of recent years (previous year: 62%). And only a few of the surveyed banks still predict more expansive lending policies.

The greater caution shown by the banks is not surprising. The mortgages market is already showing signs of overheating in some regions and segments after a long period of expansion. In addition, the dearth of investments in recent years has increased the appeal of the mortgage business for other market participants, leaving banks – which, with a share of well over 90%, continue to dominate the market – having to vie for position in this already largely saturated industry. This development is bringing the mortgages market to boiling point – a problem the Swiss banks would like to avoid in the future.
Increasing impairment losses expected in residential property financing

“What level of risk provisioning (impairment losses and provisions) do you expect you will need to cover your residential property financing business?”

As in previous years, the Swiss banks are unconcerned in the short term about risk provisions for residential property financing. After last year returned the lowest value since the study began, at 23%, this year even fewer banks – 13% – expect a rise in risk provisions in the foreseeable future. This assessment is consistent with the observation that impairment losses for default risks at the Swiss banks are currently at an all-time low.

Banks’ extremely positive short-term outlook is bolstered by the positive performance of the real estate market in recent years. The sustained negative interest phase has created almost idyllic conditions for borrowers: highly attractive financing conditions, continually rising real estate prices and an unabated job boom on the labour market are just a few of the buzzwords that come to mind in this context. It therefore comes as no surprise that the Swiss banks have experienced record-low mortgage loan defaults in recent years.

But the tide on the real estate market appears gradually to be turning, with some regions exhibiting noticeable signs of overheating in the area of investment properties. The intense construction activity seen in recent years has already led to high vacancy rates due to falling demand in the wake of declining immigration. These vacancy rates are now significantly higher than the required property supply, with the exception of a few regional specificities.

Looking to the future, the Swiss banks do not believe this situation, which is so favourable for them, will continue forever and are expecting the credit cycle to normalize. In the medium term, 39% of banks are already anticipating higher impairment losses - in the long term this figure will even rise to 69%.

A major contributing factor to this expected increased risk provisioning requirement can be found in the Swiss accounting standards for banks. These are retrospective in nature and offer only very limited possibilities for collective impairment provisions and allowances for credit defaults expected in the future. FINMA has recognized this and has presented an approach for discussion for dealing with the expected losses for Swiss banks. Initially, however, only systemically important banks are expected to have to apply the expected credit loss method.
Situation in the real estate market remains tense

“Do you agree with the following statement?: “The current housing boom and the price increases in investment properties is a considerable risk for the Swiss real estate market””

In recent years, the prices of multi-family homes have only moved in one direction: upwards. This is despite the fact that vacancy rates have increased significantly of late. The main reason for this development lies in central banks’ extremely loose monetary policy. Ever lower interest rates have led to a dearth of investments and have made the investment property market lucrative for many investors.

The development of prices for investment properties provides an example of how negative interest rate policy can lead to misallocations of capital. Considering that past recessions triggered by real estate crises have proven especially severe and protracted, the price trends on the real estate market are certainly alarming. In the past, dynamic price developments were somewhat mitigated by macroprudential measures implemented by the SNB and by new, more restrictive self-regulatory requirements on the part of banks; meanwhile, banks have built up more loss-absorbing capital since the financial crisis. But despite such measures, it can be assumed that the regulators (FINMA and SNB) will in the future continue to keep a close eye on developments in the real estate market and on banks’ lending practices.
The mortgage volume held by Swiss banks has been growing at a rapid pace for years, having now exceeded the value of CHF 1,000 billion. This corresponds to a doubling of the volume since the turn of the millennium. For some time, other providers have increasingly been appearing on the market and attempting to gain market share. These are especially insurance companies and pension funds, which face a veritable dearth of investments due to the low interest rate phase, as well as innovative FinTech companies and platforms that are also entering into competition for certain parts of the value chain. Although banks continue to dominate the market with a market share significantly over 90%, their margins have fallen due to the interest rate situation and increased competition.

The banks surveyed are divided on the issue of whether non-bank providers will remain active in the market even after the (possible) end of the negative interest rate phase. One half of the banks expects the new competition to disappear, while the other expects the opposite. This reveals considerable uncertainty among Swiss banks about the future direction of the mortgage market.

What will actually happen remains to be seen. It seems certain, however, that digitalization offers new market participants many opportunities to break up the value chain further and penetrate the market. The emergent brokerage and comparison platforms have made the value chain, as well as offerings, both more transparent and more competitive. And insurance companies and pension funds represent an increasing source of competition for banks, particularly thanks to their long-term-oriented mortgage solutions.

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Non-industry players: come to stay?

“Do you agree with the following statement?: “The margin pressure in the real estate business due to additional market participants such as pension funds and others (peer-to-peer lending, etc.) is a temporary phenomenon and will subside as soon as interest rates have returned to normal levels.”

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### Table: Non-industry players 2018

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No panic over abolition of imputed rental value

“At the end of August 2018, the commission for economy and taxes of the Swiss Council of States decided that the concept of the deemed rental value of owner-occupied residential property should be abolished. How do you assess the mid to long-term consequences for your organization?”

The “imputed rent” approach – or the taxation of notional income while mortgage interest is tax-deductible – is a specificity of the Swiss tax system. This tax incentive to remain indebted has ultimately led to a situation in which private real estate owners in Switzerland often stay in debt over a much longer period and to a much greater extent than homeowners abroad. The incentive to reduce mortgage indebtedness is relatively small in the Swiss system.

In the summer of 2018, the Swiss Parliament took a new approach, replacing imputed rent with a new system of residential property taxation. In August, the Council of States’ Committee for Economic Affairs and Taxation (WAK) presented the key data in this context. The exact design of the WAK proposal is anticipated in the spring of 2019. Any change to the system still has to overcome a number of political hurdles and is unlikely to be implemented before 2021.

Should the system actually change, it can reasonably be assumed that debtors will pay back their residential mortgages faster in the future, which could lead to a decline in the banks’ total mortgage volume in the medium to long term.
Swiss industry will not have to expect any bottlenecks in the availability of borrowed capital in the future. As in the previous year, only 17% of the banks surveyed believe that lending to SMEs will be restricted. With increasing caution in the mortgage lending business, this development should lead to the gap in bank balance sheets between mortgage loans, on the one hand, and corporate loans, on the other, narrowing following a period of widening in recent years. This would be very unusual against the background of past developments: in recent years, the volume of corporate loans has decreased in proportion to mortgage loans, and also relative to economic performance.
The assessment of future risk provisions for SME financing is very similar to that of residential property financing. Virtually no one expects higher impairment losses in the short term. However, the picture is much gloomier for the future. In the medium term, about one-third of the banks expect demand to rise; in the long term, this proportion is more than half.

The banks therefore assume that the phase of historically low credit defaults is also slowly coming to an end for corporate lending business. In light of increased geopolitical tensions and increasing signs that economic growth may have reached its apex, this assessment is unsurprising. And if interest rates should rise again, or the economic cycle should take a downward turn, it remains to be seen whether the quite strict lending standards of Swiss banks for corporate financing will in fact be as effective as desired.

...but in the long term significantly higher defaults are expected once more.

“What level of risk provisioning (impairment losses and provisions) do you expect you will need to cover your SME lending business?”
7. Structural change and FinTech
The key message regarding structural change has hardly changed from last year. Opinions on the existence of structural change are still divided, but there has been a slight increase (5 percentage points) in the proportion of those convinced that a sustainable transformation of the value chain is underway. One-quarter of the banks still believe that there is no structural change underway in banking.

In fact, the structural development of the industry needs to be looked at in a more nuanced way: in recent years, the sector has experienced an initial wave of structural change, driven in particular by the implications of regulatory change. A structural change triggered by customers can be expected, but is not currently taking place. It can be assumed that the changes in banking will take place at staggered intervals and in various customer segments. Other industries (e.g. media and tourism) have been affected by structural change at an enormous speed that cannot be expected in the banking industry due to various factors. These include regulations, limited resources, temporary market effects, and in particular, the rigid behaviour displayed by banking customers. In this context, asset protection is of key importance: customers are evidently not prepared to entrust all of their assets to a digital bank, they find it a hassle to change their main banking relationship, and they dislike changing their habits.

Particularly in traditional institutions, because of their “internal immune systems”, fundamental transformation projects in the development of new business models are hardly feasible or workable at present.

Trends in other markets do not provide a reliable guide for predicting future conditions in Switzerland, but they do demonstrate the logic of such changes in the market. One development that can be anticipated is a stronger focus by market participants on specific areas of the value chain that have so far been covered completely by banks. New business models are being developed as a consequence: models that cover the customer interface (1) and/or orchestrate solutions (2), that enable the existence of a marketplace for providers (3), concentrate on products (4) or provide infrastructure (5). The question remains of how many institutions will be necessary for each business model category to fully cover the financial needs and requirements of the Swiss population.
Structural change will initially affect retail/affluent business

“In your opinion, which of the following business areas is most affected by structural change?”

The banks agree that the “payments” area has been hardest hit by structural change (47%). Credit business, investment advice and asset management make up, together and fairly evenly distributed, the other half of the votes.

The result implies that structural change will first affect retail and affluent banking. In fact, the majority of new entrants are positioning themselves with these customers by offering basic services such as account management, FX transactions and credit and Maestro cards at much lower prices or free of charge (“free banking”). For traditional banks, these earnings mainstays are profitable, but at the same time, and for this reason, this development is making them vulnerable in their value creation. Further trends, such as the positive momentum of marketplaces and exchange platforms, are also an indicator that structural change is first having an impact on retail and affluent business. It may be assumed that investment business will also be affected by a second wave of structural change at a later point in time. Thanks to their lower expense ratio, asset managers from other markets, whose business models are based on the latest technologies, are able to offer significantly lower prices for affluent end customers and increasingly combine asset management with comprehensive investment advice (forward integration).

Considering that interest income and commission and services business represent the major income pillars for Swiss banks, the potential implications of these developments for the banks’ value creation should not be underestimated. As a consequence, it must be assumed that an increasing gap will form between the added value of the Swiss economy and that of Swiss banks. With respect to margins, the achievement of historical levels is not to be anticipated.

The key question that remains is when customer-driven structural change will materialize. From other industries, it is known that this can be a step forward in the value proposition. Applied to banking, this could be an intersect of four decisive criteria: advice, best deal, convenience and credible protection of deposits and assets.
Over the years, the key drivers of structural change have become better understood. This is accompanied by the belief (66%) that technological progress and digitalization are some of the key drivers that will ultimately trigger fundamental change in the financial services business. Just two years ago, only 26% were of this view.

Now almost one-third of the banks (27%) regard digitalization solely as an additional sales channel. Indeed, many banks are currently investing in the development of sales channels allowing customers to choose when, how and where they conduct their banking activities.

Practically all of the banks have integrated digitalization in their strategic approach. This has led in particular to short-term digitalization hype in the market. In concrete terms, various experiments have been carried out in specific functions, and innovation hubs have been founded. However, their results are only scalable to the entire company on a limited basis.

The focus on short-term digitalization initiatives has taken precedence over the examination of fundamental issues related to structural change. Only a few institutions have so far engaged in overarching consideration of how a sustainable and scalable business model will look in the longer term. This attests to a typical situation in industries affected by structural change, where the short-term implications of major structural developments are overestimated and the long-term implications are underestimated.

### Digitization recognized as main driver of structural change

“What is, in your view, the significance and potential value-adding proposition of digitization in the financial services industry? Which of the following statements best describes the current situation?”

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- Digitization will fundamentally revolutionize the financial services industry
- Digitization will add an important sales and distribution channels
- Digitization is overrated and will recede again

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<tr>
<th>Year</th>
<th>Private banks</th>
<th>Banks under foreign control</th>
<th>Regional banks</th>
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![Graph showing percentage of banks per year](image-url)
Are banks’ IT operations fit for the future?

“Would you say that your current IT architecture is “fit for purpose” in order to address current and future challenges?”

Only 58% of the banks still believe their existing IT architecture is “fit” enough to master the challenges of the future (previous year: 67%). This greater scepticism is being felt by all banking groups – with the exception of private banks, where the opposite trend is discernible.

This result may have various causes: On the one hand, customer expectations regarding digitalization in retail banking are presumably somewhat higher than in traditional private banking. On the other, some private banks have only recently renewed their core banking platform and IT architecture, or their renewal projects are still underway. At numerous cantonal and regional banks, such adjustments were already made some years ago. Many digitalization projects in banks under foreign control, and in cantonal and regional banks, are associated with the acquisition of new systems and applications, since integration in the existing core banking applications (partly still based on host systems) is either not possible at all for technical reasons, or would cost a great deal more than the acquisition of new systems. However, banks that are currently in the process of converting their core banking applications can to some extent incorporate digitalization requirements in their projects directly.

Even though banks generally aim to reduce the number of their systems and applications in order to reduce the complexity of their IT landscape / IT architecture, the reality is often different. As a rule, new digitalization projects often increase the existing complexity of the IT landscape even further due to the addition of associated new proprietary systems and applications. Banks that are now in the process of digital transformation are therefore discovering this for themselves. The insights from this process will certainly also shape opinions and feed doubts about whether the existing IT architecture is sufficiently fit for the future.
Swiss banks regard marketplaces and platforms, as well as blockchain, as posing the greatest danger to their business. Regional banks in particular (66%) view marketplaces and exchange platforms as posing a large threat to their business. This is not surprising, especially considering that an average of 75% to 80% of the operating income of retail banks stems from interest income. Today’s marketplaces increase the transparency in the market and offer consumer loans, business loans and mortgages at significantly better prices. They also reduce barriers to entry to the mortgage market for insurance companies and pension funds. These institutions are interested in investing in mortgages due to the low interest rate environment and the resultant dearth of investments.

As in the previous year, 28% of the banks identify blockchain as representing the biggest threat for established financial institutions, even though it remains unclear, in the market overall, what this technology means with regard to new business models, and in which cases of application it can provide significant added value. The potential of blockchain should certainly not be underestimated – particularly in investment business. In light of digitalization and the heightened complexity of cyber attacks, the protection and safeguarding of assets will gain in importance, potentially developing into a value proposition on the part of asset managers. Blockchain technology is used, among other things, for digitizing assets and storing them in this form (“tokenization”). In addition, the technology can lead to transactions being executed more cheaply, directly and without intermediaries.

Open banking will only reinforce these phenomena, in particular marketplaces and platforms; there is little doubt that such business models will arise. Tech-savvy companies will have a major advantage in terms of customer acquisition and customer loyalty thanks to their ability to better process and interpret customer data and turn it into customized, individual solutions.
Whereas banks last year focused on the areas of analysis and decision-making, as well as the middle and back office, this year’s result is much more balanced. The biggest increase (from 5% to 18%) is seen in the view that artificial intelligence (AI) and/or robots (process automation for previously manual processing steps) will also be used in key functions such as finance, risk and compliance. It can also be observed that the proportion of banks expressing opposition to AI and/or robots has declined by 7% in comparison with the previous year.

As with blockchain, it is still largely unclear in which areas artificial intelligence can offer the greatest added value for the bank and its customers. The market is still holding back on major investment. The main focus is on how this technology develops and what other market participants are doing in this context. Many banks are thus pursuing a follower strategy in this respect.

An undisputed advantage of robots is that they can work around the clock and have a near zero rate of error for their specific task. In asset management, particularly as a system-based support function for customer advisors, they also have the potential to significantly improve the quality of advice and the advisory experience for customers.
Customer proximity and high consulting quality are key factors for safeguarding the customer interface

“In your opinion, which factor will be decisive in order to ensure customer loyalty in the future?”

The Swiss banks are of the opinion that customer proximity (40%) and high quality of advice (27%) are crucial to ensuring customer loyalty in the future, as well. However, the following questions remain unresolved: How can customer proximity be measured? And, in the context of advisory services, how is it possible not only to create the perception of added value for the customer, but also to achieve value extraction?

The EY relevance study (2016) identified an increasing discrepancy between customer satisfaction and customer loyalty. Half of the end customers surveyed in Switzerland were satisfied with the quality of advice provided by their bank, but saw potential for improvement in other aspects from a customer perspective; according to the relevance study, 83% of the bank customers surveyed believed that the bank did not act in their long-term financial interests. Of those surveyed, 67% believe that products and services could be better geared to their needs. According to 70% of the bank customers, the bank did not understand their individual requirements.

It is true that the financial services sector lags far behind other industries when it comes to understanding customers. Lack of clarity persists regarding essential customer needs and the implicit drivers of customer decisions. Customer segmenting and service based on traditional elements will be of limited usefulness for future business models. Instead, one key lies in the profiling of individual customers and the associated adaptation of products, channels and approach/communication.

What do customers want? New business models that record above-average growth of the customer base imply that the following three services are of key importance: individual financial solutions in conjunction with comprehensive advising (1), the best price offers including evidence (2) and convenience (3), such as that with which customers are familiar from other industries. To this is added the protection of assets and personal data (4) in the specific case of investment advising.
8. Priorities for 2019
Although banks have been heavily involved in implementing new regulatory requirements in recent years, growth and innovation are once again the focus of attention today. The stronger prioritization of these topics has been noticeable for some time. Even though two years ago only 27% of the banks defined growth and innovation as priorities, last year the figure was 43% and now almost half (49%) of all banks surveyed.

One-third of the banks surveyed see efficiency improvement programs and cost-cutting measures as the dominant topic in the next 6 to 12 months. This also represents a slight increase compared with the previous year’s figure of 27%.

Although the banks are not very hopeful that the wave of regulations in the financial sector will recede, only 19% see the regulatory agenda as the dominant topic in the next 6 to 12 months (previous year: 30%).

These differing strategic priorities are only contradictory at first glance, for in the long term, it will be crucial for banks to strike the right balance between revenue growth and profitability growth. The results of the survey can be interpreted as meaning that the banks would very much like to focus on innovation (and also have to do this in the long term), but in the short term are still very busy with the cost-cutting measures made necessary by margin erosion.

In the short term, cost-cutting measures may certainly be expedient, but in the long run banks will face the challenge of better utilizing the possibilities for standardizing and automating business processes, while also not missing the innovation agenda.

**Innovation in focus - costs as a task**

“Which of the following topics do you expect will dominate the financial services industry over the next 6 to 12 months?”

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<thead>
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<th>Cost reduction and efficiency gains</th>
<th>Risk, compliance and regulation</th>
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**Private banks**

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**Banks under foreign control**

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**Regional banks**

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**Cantonal banks**

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The banks again wish to place considerably more strategic emphasis on the topics of innovation and growth, as well as cost-cutting and efficiency improvement. The search for the right balance between these strategic approaches is also reflected in the identification of specific priorities, displaying a relatively balanced mix from both areas.

However, as in the previous year, one particular risk and regulation issue leads the list of priorities: cyber security. This is unsurprising since the risk posed by targeted hacker attacks is now regarded by many banks as the greatest threat to their business model.

In comparison with the previous year, the banks’ priorities now represent quite a balanced picture. It is noteworthy that the banks evidently aim to achieve the desired growth in investment business largely by investing in advisory services and sales channels (2nd place), not necessarily through the development of new investment products (19th place). In addition, the banks are highly aware that they need to invest heavily in further training measures for their staff so as to give their employees even better preparation for the changes expected as a result of digitalization (3rd place). Meanwhile, the far-reaching implications of the IBOR reform are only on the radar of the larger banks so far, and clearly remain underestimated by many institutions (17th place).

Overall, the banks’ priorities for the coming year suggest that they tend to be less concerned about a possible transformation of their business model. The topics of “transformation in new business models”, “partnerships with non-banks”, “build-up of new business segments” and “new markets and internationalization” tend to be placed in the middle rank or even very far down the ranking of the most important topics. This raises the question of whether this “more of the same” approach will really be sufficient to make the banks fit for the longer-term future.
9. Outlook - Banking in 7 to 10 years
No end to the wave of regulation in sight

“To what extent do you agree with the following statement?”
There will be substantially more regulation in the Swiss banking sector.

In the wake of the financial crisis, banks have had to implement a wave of new regulations at both the international and national levels. The scope and complexity of the implemented regulatory projects have been considerable at times. Significantly higher capital and liquidity requirements, tighter rules in derivatives trading and new, close-meshed investor protection regulations are only some of the key measures concerned. Many of the most striking weaknesses that existed prior to the outbreak of the financial crisis have now been addressed, and the banks now possess greater stability and crisis-resilience than they did in pre-crisis times.

Although much has been achieved and the banks are now on a more solid footing than they were a few years ago, a clear majority of the Swiss banks (69%) do not expect the regulatory wave to end. The banks’ hope that financial sector regulation will tend to decline again in the future, which was evident in our prior-year study, has fallen a little this year.

This trend reversal is particularly discernible among the cantonal banks. Whereas last year about half of the cantonal banks surveyed (46%) were of the opinion that the wave of regulation had peaked, 80% are again certain that the financial sector will continue to undergo increased regulation in the future.
In 2017, Swiss banks generated gross added value of around CHF 31 billion, representing 4.8% of the total gross added value of Switzerland. This is a considerable decline in comparison with the relative share of around 8.6% at the start of the millennium.

However, when assessing the banking industry's ability to create value overall, it should be considered that banks are strongly interconnected with other industries in economic terms. In 2017, the additional added value initiated with other “supply industries” was CHF 16.7 billion. If this figure is taken into account, the effective value creation of the banking industry in a broader sense corresponds to around 7.3%.

However, the banks are not very optimistic about the future growth of the value added by Swiss banks. Of the banks surveyed, 63% believe this will not increase in the future. Despite the bank managers’ conviction that their own institution will continue to grow (more than 80% are convinced of this), they see the future for the sector as a whole less rosy.

All of the following developments have led the banks surveyed to believe that the value added by Swiss banks will not grow significantly, despite good growth prospects for some individual institutions: structural change, which could lead to new business models with disruptive effects, digitization, falling prices for banking services, exceptional economic conditions, the current difficult relations with the EU, and margin erosion in the traditional banking business.
The banking sector has undergone great changes since the outbreak of the financial crisis 10 years ago. The wave of new regulations has forced many banks to build up their equity and redesign their business models. In addition, the persistent low interest rates have eaten away at banks’ income, leading to serious margin erosion. As a result, the profitability of Swiss banks has declined considerably, and the banks surveyed do not see this changing in the long term. The view held by 70% of the banks is that shareholders will have to adjust to falling returns in the years ahead. This is slightly less than in the previous year (74%), but still a large majority.

Many banks are currently far away from their target return on equity and there is little to suggest that this situation will turn positive in the near future. Meanwhile, although the business models of US banks are to some extent very different from those of Swiss banks, a look across the Atlantic could bring some hope: for several quarters, many of the major US banks have again been generating enviable returns, sometimes of up to 15%. This is thanks not least to the recent rise in US interest rates and the associated margin increases in lending business. In light of this development, it is understandable why banks in Europe and Switzerland are increasingly calling on central banks to tighten monetary policy.
Banks continue to expect competition from outside the industry

“To what extent do you agree with the following statement?”

Non-financial competitors / disruptors (Fintech) will pose a threat to banking institutions.

Most banks (66%) still believe that competitors from outside the industry are threatening their market position. For the first time since this study was conducted, however, this feeling of there being a threat has not increased (previous year: 73%).

The banks seem to be gradually gaining some clarity about what future business models will look like in the banking industry and where the possible weaknesses of the business models of non-industry providers might lie. This will enable the banks to prepare better for the new competitive situation and to develop accordingly. It is also hoped that providers from outside the industry still need some time to mature into competitors that banks must take seriously.

The banks therefore express somewhat greater confidence that they will be able to defend their market position in the future and need not cede the field to other providers. This increased confidence is evident among all banking groups.
Banks want to defend customer interfaces

“To what extent do you agree with the following statement?”
Swiss banks will gradually lose control of the customer interface and increasingly become pure suppliers of financial products.

“...”
Banks in their current state will still be relevant to the daily lives of consumers in 7 to 10 years’ time.

Replacement of the customer interface and “open banking” could indeed lead to a paradigm shift in the banking sector and ultimately undermine banks’ traditional business models. It is therefore not surprising that industry representatives in Switzerland have so far rejected a PSD2-equivalent regulation and pointed out the associated risks for the security and protection of customer data.

Despite such partly justified concerns, it can be assumed that open banking will also continue to develop without a legal regulatory structure, and is ultimately likely to become established. In this context, new digital ecosystems and platforms could arise as part of a modular system, thus also fundamentally changing the way in which financial services are provided.
A significant majority of the Swiss banks (78%) do not believe that banks will share financial information about customers with global technology companies such as Facebook or Google.

This stance may come as quite a surprise in light of the regulatory developments in the EU. On the basis of the revised Payment Service Directive PSD2, which entered into force in January 2018, European banks must allow legitimized third parties to access the account data of their customers and to initiate payments. The banks holding the accounts are hereby obligated to implement the IT interfaces (APIs) necessary for this purpose. In the US, as well, there are increasing signs that banking customer data will be exchanged with large technology firms in the not-too-distant future. According to media reports, global technology giants such as Google, Amazon and Facebook have already asked many of the major US banks to exchange detailed financial information about their customers.

In light of these international trends, it seems quite possible that the shift towards open banking will also prevail in Switzerland eventually, despite the regulatory obstacles that exist at present. In particular for business with retail customers, a development of this kind seems to be only a matter of time.

However, the crucial issue is whether bank customers will increasingly demand increased data exchange with third-party providers for reasons of convenience, or whether bank customers will value data security and confidentiality more highly.

Many banks believe that in the coming years there will be a reaction against the increasing opening of customer interfaces and access rights for third parties, thus preventing data exchange with third parties.
No end to pricing pressure in sight

“To what extent do you agree with the following statement?”
The price of banking services will fall.

Competitors from outside the industry are increasingly pushing their way into the terrain of banks and attracting customers with low-cost services. In addition, customers are increasingly on the lookout for digital solutions, for which they are no longer willing to pay such high prices. Against this background, it is not surprising that 74% of the banks surveyed expect the prices for banking services to fall. Price pressure on banks has risen again versus the previous year (previous year: 67%).

The optimism about future price trends that was still quite widespread among cantonal banks last year has now dissipated. Whereas last year, significantly fewer than half of the cantonal banks surveyed (38%) predicted falling prices for banking services, this proportion has now risen considerably, to 85%. Strong customer proximity and greater security thanks to the existing state guarantees remain important arguments in the maintenance of customer loyalty at these institutions, but they alone will not suffice to quell price pressure in the long term.

In private banking, by contrast, somewhat lower price pressure is anticipated than in the previous year. Among the private banks, 68% (previous year: 78%) expect banking services to become cheaper in the next 7 to 10 years.

To what extent do you agree with the following statement?

1. Entirely disagree
2. Partly disagree
3. Partly agree
4. Entirely agree

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The battle for talent is heating up

“To what extent do you agree with the following statement?”
Talent recruitment will become increasingly difficult.

In order to navigate this process of change, banks need new employees who are better able to meet the new requirements. However, as the search for employees with the desired professional profiles will become ever more difficult in the future, banks are required to invest more in training and educational measures. In this context, it is of immense importance for banks to assess today what professional profiles will be decisive for future business success.

Of all the banks, 86% – thus significantly more than in the previous year (70%) – forecast that it will become increasingly difficult going forward for banks to recruit talent. This finding increased for all banking groups within the last year, but especially in the case of private and asset management banks. Of these banks, 85% now believe that competition for talent will increase in the future (previous year: 60%).

Many forecasts suggest that demographic trends will lead to a shortage of skilled workers. Digitalization and structural transformation are also changing the world of work. Old job profiles are being replaced by new, more complex and more challenging career paths. This trend is intensified by the breakup of the value chain and the associated increase in the degree of specialization.

Entirely disagree
Partly disagree
Partly agree
Entirely agree

Cantonal banks
Regional banks
Banks under foreign control
Private banks

2017

2018

2017

2018

2018
Future outlook for the banks becoming a little more gloomy

“To what extent do you agree with the following statement?”
Do the following business areas have good prospects for the future?

The banking sector is currently in a state of upheaval – both internationally and in Switzerland. Banks face numerous challenges, some of which are fundamental. This situation gives rise to the question of what future prospects can be expected for the established business models of Swiss banks. Although the banks continue to see a positive outlook for all business areas – with the exception of investment banking – their assessment has become noticeably gloomier.

Private banking (minus 10 percentage points) was ranked best at 69%, followed by retail banking and asset management at 56% each (minus 8 and minus 13 percentage points, respectively). In the case of investment banking, only 22% of banks see the outlook for the future as intact (minus 26 percentage points).
10. Key messages
Market environment for banks remains challenging

More than 10 years have passed since the outbreak of the financial and economic crisis in 2007. Since then, the monetary policy of the major central banks has been characterized by quite unconventional measures such as negative interest rates and extensive bond purchase programs. While these measures have had the direct, intended effect and the global economy was brought back from the brink of an uncontrolled negative spiral, the unintended, long-term consequences of this development are becoming more clearly recognizable: the prices of many assets have reached new highs and global indebtedness has grown rapidly, now accounting for more than 300% of global economic output.

In addition to these challenging economic and monetary conditions, banks have had to face a wave of new regulations at both the international and national levels. In addition to significantly heightened capital and liquidity requirements, this includes measures to ensure the collection of taxes, which have resulted in a profound transformation of the cross-border asset management business of Swiss banks. It can also be observed that regulators increasingly represent national interests and place additional requirements on relevant foreign locations, with the effect of greatly impairing the global management of banking business.

This situation poses enormous challenges for banks. Low interest rate policies have eaten away at margins in lending business, and interest income has only been kept stable by significantly expanding lending volumes. In the commission and service income business, as well, banks have had to contend with painful margin losses. This is due to several factors, not least the generally higher price sensitivity on the part of investment clients and the increased tax regularization of foreign assets held at Swiss banks seen in recent years.

The banks have so far performed relatively well in these difficult conditions. Nevertheless, it is worth noting that since the turn of the millennium the aggregate business performance of Swiss banks has fallen by 9.1% and the aggregate gross profit from operating activities by 40.9%. This development also has consequences for the value creation of banks, which has decreased by around CHF 6.8 billion, or 18%, since the year 2000. Banks’ relative share of the total value added by the Swiss economy fell from 8.6% in 2000 to just 4.8% at present.

Negative interest rates are still a heavy burden – banks are increasingly willing to pass on these costs, except to retail customers

Banks are suffering under the negative interest rates and each year take a more negative view of low interest rate policies. So far, banks have been able to keep their interest income from dropping thanks to the strong expansion of loan book volumes. However, the mortgage market is gradually showing signs of saturation and the significant growth seen in recent years certainly cannot be continued into the future. This means that there is a risk of the banks’ profitability problem worsening in the long term. It is therefore not surprising that banks’ willingness to bear the burden of negative interest rates alone is decreasing from year to year. Whereas in 2015, 70% of the banks surveyed categorically ruled out passing on negative interest rates, the figure is now only 34%. In addition, one-third of the banks surveyed stated that they wanted to lower the threshold for passing on negative interest rates in the foreseeable future. However, in retail customer business, such measures remain taboo for the vast majority of banks, and it would be virtually inconceivable at present for customer assets under CHF 100,000 to be charged negative interest in the near future.

Small banking regime well-received – nevertheless banks see little chance of an imminent end to the wave of regulations and continue to anticipate high regulation costs

In July of this year, FINMA launched the pilot phase of the “small banking regime”, which provides concrete forms of regulatory relief for small banks (i.e., banks in supervisory categories 4 and 5). The majority of the banks (56%) – especially small and medium-sized institutions – welcome the loosening of regulations. For many banks, however, the regulatory relief does not go far enough yet, and it appears that the banks would like to see the small banking regime extended to other banks and regulatory areas.
Last year’s clear hope that regulatory efforts and the associated costs had peaked and would now normalize with less regulation and lower costs has not yet materialized. This year, less than a third of the banks surveyed believe that the financial sector will be less regulated in the future. Meanwhile, 82% of the banks think that the costs of regulation will remain high and will not fall in the long term.

**Awareness of the fundamental importance of digitalization for the financial industry is increasing from year to year**

Swiss banks are becoming increasingly aware that digitalization will be fundamentally significant for banks’ business models. Two-thirds of the banks are now of this view.

Digitalization is the strongest driver of long-term structural change. It will be interesting to see whether the banks’ increased awareness of the profound effects of digitalization will actually lead them to increasingly address the fundamental issues of structural change and consider in a holistic way how sustainable business models for banks could look in a digitized world.

**Struggle for EU market access – private and asset management banks fear negative consequences**

Around half of the managed assets at Swiss banks originate from international customers. With a market share of 27.5% in cross-border asset management business with private customers, Switzerland is the global market leader in this attractive business. Therefore, access to international markets, particularly the European market, is of key importance for the competitiveness of Swiss banks. For some time now, Swiss politicians have been negotiating with the EU to reach a financial services agreement that would also regulate the market access of Swiss banks in the EU, but this has not been successful yet.

Despite the threat of losing market access to the EU, Swiss banks are keeping a cool head. Nearly two-thirds of the banks surveyed do not fear any serious consequences for their institution. However, very differing views are held on this topic among the various banking groups. For instance, particularly in cross-border asset management business, firmly anchored private and asset management banks appear to be much more nervous. Only 27% of these banks do not see any negative consequences for their institution. Under certain circumstances, the majority of these banks would have to open new branches abroad, and in some cases even relocate important parts of the value chain and thus also attractive jobs to foreign locations. That would weaken the Swiss financial centre.

**Banks want to keep growing and are targeting the investment business – strategic agenda focused on innovation**

Despite the challenging market environment, the banks continue to look to the future with optimism and are forecasting better operating performance. This optimism can be observed for all planning horizons. Against an overall economic picture of shrinking margins and transformation pressures in the core business coupled with geopolitical tensions and signs of waning growth momentum in the global economy, this optimism may seem quite surprising.

Although the banks have grown strongly in recent years, particularly in the lending business, the majority now see the greatest growth potential in the investment business (investment advice and asset management). It remains to be seen, however, whether for the majority of banks this diversification strategy will actually bear the hoped-for fruits. There is reason to suspect, after all, that the sum total of banks’ ambitions for investment business at least exceeds the market potential for Swiss business.
The growth efforts of the Swiss banks are also reflected in the question of the banks’ fundamental strategic approach for the next 12 months. Whereas in recent years banks have focused on implementing the new regulatory provisions, banks are now focusing again on growth and innovation.

What are the signs of the times and how can banks deal with them?

The economic environment has been in a state of emergency for several years now. The longer this situation persists, the greater the risk of market corrections or distortions on international financial markets. The fact is that the scope for national banks to react to a new crisis is severely limited by the already very expansive monetary policy. These monetary and economic difficulties are compounded by intensifying geopolitical tensions. Expanding trade protectionism coupled with the political resurgence of nationalistic-leaning tendencies in major industrialized nations could pose a threat to the global economy.

All in all, the current outlook for the future is again increasingly being overshadowed by uncertainty compared with recent years. Even though the direct consequences of the financial crisis are less noticeable today, it must not be forgotten that the fundamental global debt problems have not yet essentially been resolved.

What does this mean for the Swiss banks? It would be fatal to shut one’s eyes to the signs of the times and simply ignore them. Increased caution could therefore be the order of the day. However, opportunities must also be identified and exploited. In turbulent times especially, demand will only increase for the traditional strengths of Switzerland and the Swiss financial centre: security and asset protection. Given their stability and above-average capital resources, their highly regarded expertise worldwide and the political stability of Switzerland as a business location, the Swiss banks have plenty of good arguments on their side to attract international clientele.
Contacts

Patrick Schwaller
Managing Partner
Audit Financial Services

Olaf Toepfer
Partner
Head Banking & Capital Markets

Bruno Patusi
Partner
Head Wealth and Asset Management

Stéphane Muller
Partner
Head Financial Services
Suisse Latine

Timo D’Ambrosio
Senior Manager

Maagplatz 1
8005 Zurich
Telephone: +41 58 286 69 30
patrick.schwaller@ch.ey.com

Maagplatz 1
8005 Zurich
Telephone: +41 58 286 44 71
olaf.toepfer@ch.ey.com

Maagplatz 1
8005 Zurich
Telephone: +41 58 286 46 90
bruno.patusi@ch.ey.com

Maagplatz 1
8005 Zurich
Telephone: +41 58 286 55 95
stephane.muller@ch.ey.com

Route de Chancy 59
1213 Genève
Telephone: +41 58 286 32 20
timo.dambrosio@ch.ey.com
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