

Would A Yes Vote For A Swiss Sovereign Money System Be A Game Changer For Banks?

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On June 10, 2018, the Swiss population will vote on proposed material changes to the Swiss monetary system after a public initiative called for a national referendum on the introduction of sovereign money (or full money).

The proposal calls for the Swiss National Bank (SNB) to be the sole creator of money, prohibiting commercial banks from creating electronic money. Currently in banking systems worldwide, banks can create electronic money by lending to customers and crediting this amount to the customers' demand accounts. In Switzerland, about 85% of the SNB's narrow monetary aggregate M1 (a measure of the money supply) is electronic money in the form of demand deposits. Only about 15% of M1 is coins and notes issued by the SNB.

In essence, the public initiative calls for the transfer of all demand deposits from bank balance sheets to an off-balance vehicle. This would prevent banks from creating electronic money. Instead, the SNB would be the sole creator of legal means of payment.

While S&P Global Ratings does not expect a majority vote for the adoption of the sovereign money system, such a vote could affect the creditworthiness of Swiss banks. However, even after a majority vote, the uncertain outcome of the legislative process makes the exact effect on the banks' creditworthiness unclear. In any case, we would expect the Swiss parliament and the SNB to proceed cautiously to minimize the impact on the Swiss financial and economic system.

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Key Takeaways

- A majority vote in favor of a sovereign money system could result in a high degree of uncertainty among banks and investors, as there are many practical aspects to consider and questions around the final legislative outcome.
- If we see increasing funding risk or investors questioning banks' ability to adapt to a potential new regime, a transition to a sovereign money system could have an immediate effect on outstanding Swiss bank ratings.
- In the long term, the introduction of a sovereign money system could weaken Swiss banks' profitability and raise questions about their future business model.

Funding And Liquidity

The adoption of a sovereign money system would have a significant long-term bearing on Swiss banks' funding and liquidity profiles. Customers' demand deposits would be carved out from banks' balance sheets and transferred to an off-balance vehicle comparable to customers' security deposits. The proposal suggests that, initially, central bank loans would plug the gap in banks' balance sheets. Over a transition period of 15-20 years, banks would then replace the central bank loans with their own funding sources. All forms of capital market funding, savings, and term deposits would continue to provide bank funding, since these do not form part of the monetary base. We understand that foreign currency deposits would not be affected.

Following a Yes vote in the referendum, we would expect increased uncertainty among investors, eventually resulting in an increase in bank funding costs. If we see increasing funding risk, a transition to a sovereign money system could have an immediate effect on outstanding Swiss bank ratings.

A Yes vote would increase uncertainty among investors

Assuming a smooth transition phase, the final impact on banks' funding structures could be an increase in the average duration of their liabilities, making sudden liquidity outflows less likely or less sudden. While demand deposits would essentially be bankruptcy-remote, bank runs would still be possible on term deposits and wholesale funding, although this would happen over a period of weeks or months.

The adoption of a sovereign money system would likely increase banks' reliance on wholesale funding, which could be a risk factor in the event of another crisis. The lack of access to wholesale funding exacerbated the effects of the financial crisis on Swiss banks.

Since demand deposits would probably no longer generate interest payments, customers could be more inclined to move their demand deposits to term deposits, and as such, back to banks' balance sheets. In addition, some form of money market products could provide "sticky" short-term funding to banks and interest payments to customers.

In light of the uncertain outcome of any potential legislation, the final long-term effect on banks' credit profiles is unclear. It could be either beneficial or detrimental depending on the final legislation and banks' strategic decisions on their future funding structures and liquidity management.

Swiss BICRA

A transitioning funding environment could affect our assessment of systemwide funding within our Banking Industry and Country Risk Assessment (BICRA) on Switzerland. This would influence the industry risk assessment and could affect the anchor for domestic banks, and therefore all outstanding bank and nonbank financial institution ratings in Switzerland.

We currently assess the risk from systemwide funding as low, mainly based on two factors. First, the strong deposit base of about 76% of total domestic loans as of 2017 providing a stable funding source. Second, limited dependence on external funding, which we see as more vulnerable during financial stress. We expect the banking sector's two-year average annual net external debt will remain below 20% of total domestic loans in the coming years.

Sovereign money could increase banks' reliance on less stable funding sources

The implementation of a sovereign money system could significantly influence the size of the domestic deposit funding base, potentially increasing banks' reliance on less stable or more expensive funding sources. If we conclude that the introduction of sovereign money will have a materially negative bearing on systemwide funding risk, this could have a negative effect on the

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ratings.

The potential impact on economic risks is less clear and not likely to materialize in the short term, though it could also be material.

Profitability

The segregation of on-demand deposits from banks' balance sheets removes a stable and relatively cheap funding source for banks. The replacement with longer-term deposit products or wholesale funding sources could increase banks' funding costs in the long term, weaken their bottom-line profitability, and raise questions about their future business model. In the context of negative interest rates, as is the case today, the effect would either be negligible, or possibly even positive. Again, the long-term effect would depend on the final legislation and banks' business decisions.

Swiss Referendums

Based on the outcomes of other referendums in Switzerland, we anticipate that the introduction of a sovereign money system would take several years. This is because a federal-level initiative in Switzerland proposes a change to the constitution. The implementation into law is up to the legislator and usually takes time as it often needs to take into account competing legal norms. Furthermore, additional referendums--aimed at counteracting the constitutional changes or on the implementation laws themselves--could follow.

In the case of the sovereign money initiative, the proposal includes a maximum period of three years for the new legal setup to become effective.

The introduction of a sovereign money system would take several years

Swiss Bank Ratings

We do not expect a majority vote in favor of sovereign money, but even if it occurred, we are confident that the SNB would guide the banks in changes to their funding and liquidity profiles to ensure the smooth functioning of the Swiss financial industry.

Should we observe increasing funding risk or investors questioning banks' ability to adapt to a potential new regime, this could have a negative influence on our bank ratings, due to changes in our assessments of industry risk in our BICRA or of banks' funding profiles or business positions.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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