EY
Banking Barometer
2021

Resilience

Building a better
working world

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The coronavirus pandemic has been casting a pall over the world since the start of 2020. The protective measures brought in around the globe triggered a simultaneous supply and demand shock and dealt a bitter blow to the economy. As a result, stock markets around the world plummeted in the spring of 2020, with volatility at times even exceeding the record levels of 2008. Only unprecedented relief packages by governments and central banks prevented the economy from collapsing, and these measures were followed by a strong, rapid rebound on stock markets. The Swiss economy was not immune to the effects of the coronavirus pandemic either. For instance, SECO is currently forecasting a GDP decline of 3.3% for 2020, the sharpest fall since the oil crisis in the early 1970s.

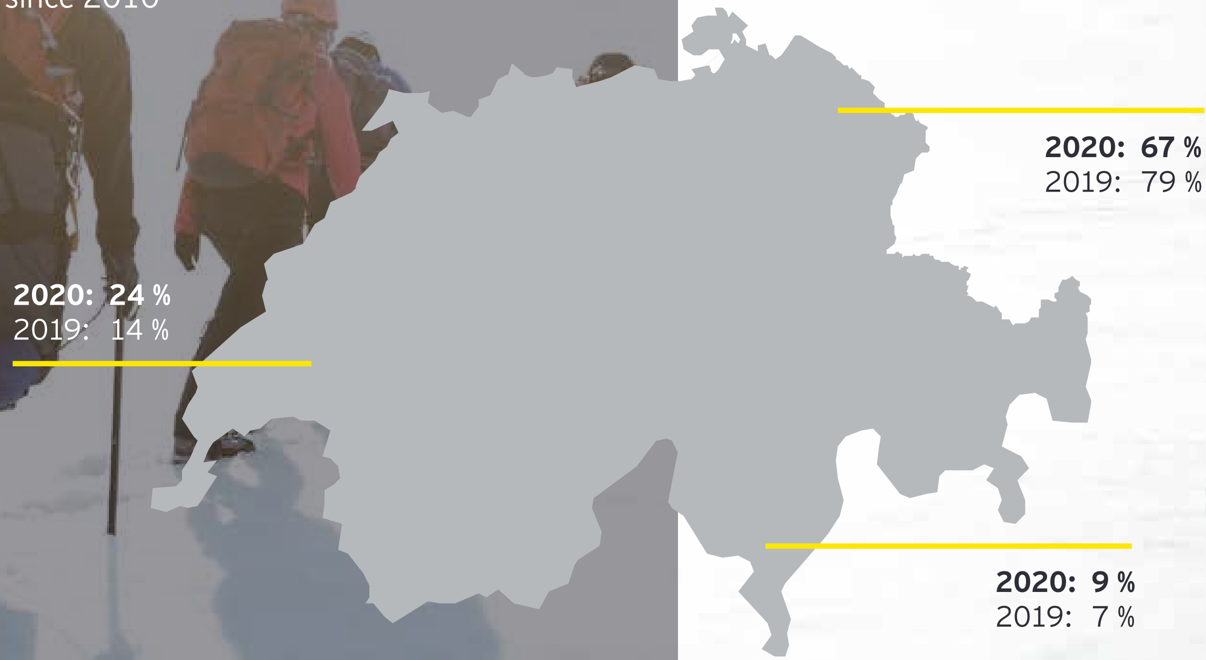
This coronavirus crisis is an enormous challenge for banks. Swiss banks may have succeeded in tackling the short-term impact of the pandemic and even made an important contribution to supporting the Swiss economy through the federal government's SME loan program. But several questions come to mind: what will the fallout of the pandemic be for Swiss banks going forward and what opportunities might it bring? How well are banks prepared for fresh turmoil in the economy and financial markets? Is there a risk of widespread loan defaults, especially after government relief measures expire? Or could the banks even emerge as winners from the coronavirus crisis? Can banks selectively optimize distribution, especially as a result of changing customer behavior? Is the crisis accelerating structural change in banking?

Besides the challenges posed by the coronavirus pandemic, it should not be forgotten that banks were already feeling the pinch on revenues and earnings before the crisis had even erupted and have suffered significant margin erosion in both the interest income and investment businesses in recent years. As a result of the foreseeable long-term entrenchment of negative interest rates due to the coronavirus crisis, there is little in the way of improvement on the horizon. How do the banks intend to safeguard their long-term ability to create value? Is it now simply a matter of time before negative interest rates have to be passed on across the board? Or are more tough cost-cutting measures now in store? What will the banks' strategic focus be in the year ahead?

The EY Banking Barometer 2021 answers these and other questions. We hope you enjoying reading this publication and look forward to a lively discussion with you.

1 Study design

- Survey by EY in November 2020
- Survey of 100 banks in Switzerland[1]
- 11th edition since 2010



[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

Breakdown of survey sample

Type of bank	2020	2019
Private banks[2]	31 %	28 %
Banks under foreign control	30 %	17 %
Regional banks	21 %	38 %
Cantonal banks	18 %	17 %

Bank size by customer assets	2020	2019
Under 5 billion francs	27 %	69 %
Between 5 and 1 billion francs	38 %	7 %
Between 10 and 50 billion francs	27 %	17 %
Over 50 billion francs	8 %	7 %

[2] Including investment banks

2 Key messages

1 Global economy in a state of emergency – banks showing resilience

The global economy has been in a **state of emergency** since the outbreak of the coronavirus pandemic at the start of 2020. Only determined intervention by governments and central banks prevented a collapse. In the lending business, the crisis led to an increase in credit risks in individual sectors. But **significant loan defaults** have been **avoided** so far because of the comprehensive government relief measures. At the same time, the **surge in crisis-induced volatility** led to more trading by customers and investors again, boosting banks' **trading and commission business**.

Swiss banks entered the coronavirus crisis from a **position of strength**. The multi-year "fitness regime" triggered by the 2008 financial crisis paid off as the banks could build up their resilience by reducing risks and further expanding their equity and liquidity cushions. It is not surprising, then, that the banks have so far **coped well with the endurance test** triggered by the coronavirus pandemic: solid results, no system outages, a largely smooth transition to working from home and no negative headlines. The banks have also proven deft and dependable in dealing with the deluge of corporate customers brought about by state-subsidized loan programs, which they themselves proactively helped to shape. In short, the **banks** have made an **important contribution** to tackling the crisis and, unlike in the financial crisis in 2008, have been part of the solution not the problem.

2 No panic despite expected loan defaults

Despite this good start, the banks all agree that the economic consequences of the coronavirus pandemic will leave some scars. For example, a majority of the banks fear that there will be a sharp **increase in impairments** in the **short term**, both in the SME lending business (up 63 percentage points) and residential construction financing (up 29 percentage points). Consequently, only 59% of the banks surveyed (down 8 percentage points) are still expecting positive business performance over the next 6 to 12 months.

In the long run, however, the banks are **not panicking** about the risk of loan defaults. 52% of the banks forecast unchanged impairments in the long term in the residential construction financing business, with 44% forecasting the same in the SME lending business, and it appears they expect the period of increased loan defaults to be on the short side. This is mainly due to the **healthy structure of the banks' loan books**, which consist mainly of mortgage loans.

Swiss banks are a strong partner for the SME economy. But loan exposures to corporate customers account for only a small share of total lending. Moreover, the banks believe **Swiss SMEs are resilient** – 83% of them expect SMEs to recover from the crisis within the next two to three years – so that no widespread loan defaults are expected.

3 Are negative interest rates for private customers inevitable?

Any normalization of monetary policy has become a distant prospect, with central banks continuing to expand the money supply as a result of the coronavirus crisis. The vast majority of the banks (82%) believe **interest rates** in Switzerland will **still be very low in 10 years' time**. The prospect that low/negative interest rates may persist for several more years is exacerbating the structural earnings difficulties of banks and the margin erosion in the important interest income business that has been going on for several years now. The higher-interest paying loans and financial assets from the past are gradually expiring without any adequate replacement. This also applies to investors who are leaving funds from the repayments of maturing bonds in their bank accounts for the time being due to the lack of alternatives, further exacerbating the banks' earnings problems.

Given these developments, it is unsurprising that by now **only 11%** of the banks surveyed categorically **rule out passing on negative interest rates** to private customers. Last year it was 21%, while five years ago the figure was as high as 70%. Charging negative interest on customer balances is therefore no longer taboo, especially for customers who do not use any other revenue-generating services for the bank apart from plain account management.

This year, there has been some respite from discussions around setting a threshold for negative interest rates, and 50% of banks – about the same amount as last year – say they intend to lower this bar. One reason is that the SNB is increasing the exemption threshold for paying negative interest. Another is that, in the wake of the coronavirus pandemic, the banks have deliberately shown restraint in passing on negative interest, presumably also for reputational reasons. But due to the increasing pressure on the banks' revenues and earnings, it appears this will only be a momentary state of affairs.

4 Coronavirus crisis providing new insights on costs and innovation

As everyone knows, in every crisis lies an opportunity. For instance, the coronavirus pandemic has led to an unexpected **acceleration in the digitalization** of business models and processes. The banks had to switch to working from home in a very short time and, thanks to the investment they have made in IT in recent years, they have mastered this challenge quite successfully and without any significant problems. Bank customers have also increasingly used digital channels to conduct their banking transactions, which has ultimately led to online and mobile banking being much more widely accepted today than before the crisis.

This experience has brought **new perspectives**, which can be of service given the challenges lying ahead. With the threat of loan defaults, gradual margin erosion in the lending and investment businesses, ongoing competition from challenger banks and FinTechs, and a largely saturated domestic market, it is unsurprising that the banks want to **focus** primarily on **cost cutting** (at 46%, it is the most frequently mentioned issue in focus) over the next 6 to 12 months. It is therefore only natural that jobs are increasingly being moved from the expensive urban centers to the cheaper periphery or to employees' homes, at the same time as the existing office real estate and branch networks are being reviewed.

But savings alone will not be enough to ensure the banks still have the ability to create value in the future. The banks are well aware of this, with 44% citing **"innovation and growth"** as the **second most important area** to focus on. To continue with the expansion of digital channels and to take adequate account of changing customer needs, further investments in innovation are needed, on top of cost-cutting measures.

5 Green wave now rolling into the lending business

The topic of sustainability has shifted increasingly into the focus of investors and customers in recent years. There is **no stopping the green wave** this year either, and it has now **also** reached the banks' **lending business**. Where last year, 56% of banks said they would not consider sustainability/ESG factors when lending to commercial customers, this year there has been a significant shift in opinion and only 27% of banks are still willing to ignore ESG criteria when lending. This significant decrease over the course of just one year underlines the urgency of adequately integrating ESG into the banks' lending business.

The trend toward sustainability has also been more pronounced in other areas. 79% of the banks – 8 percentage points more than in the previous year and a clear **majority** – want to **significantly expand** their range of **sustainable investments**. In addition, a slight majority of banks (51%) now state that they have integrated the topic of sustainability in their **advisory and investment processes**, making it a **mandatory part** of them (up 21 percentage points).

The banks seem to be very aware of the importance of the issue and are working hard to meet the growing needs of their stakeholders. But a clear majority of the banks (62%) are also of the opinion that **more far-reaching regulatory requirements** are needed, especially binding, uniform standards so that the full potential can be exploited.

3

Market environment

«In a state of emergency»

Gross Domestic Product

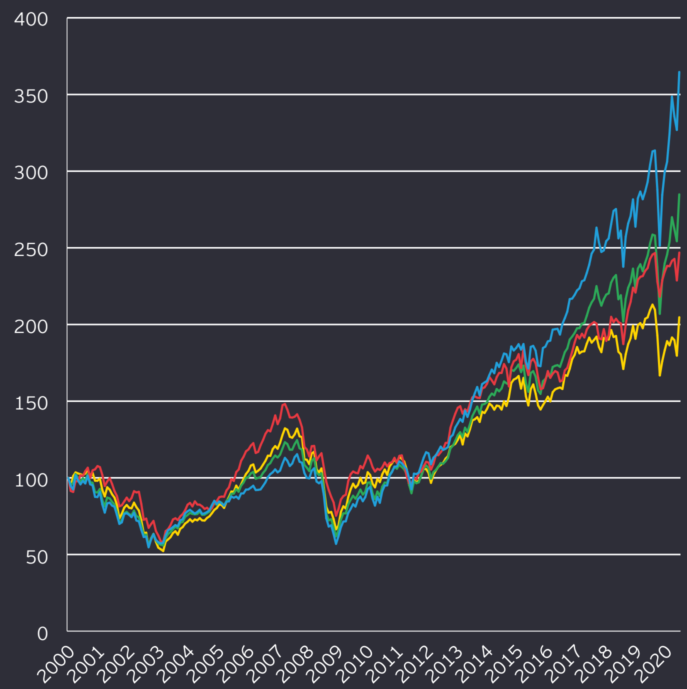
Quarter over quarter changes in %

Source: OECD

Stock markets

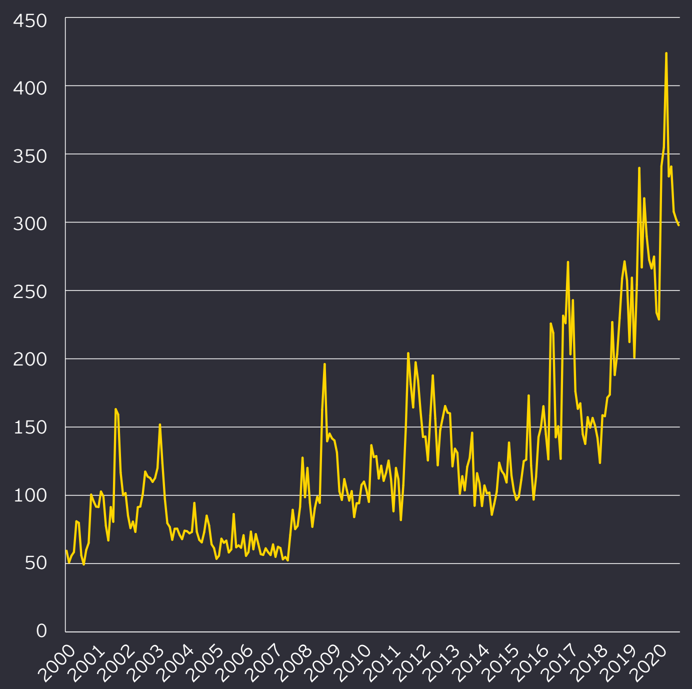
Indexed, 1.1.2000 = 100

Source: MSCI



Economic Policy Uncertainty Index

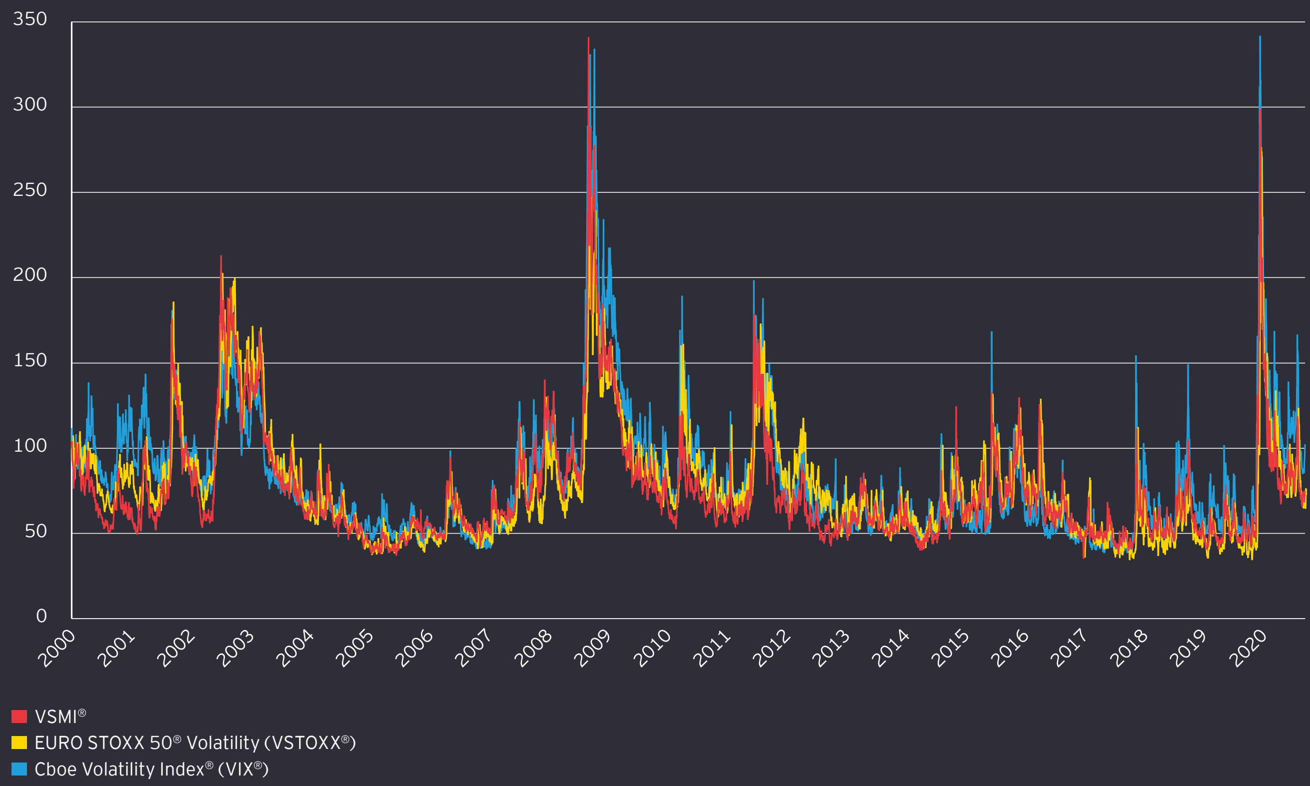
Source: Davis, Steven J. (Policyuncertainty.com)



Volatility

Indexed, 1.1.2000 = 100

Sources: SIX, STOXX, Cboe



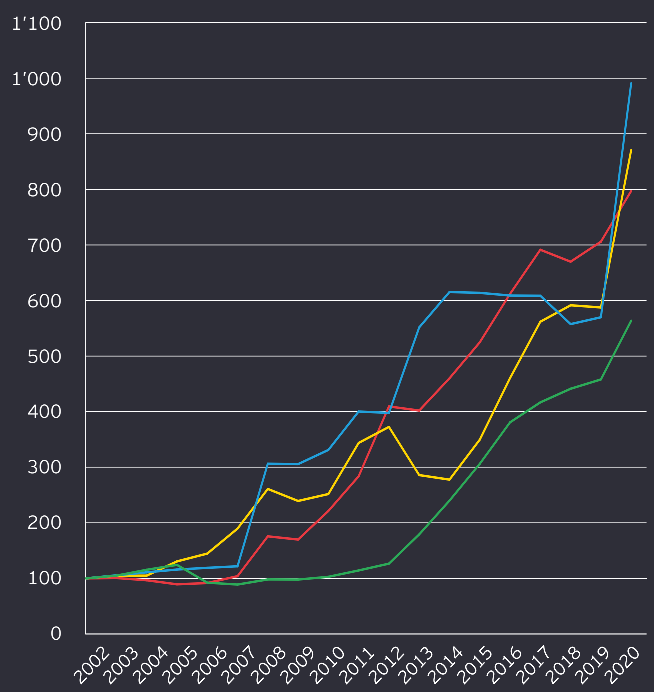
The world has been in a state of emergency since the coronavirus pandemic struck at the start of 2020. The protective measures adopted around the globe triggered a simultaneous supply and demand shock and shook the economy to the core. As a result, stock markets around the world plummeted at an unprecedented speed around the spring of 2020, with volatility at times even exceeding the record levels of 2008. Only determined intervention by governments and central banks prevented a collapse in the economy. The unprecedented relief packages and almost blank-check promises by central banks also led to a strong and rapid rebound on the stock markets, with some market segments even reaching new highs in the summer. Financial markets may be in a V-shaped recovery, but the real economy is still suffering from the effects of the coronavirus pandemic. The International Monetary Fund (IMF) expects global economic output to fall by 4.4% in 2020, the sharpest decline in decades.[3] Not surprisingly, the impact of the coronavirus pandemic has not spared the Swiss economy either. Although it has been relatively robust despite the national lockdown from mid-March to the end of May, SECO is currently forecasting GDP will contract by 3.3% in 2020, the sharpest fall since 1975.

[3] as of October 2020.

Total assets of central banks

Indexed, 1.1.2002 = 100

Sources: SNB, EZB, St. Louis FED, BoJ

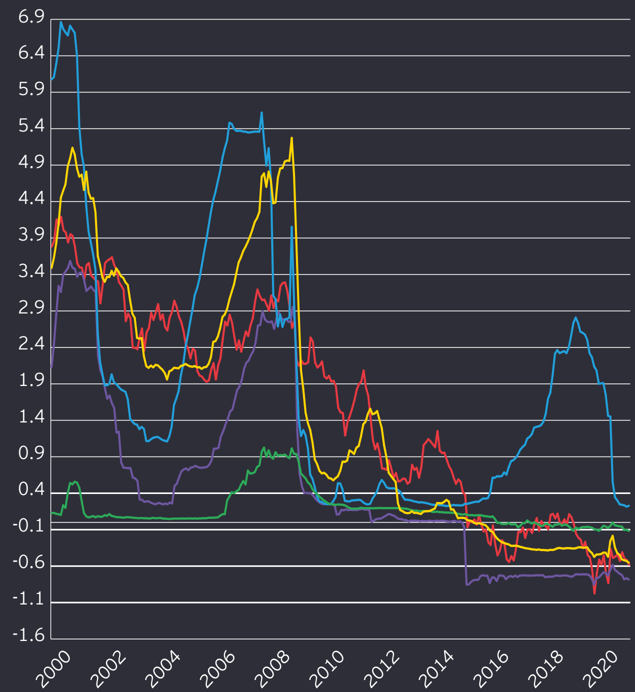


- Swiss National Bank
- European Central Bank
- Federal Reserve System
- Bank of Japan

Interest rates

in %

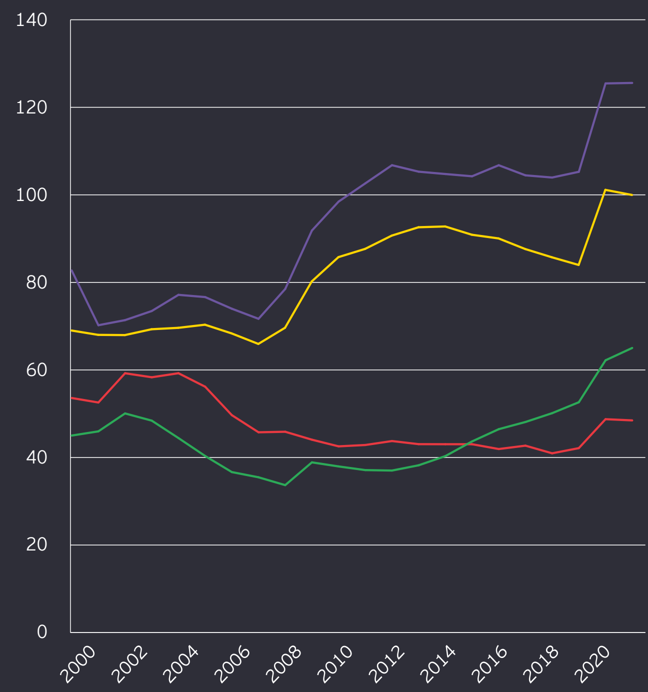
Source: SNB



- LIBOR CHF 3M
- LIBOR USD 3M
- LIBOR JPY 3M
- LIBOR EUR 3M
- CHF 10J Swiss Bonds

National debt as % of GDP

Source: IMF



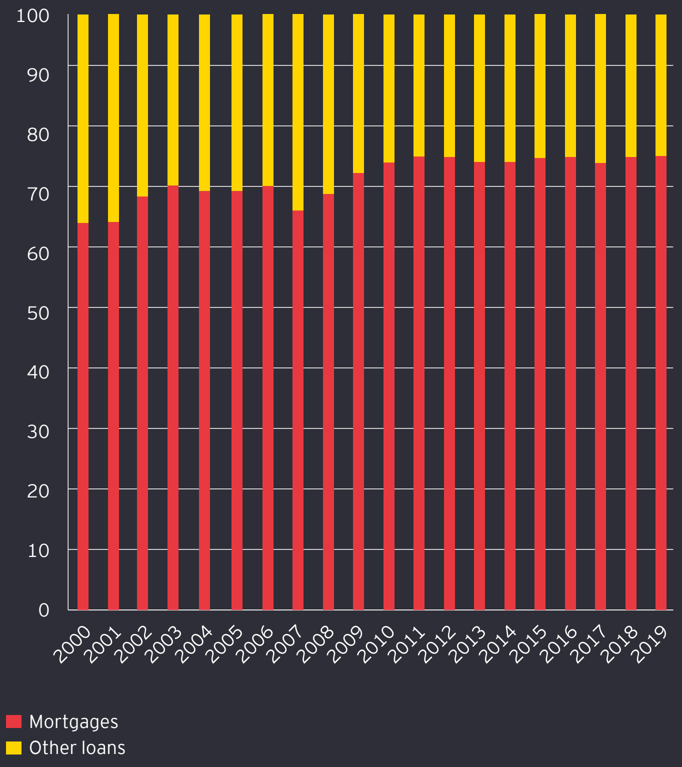
- Switzerland
- Advanced economies
- Emerging Market and Middle-Income Economies
- Euro area

Governments and central banks responded with determined support measures on an unprecedented scale, preventing the global economy from plunging into depression. Fiscal and monetary policy measures have accelerated global indebtedness yet further to such levels that government debt mountains are now larger than they were after the Second World War. The extent of the support packages is also reflected in the size of the most important central banks' balance sheets. These have ballooned again by between 14% and 74% since the start of the crisis in March 2020.

What is still unclear is the long-term consequences of this development, particularly the rapid accumulation of additional debt in 2020. But it seems certain that the coronavirus crisis will lead to a long-term baking in of ultra-expansive monetary policy, with interest rates remaining at their extremely low levels for a long time to come. A look at the base rates of key currency regions such as the US dollar, euro and also the Swiss franc shows that there has been virtually no correlation between expansive and restrictive monetary policy and economic ups and downs for some years now. This has reinforced many problems that could already be seen before the coronavirus crisis: misallocation of capital due to distorted risk premiums and a dysfunctional pricing mechanism, inflated asset prices, an ever-increasing global debt burden, risks to retirement provision, and rising inflation risk. And the list could go on.

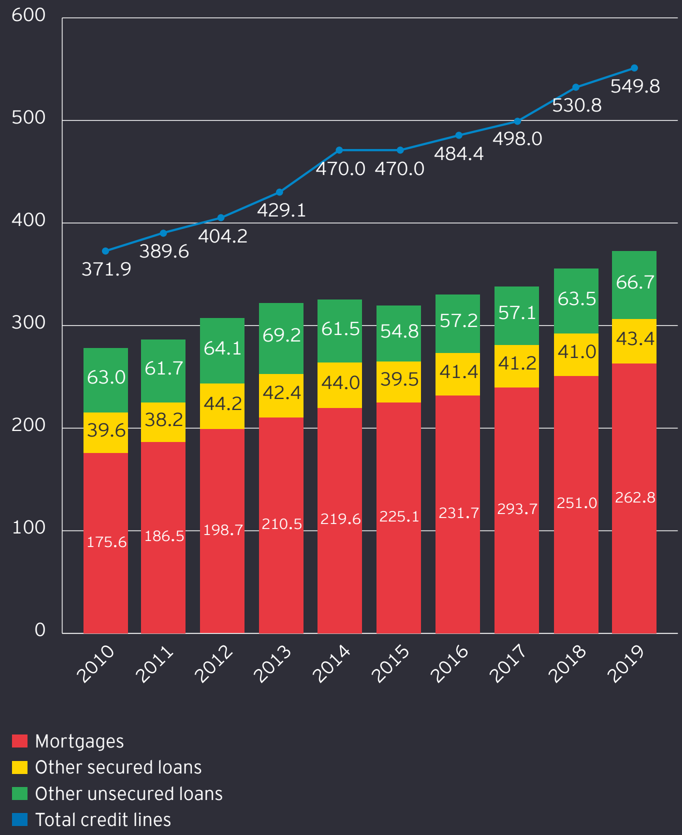
Structure of loan portfolios

In % Source: SNB



Loans to corporate customers

in CHF billion Source: SNB



The Swiss banks have so far passed the endurance test posed by the coronavirus pandemic with flying colors and shown they are in good shape and able to create stable levels of value. The banks have reported increasing trading volumes and the accompanying transaction-based revenues, no systems outages, a largely seamless transition to working from home and no negative headlines. There have been no significant loan defaults in the lending business so far thanks to the healthy structure of loan books and good risk management. The banks have also proven deft and dependable in dealing with the deluge of corporate customers brought about by state-subsidized loan programs, which they themselves proactively helped to shape. In short, the banks have made an important contribution to overcoming the crisis and, unlike in the financial crisis in 2008, have been part of the solution not the problem.

Why are Swiss banks proving resilient? The multi-year "fitness regime" triggered by the 2008 financial crisis and the regulatory approach known as the "Swiss finish" (an extra layer of rules that the country's banks must follow) has paid off. Banks have reduced risks and strengthened their capital and liquidity buffers. But the Swiss banks' greatest asset is what is in their loan portfolios. Taken as an average, 75% of the banks' loan books consist of mortgages, while this figure even exceeds 90% among the domestically focused retail banks.[4] Around 80% of these mortgages are secured against residential properties.[5] The rapid growth in prices in this real estate segment has been very stable for many years. In all likelihood, the coronavirus crisis will not change this state of affairs any time soon.

Hardly any market observers are expecting any significant correction in residential properties, even if some overheating can be discerned in certain regions. It should also be noted that the loan-to-value ratios of the properties

[4] Source: SNB and own calculations (as of the end of 2019).
[5] Source: SNB and own calculations (as of the end of 2019).

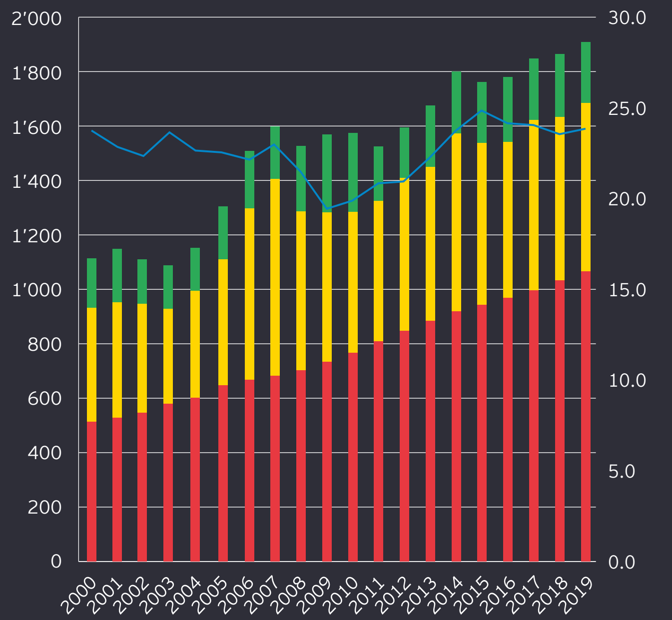
financed are moderate. Based on our estimates, the average loan-to-value ratio in the Swiss banks' loan books is between about 55% and just under 60%, which is an additional safety cushion for the banks if property prices should fall. Finally, historically low interest rates – which seem to be baked in at an ultra-low level for the foreseeable future as a result of the coronavirus pandemic – and the high proportion of fixed-rate mortgages will ensure that hardly any mortgage borrowers should get into serious difficulties in servicing their repayments right now.

It is a somewhat different story in the lending business with commercial customers. The coronavirus crisis has significantly increased the likelihood that companies will experience increased financial difficulties, especially those in sectors of the economy directly or indirectly affected by the protective measures. But the slump in Switzerland has so far been significantly tamer in comparison with other countries, partly thanks to the state support on offer, but also to the financial war chests that many (mainly privately held) companies can draw on. There is therefore still no answer to the question as to whether and to what extent loan defaults by corporate customers will increase. But it should be noted that loans to corporate customers at Swiss banks (totaling CHF 373 billion) make up a rather small share of all loans and about 70% of these are backed by mortgages.[6]

[6] In cases involving SME financing (i.e. companies with up to 250 employees), this rate is even slightly higher at 78%. (Source: SNB and own calculations, as of the end of 2019).

Interests and lending volume

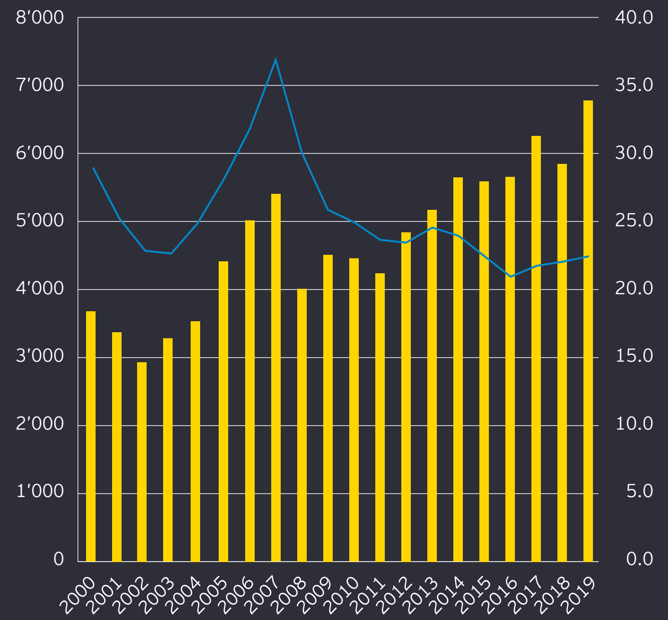
in CHF billion Source: SNB



- Mortgages
- Amounts due from customers
- Financial assets
- Gross result from interest operations

Securities holdings and result from commission business

in CHF billion Source: SNB



- Securities holdings
- Result from commission business

Stock performance banks versus market

Indexed, 1.1.2000 = 100 Source: SIX, Investing.com

- Swiss Performance Index SPI TR
- SPI ICB Supersector 8300 Banks Total Return
- UBS
- Credit Suisse

The banks have done their homework and have so far shown themselves to be in strong shape in the coronavirus crisis. But the actual extent of the economic consequences of the coronavirus crisis is still largely masked by the government relief measures. Moreover, the long-term effects on the real economy in Switzerland and especially internationally are difficult to assess. How the coronavirus crisis will ultimately affect business performance and Swiss banks' financial footing is still very much up in the air. Due to their robust capital base, many banks are in a good position to survive the coronavirus crisis largely unscathed.

But besides the challenge of dealing with the immediate crisis, it must not be forgotten that structural problems continue to beset the banks. The environment for Swiss banks has deteriorated quite significantly in recent years due to persistent negative interest rates and the increasing pressure on margins. This has led to the banks suffering from structural earnings weaknesses in their core businesses (lending and asset management) for several years now. The banking industry is also undergoing a structural transformation, driven by technological change and evolving customer expectations, and competition is becoming increasingly fraught as challenger banks, FinTechs and BigTechs muscle their way in, and new trends such as open banking and market platforms make an appearance. Many listed banks are currently trading at well below their book value. Bank shares have not fared much better if we take a short-term view. Not only did they lose more ground than the rest of the market in February and March, but they also lagged in the subsequent recovery phase. One explanation for this underperformance may be investors' assessment that, after government support measures for the real economy come to an end, borrowers might then default, and if that happens interest rate levels (an all-important factor for the banks) will not then be expected to normalize for a long time to come.

4

Operating business development

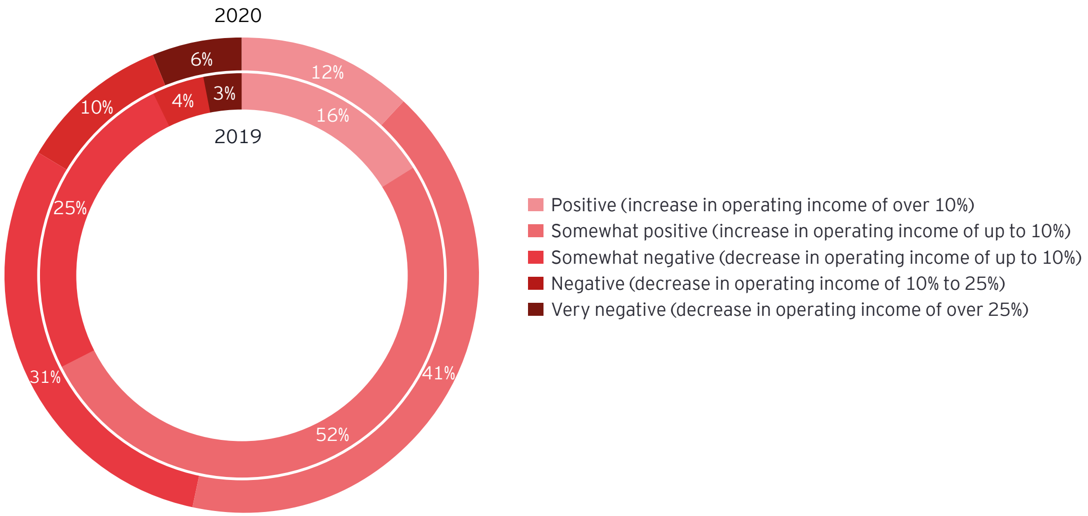
“

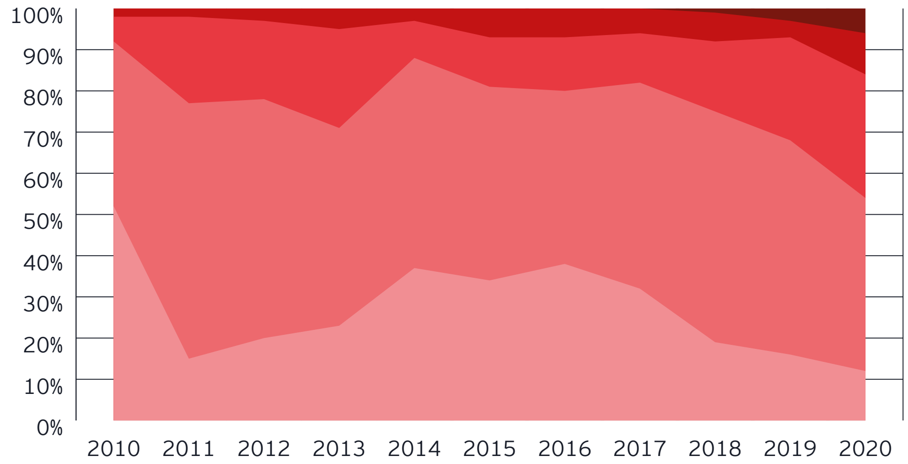
The coronavirus crisis has shown us that Swiss banks are very resilient.

Patrick Schwaller
Managing Partner
Audit Financial Services

Coronavirus pandemic whips up headwinds

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

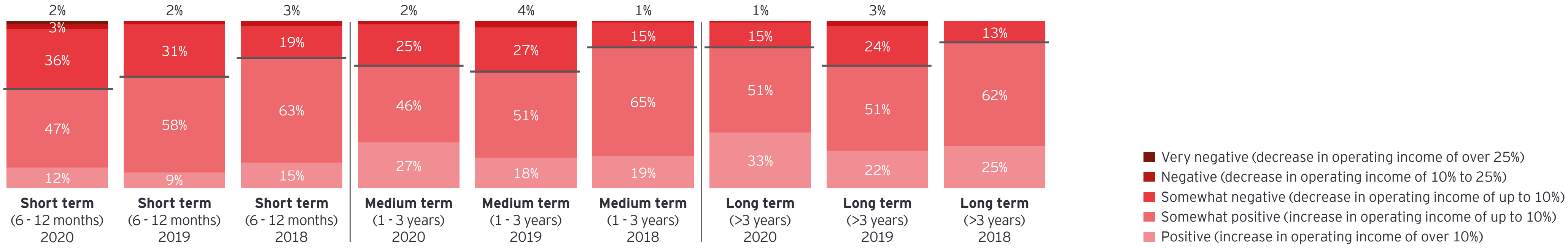




- Despite the current challenges posed by the coronavirus crisis, more than half of the banks (53%, previous year: 67%) still rate their business performance in recent months as positive. The reason for this resilience is increased commission income from high trading activities and the still relatively low levels of loan defaults (see Section 7).
- Nevertheless, this year's survey once again reflects the gloomy picture that has very much been the order of the day since 2014 in the assessment of the Swiss banks' business performance. 47% of the institutions surveyed already rate current operating business performance as negative (previous year: 32%, up 15 percentage points).
- The results of the survey show that the coronavirus pandemic has not only created major challenges for the banks in the short term (see p. 23), but has also amplified the already existing structural problems, particularly the erosion of margins in the investment and interest income business, the latter due to low interest rate policy. For example, the average indicative rate for 10-year mortgages fell back to almost the record low of just below 1% in the course of 2020.

Justified confidence or calculated optimism?

«What kind of development do you expect in your organization's operating business?»



- The economic reverberations of the coronavirus pandemic have led to a deterioration in the credit quality of many businesses, especially in the hospitality, travel and event industries, and this has not left the banks unscathed either. For instance, this year only 59% of the banks surveyed (previous year: 67%, down 8 percentage points) are still expecting positive business performance in the next 6 to 12 months.

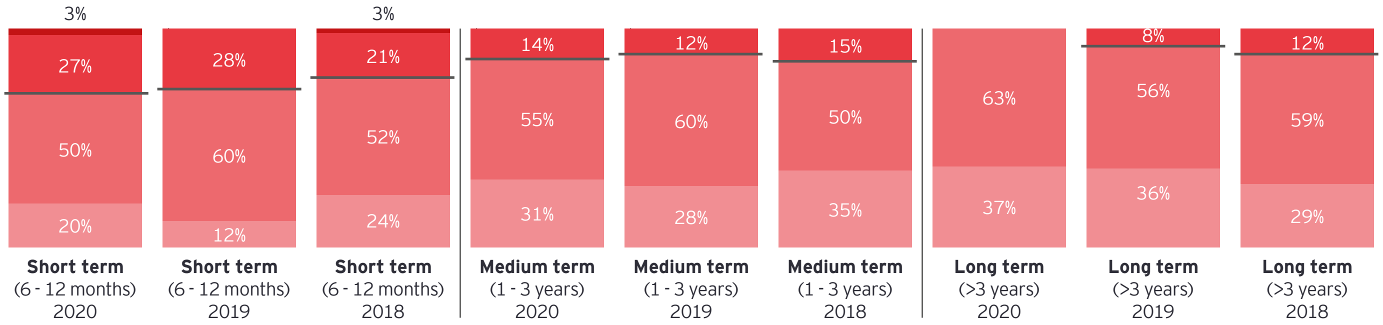
- On the other hand, the institutions in the survey are even more positive about their medium and long-term prospects than they were last year. 73% of the banks questioned expect their operating business to perform positively in the medium term. For the long term, the figure rises to 84%.

- Where does this confidence about creating value in the future come from? The banks have had to accept significant margin erosion in both their interest income and investment businesses in recent years. As a result of the long-term entrenchment of negative interest rates due to the coronavirus crisis and ongoing structural changes in the financial industry, there is little improvement on the horizon here, even if the banks seem to be slowly getting used to the low interest rates (see p. 34). So does the banks' self-assessment seem optimistic here – perhaps even too optimistic?

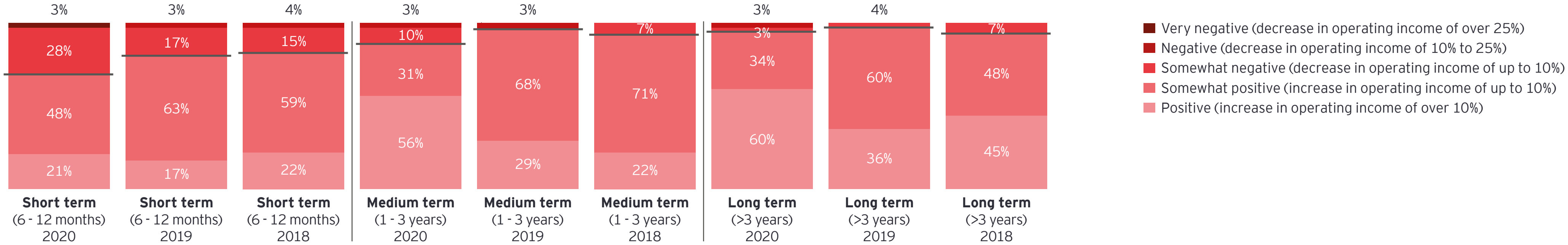
Private and foreign banks brimming with confidence

«What kind of development do you expect in your organization's operating business?»

Private banks



Banks under foreign control



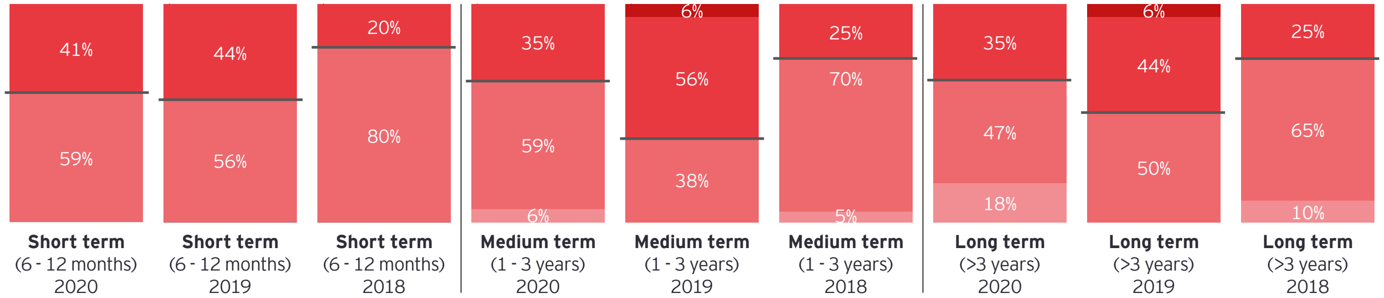
- The private banks hardly see any impact from the crisis in the short term. 70% (previous year 72%) expect performance to be positive in the short term. Although the decline among the foreign banks is slightly greater than in the previous year, a clear majority (69%, previous year: 80%) are still expecting a positive business performance in the short term.

- These banks, which are primarily active in asset management, were the ones most likely to benefit from rising volatility and increasing trading volumes over the course of the crisis. They are also significantly less affected by potential loan defaults.

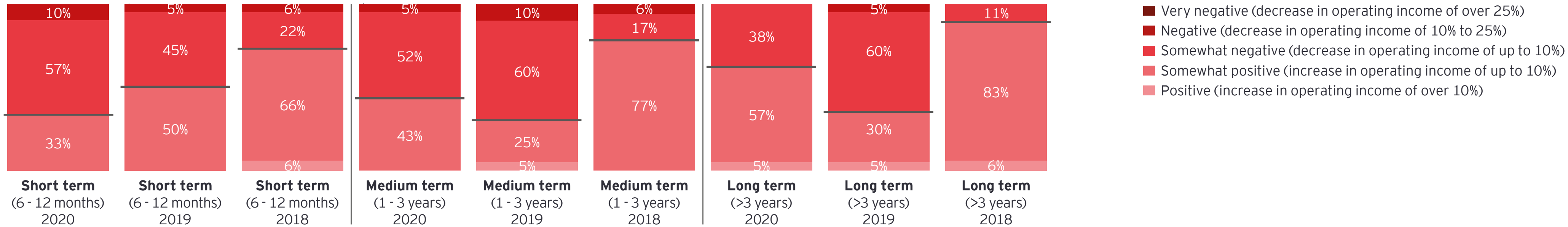
- The banks are also optimistic in the medium and long term. All of the private banks surveyed and 93% of the foreign banks surveyed expect business performance to be positive in the long term.

- As a result of rising uncertainty, Swiss banks will probably be able to benefit from Switzerland's reputation as a safe haven. The private and foreign banks seem confident they will be able to attract additional assets due to this factor. In uncertain times, demand is huge for the security that Swiss banks can offer.

Cantonal banks



Regional banks



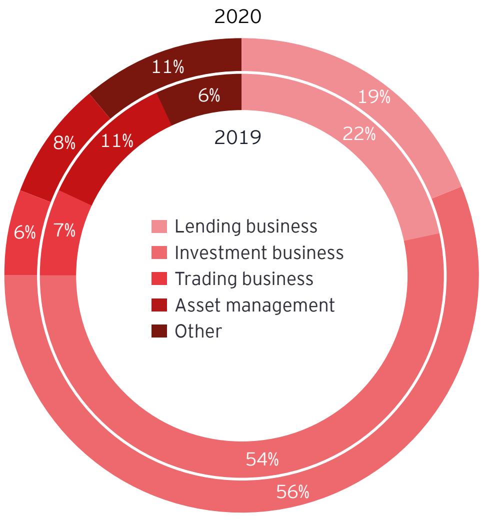
- The short-term outlook for the business performance has become much gloomier, especially for the regional banks. 67% of them expect the business trend to be negative in the short term (previous year 50%, up 17 percentage points). This may not be surprising given increased credit risks. But the cantonal banks are not reporting any signs of a downturn in sentiment in the short term. In this segment, more than half (59%) of respondents are still expecting results to get better (up 3 percentage points). The cantonal banks seem confident that, as in past crises, the current emergency could prove a boon as they are regarded as more secure.

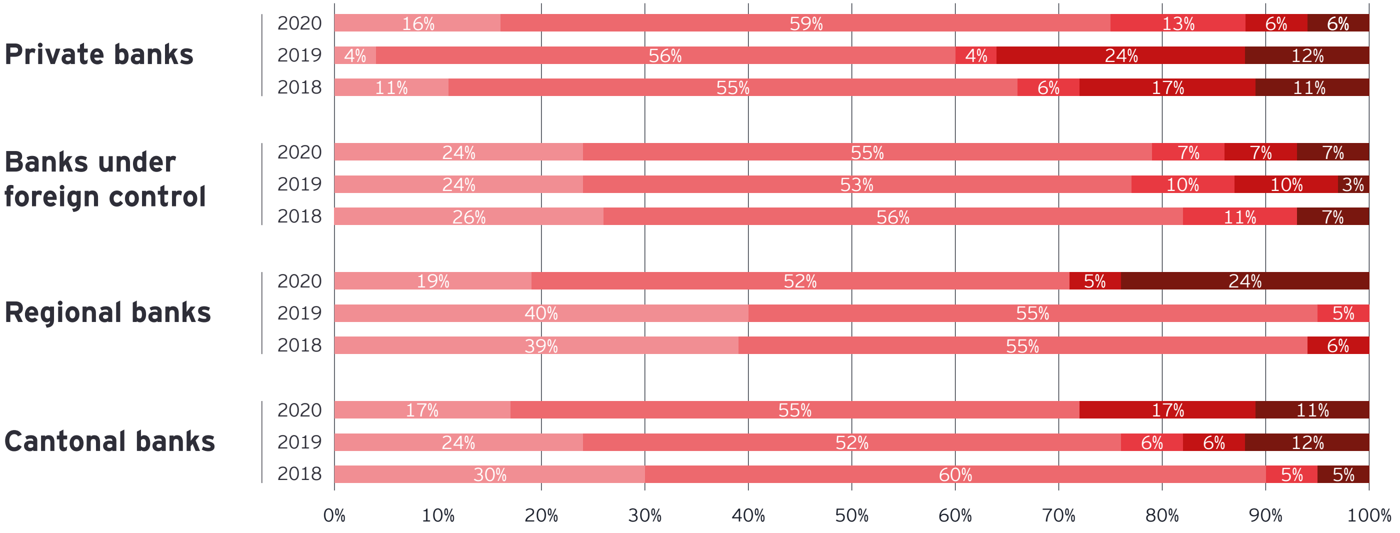
- Although retail banks disagree on the short-term business outlook, the picture is different for long-term expectations. Both groups are clearly more optimistic compared with the previous year. 65% of the cantonal banks (up 15 percentage points) and 62% of the regional banks (up 27 percentage points) are expecting business performance to be positive in the long term.

- The reasons for this increased confidence can be found in how they have managed crises in the past. The retail banks have shown themselves to be surprisingly resilient and have coped well with the turmoil triggered by the coronavirus crisis. These banks were also able to sustainably improve their reputation and increase their business relevance by supporting local businesses. It remains to be seen whether this will be enough to successfully shape the future in view of the many challenges posed by the coronavirus crisis.

Huge scramble for investment business

«In which business segment do you expect the biggest growth potential for your organization?»





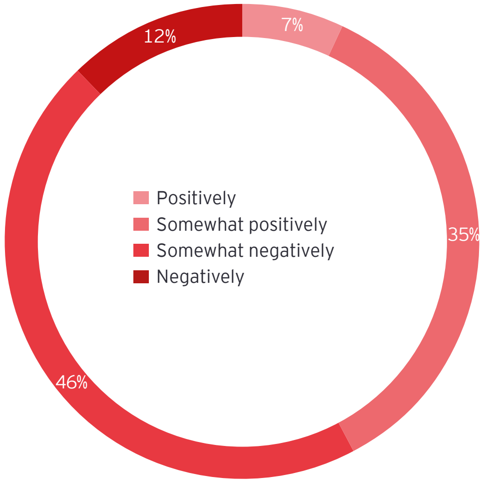
- Most of the banks (56%) still see the greatest growth potential for their institution in the investment business.

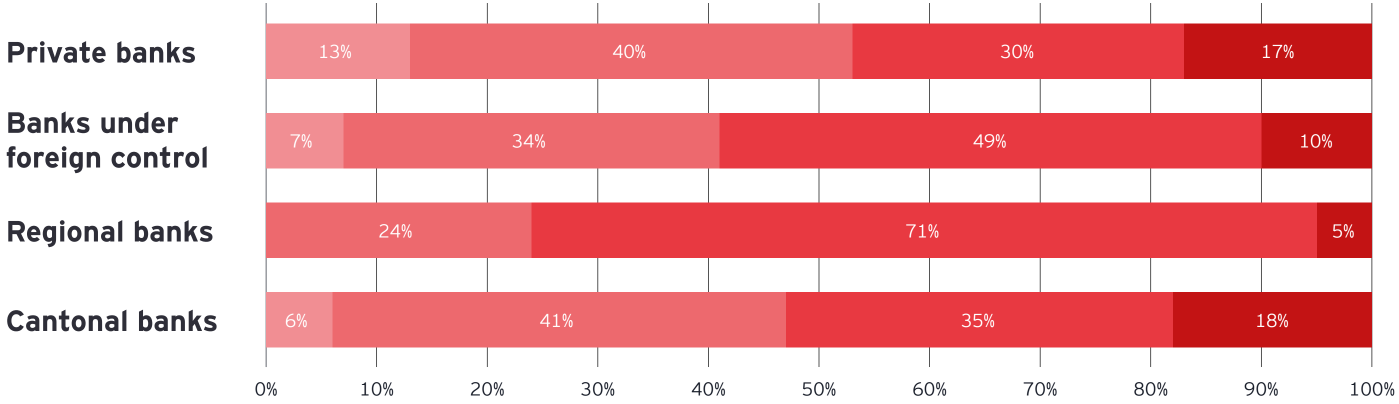
- The increasing importance of the investment business is also reflected in the banks' business results in recent years. Income from commission business and services has climbed by 7.1% since 2016. In the same period, net interest income declined by 1.4%, despite higher credit volumes.

- Due to persistent negative interest rates, more and more investors are scouting around for lucrative investment opportunities, which, in turn, is creating additional openings for Swiss banks. Nevertheless, there are inherent limits on the volume of investment business, which is why growing beyond a certain level of market penetration is only possible if it is at the expense of competitors. The emerging markets are still considered to have great growth potential, although they are sometimes difficult for Swiss banks to tap into. This applies in particular to the retail banks.

Is the coronavirus crisis a headwind or a tailwind?

«How did the Corona crisis and the resulting market consequences impact your institution financially so far?»





- The impact of the coronavirus crisis on financial institutions has been mixed. In the lending business, the crisis led to an inherent increase in credit risks in individual sectors. Due to the broad-based package of government relief measures, many loan defaults have been dodged so far. At the same time, the return of crisis-induced volatility led to more trading by customers and investors again, boosting banks' trading and commission business.

- Overall, the assessment of the financial impact of the coronavirus crisis has revealed a checkered picture: 58% of the banks assess the impact as more negative and 42% as more positive.

- With positive assessments from 53% of respondents, private banks seem to have benefited the most from the coronavirus crisis, which is unsurprising given their greater level of expertise in the investment business and the marked increase in trading volumes.

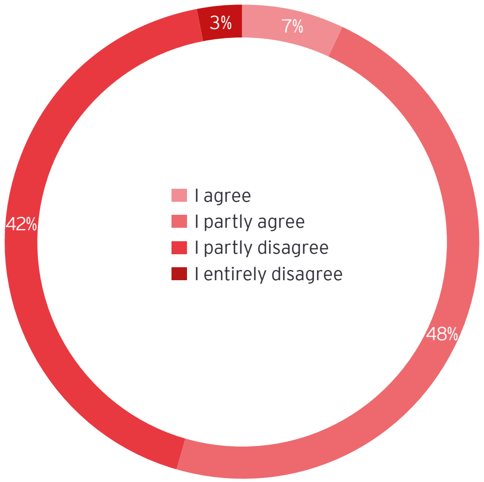
- Thanks to the state guarantee, the cantonal banks are considered a safe haven in times of crisis, which is why it is not surprising that 47% of the cantonal banks see positive effects from the coronavirus crisis.

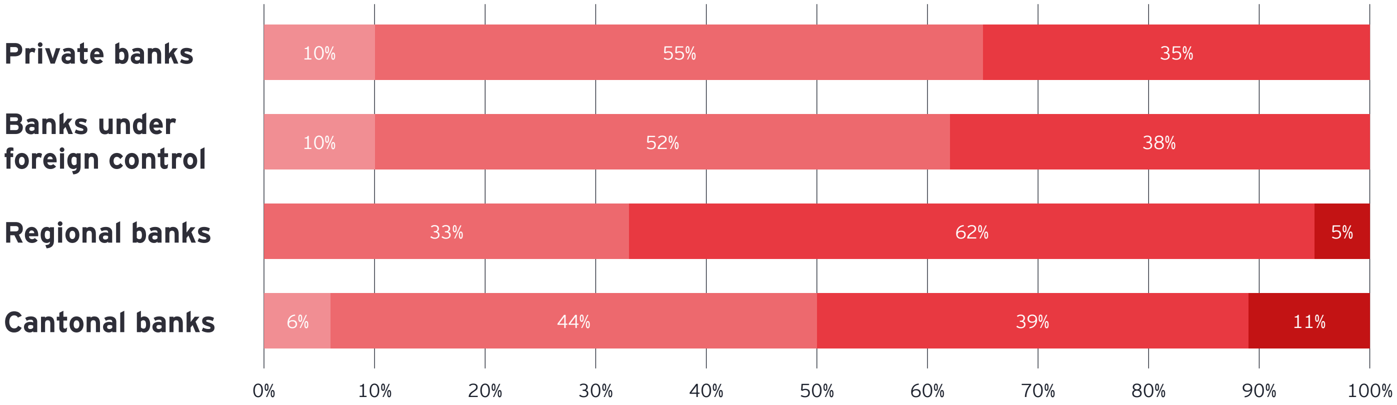
- But the regional banks are not in concordance with this positive assessment: 76% see predominantly negative effects. Due to their business model, they benefited the least from additional commission income and are the most affected by the persistently negative interest rates. They are also more focused on SME loans[7], which are at risk of becoming impaired in certain segments (see Section 7).

[7] The share of corporate loans by regional banks to companies with fewer than 250 employees was 92% per 30 September 2020 (source: own calculations based on SNB data).

Are Swiss asset managers emerging as winners from the crisis?

«Do you agree with the following statement? Overall, the Corona crisis and/or its resulting effects represent an opportunity rather than a threat for Swiss banks.»





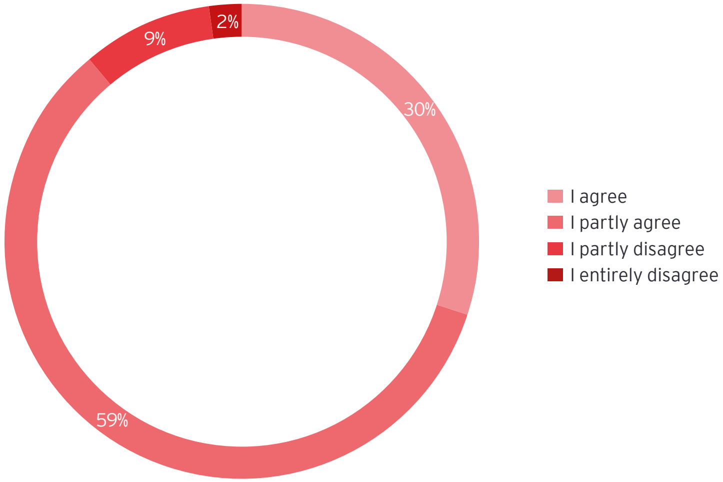
- Given the expected long-term baking in of negative interest rates, it is unsurprising that the majority of retail banks (regional banks: 67%, cantonal banks: 50%), which have been hit harder by the erosion of margins in the interest business and by increased credit risks, do not see the coronavirus crisis as an opportunity.

- The private banks and foreign banks have a more positive view of the after-effects of the coronavirus crisis: 65% of the former and 62% of the latter see this as an opportunity. The increased uncertainty in financial markets since the coronavirus pandemic erupted may once again lead to banks specialized in the (international) investment business benefiting from Switzerland's reputation as a safe haven and attracting additional assets. This could pay off for Swiss asset managers in particular.

- But proceeding with caution must still be the default mode for dealing with the coronavirus pandemic. The extraordinarily high level of uncertainty can be seen in the attitude of the cantonal banks, for example. Although this banking group is relatively homogeneous, the assessment of the long-term consequences has ended in a stalemate: half sees the crisis more as an opportunity, the other half more as a threat.

State rescue measures help but what comes next?

«Do you agree with the following statement? The actual extent of the financial impact of the Corona crisis is mostly masked by government support measures and will only be fully visible when these measures end.»



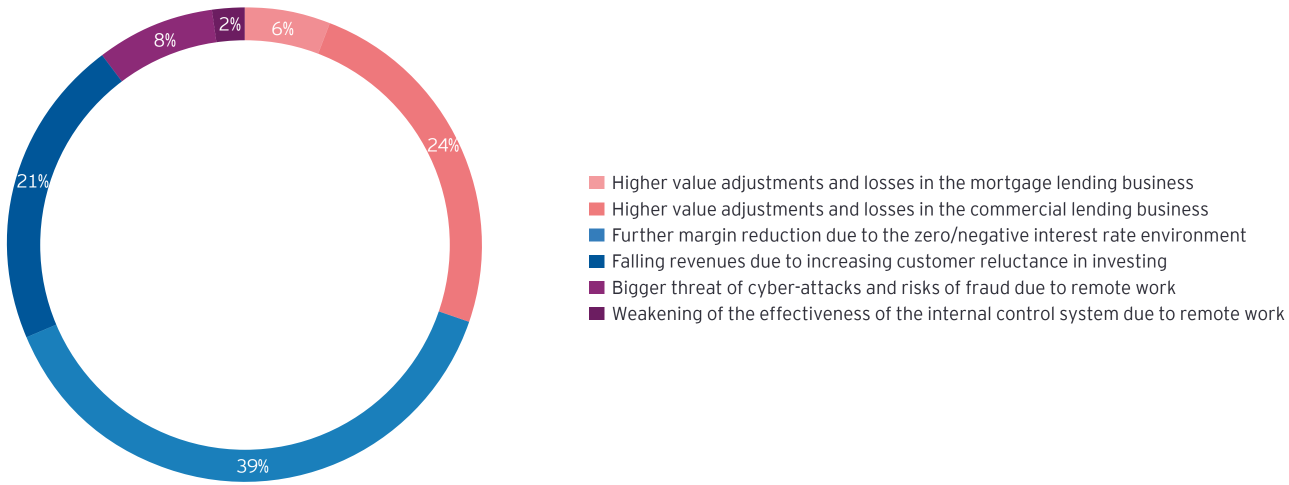
- The Swiss banks agree that the real extent of the economic consequences of the coronavirus crisis is largely being masked by the government relief measures. Only a minority of just 11% of banks disagree.
- Although the banks fear a negative impact on the economy after the government relief measures come to an end, the majority of them assess their own business performance as positive (see p. 18). This shows that the banks definitely have faith in their own strength and resilience.

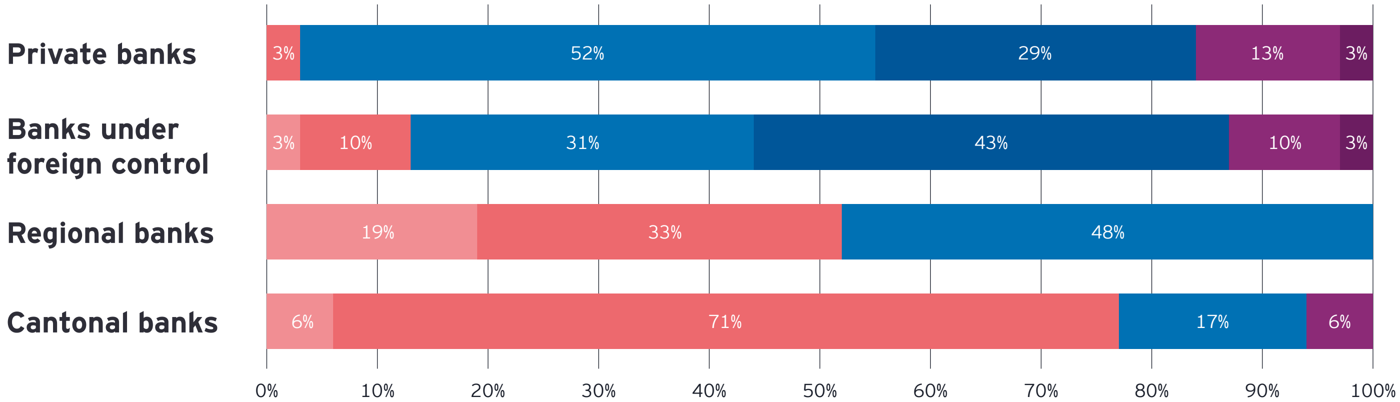
«Which of the following possible developments due to the Corona crisis do you consider to be the greatest risk for your institution?»

- When asked about the greatest risks from the coronavirus crisis, the banks primarily referred to the known inherent risks from their primary core business. According to the survey, 52% of the regional banks and 77% of the cantonal banks cite loan impairments as the biggest risk. 48% of the regional banks fear mainly a further erosion of margins in the interest rate differential business. For 43% of the foreign banks, the biggest risk is declining commission income.

- Unlike the other banking groups, the private banks see the erosion of margins in the interest differential business as their biggest risk, rather than their core business.

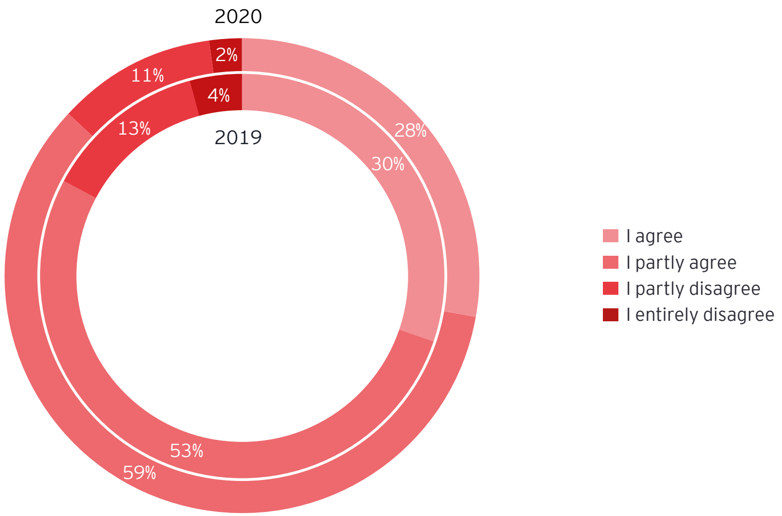
- The financial institutions were able to switch to working from home relatively well and without major problems. The investments in technology in recent years have paid off here. Remote work has not been identified as the biggest risk by the banks.

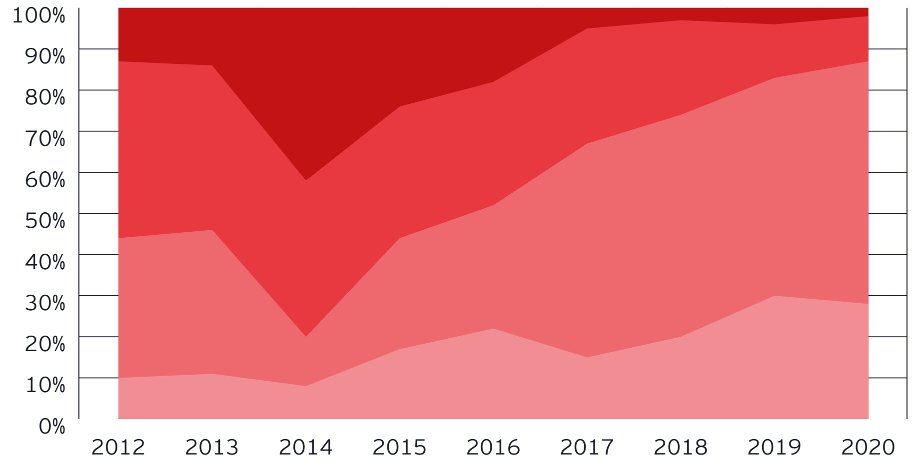




Rising profits despite falling prices – are tough cost-cutting measures around the corner?

«Do you agree with the following statement? The prices of banking services will fall.»





- In the assessment of the pricing of banking services, a remarkable trend has emerged since 2014. Where just 20% of the banks surveyed in 2014 expected increasing price pressure, this has now risen to 87% (previous year: 83%). This is a new high since the survey was conducted.

- The reasons for this are clear. FinTechs and challenger banks have been pushing deeper into the banks' territory with low-cost offers and expanded their customer base. But it is actually the established institutions that have been making changes to the pricing structure in the Swiss banking market. Digital solutions are also now at the center of customers' wishes, with customers tending to expect lower fees.

- The banks are thus faced with the immense challenge of how to secure their profitability in the long term in an environment of ultra-low interest rates, while having to deal with the increasing squeeze on fees for banking services.

- Despite the current pressure on prices, the banks surveyed are quite positive about the future (see p. 18). But this positive view is only likely to be justified if the banks succeed in tapping new sources of income or launching additional cost and efficiency measures.

5

Negative interest rates

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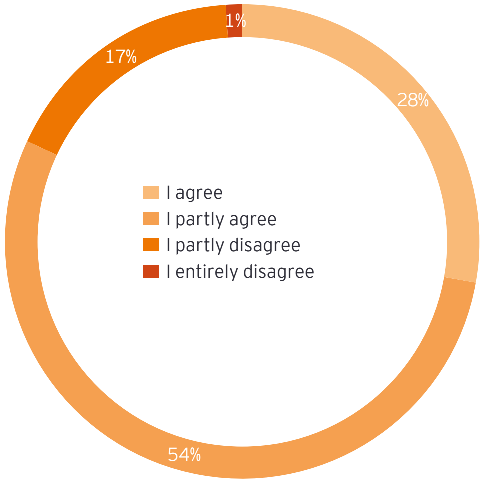
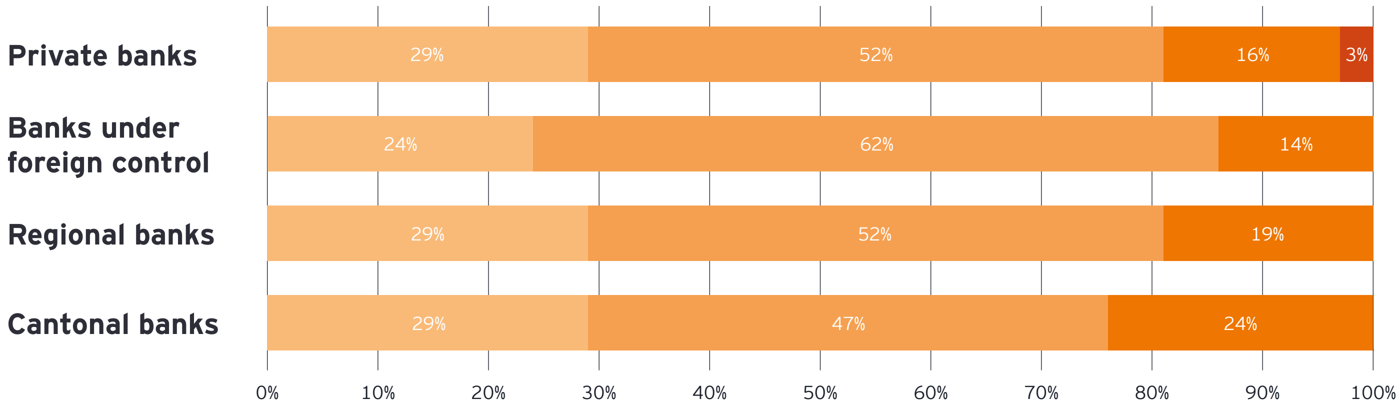
The higher exemption threshold is alleviating the negative impact of negative interest rates to a degree.

Olaf Toepfer
Partner
Leader Banking & Capital Markets

Farewell interest rates – are Japanese conditions heading to Switzerland?

«Do you agree with the following statement? The Corona crisis leads to an increasingly permanent ultra-expansionary monetary policy, with the consequence that in Switzerland key interest rates will still be negative in 10 years ("Japanese standards").»





- Since December 2014, interest rates in Switzerland have been in negative territory. The central banks' response to the coronavirus pandemic has once again cemented the low interest rate environment and the end of the monetary policy state of emergency is a distant prospect.

- A belief in an imminent turnaround in interest rates has also dissipated among the Swiss banks. At 82%, the vast majority of banks believe that base rates in Switzerland will still be negative in 10 years' time ("Japanese conditions").

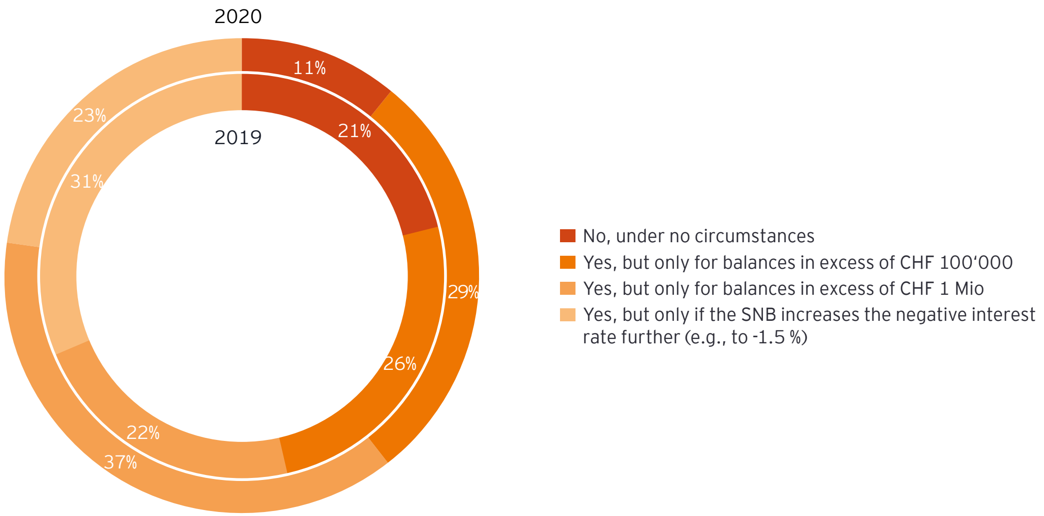
- The gloomy outlook for long-term interest rates is in marked contrast to the generally more positive outlook for the future of the banks: 73% and 84% of the banks respectively anticipate better business performance in the medium and long term. The entrenchment of the low interest rate environment, possibly for years to come, is exacerbating the main problem faced by the Swiss banks, which has happening for several years: the erosion of margins in the interest business.[8]

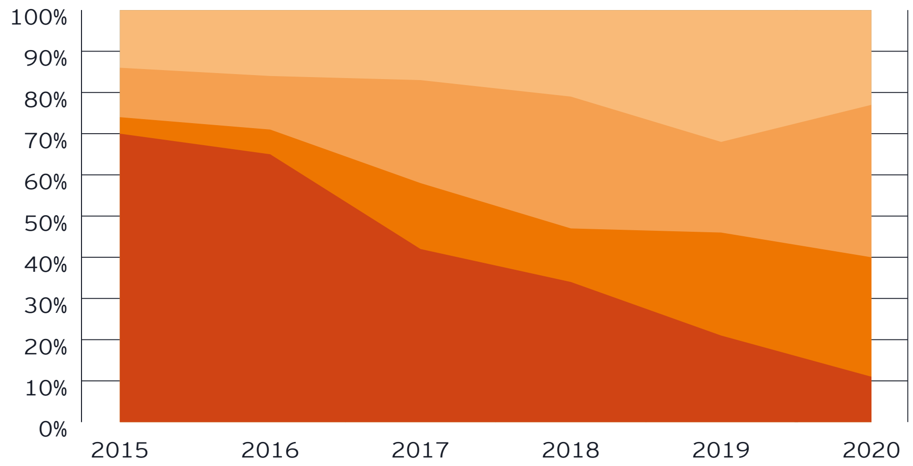
- So what is the reason for this optimism? Only 13% of the banks say a prolonged negative interest rate environment with unchanged exemption thresholds (status quo) is the biggest challenge for the interest rate differential business, and this is the first sign that banks have gradually come to terms with negative interest rates (see p. 34).

[8] Where the interest margin of the domestically focused banks was still 1.80% in 2007, it has since fallen to 1.12% (source: SNB, per the end of 2019).

Are negative interest rates for private customers inevitable?

«Does your organization intend to introduce negative interest rates in the private customer business?»

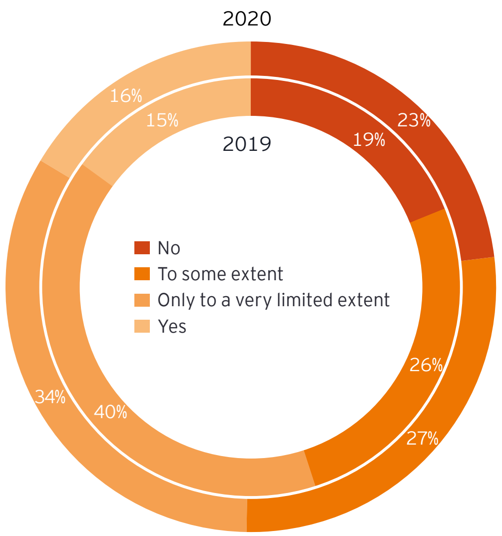


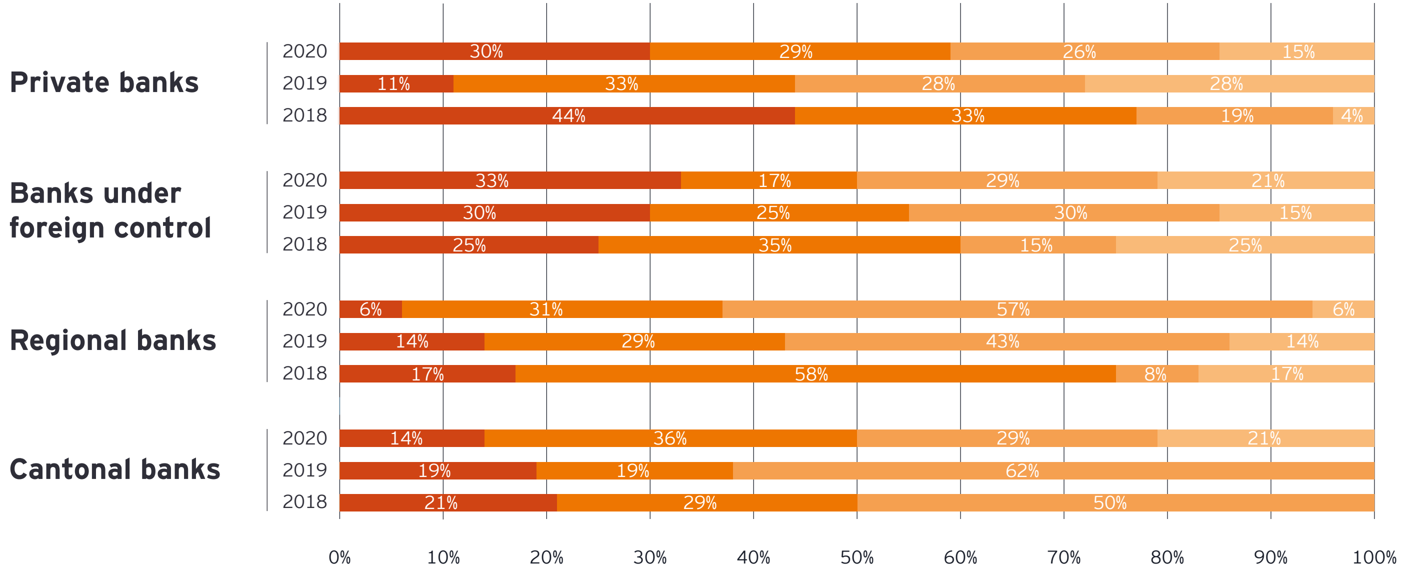


- Any normalization of monetary policy has become a distant prospect with central banks continuing to expand the money supply as a result of the coronavirus crisis. The prospect that low/negative interest rates may persist for several more years is exacerbating the structural earnings difficulties of banks and the margin erosion in the important interest income business that has been going on for several years now. The higher-interest paying loans and financial assets from the past are gradually expiring without any adequate replacement. This also applies to investors who are leaving repayments of maturing bonds in their bank accounts for the time being due to the lack of alternatives, further exacerbating the banks' problems.
- Given these developments, it is unsurprising that by now only 11% of the banks surveyed categorically rule out passing on negative interest rates to private customers. Last year it was 21%, while five years ago the figure was as high as 70%. Charging negative interest on customer balances is therefore no longer taboo, especially for customers who do not use any other revenue-generating services for the bank apart from plain account management. No banking group is now immune from the trend where negative interest rates are increasingly being passed on. Among retail banks, for example, only 14% (regional banks) and 6% (cantonal banks) now categorically reject the idea of passing on the costs to their customers.

Higher exemption thresholds mean banks have put plans to lower negative interest rate thresholds on ice for now

«Does your organization intend to reduce the minimum balance for passing on negative interest rates to your customers?»





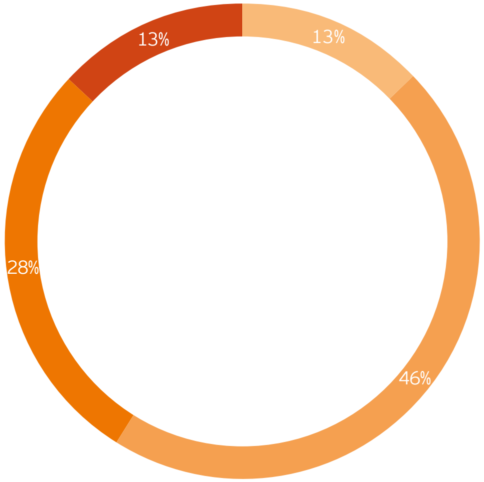
- Last year, 55% of banks considered lowering the threshold for negative interest rates. Although the central banks' response to the coronavirus pandemic has further baked in the low interest rate environment and there is still pressure on margins in the interest income business as a result, slightly fewer banks (50%) than in the previous year plan to reduce the threshold for passing on negative interest rates.

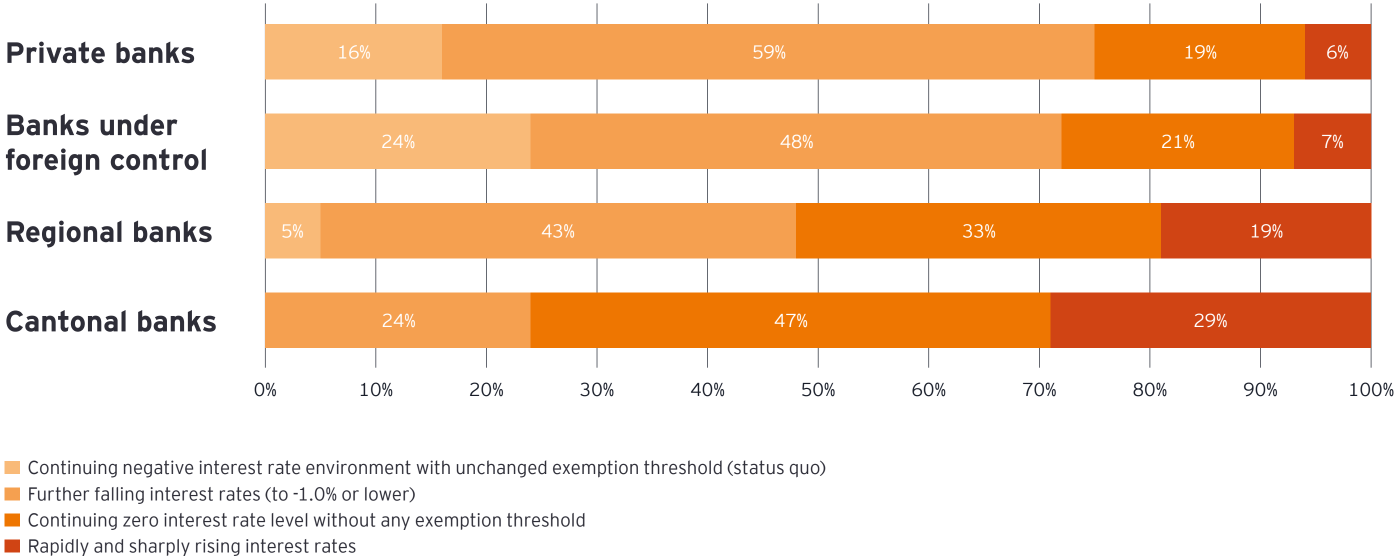
- One obvious reason for this is the SNB's increases in the exemption threshold for negative interest rates in November 2019 and April 2020, which has taken some of the pressure off banks. Moreover, Swiss banks have so far kept their cool during the crisis and stood by their customers as dependable partners. They would have been seen in a different light if more of them had passed on negative interest rates.

- But given the increasing pressure on the banks' revenues and earnings, this appears to be only a temporary state of affairs and the gradual introduction (or stepping up) of negative interest rates on customer balances will increasingly become a reality. This is especially true for customers who do not use any other revenue-generating services of the bank apart from pure account management.

Fears of interest rates falling even further

«Which interest rate scenario would represent the greatest challenge for the interest margin business of your institution?»





- For 46% of the banks surveyed, the greatest danger is that interest rates will fall even further from today's levels. But 28% consider long-term zero interest rates with no exemption thresholds the worst scenario, while 13% see the greatest danger in sharp and rapid rises in interest rates.
- It is worth noting that for only 13% of the banks, the status quo (today's negative interest rate environment with unchanged exemption thresholds) is the most negative scenario, which suggests that many banks have now apparently come to terms with the current situation to some extent.
- The quite different assessments between the banking groups is striking. But it is hardly surprising that the private and foreign banks consider even lower interest rates to be the worst option since they cannot cushion the negative effects of negative interest rates through the exemption thresholds or the mortgage business. The exemption thresholds are extremely important for the cantonal and regional banks, as they reduce the pressure on margins in the interest income business.

6

Financial market regulation

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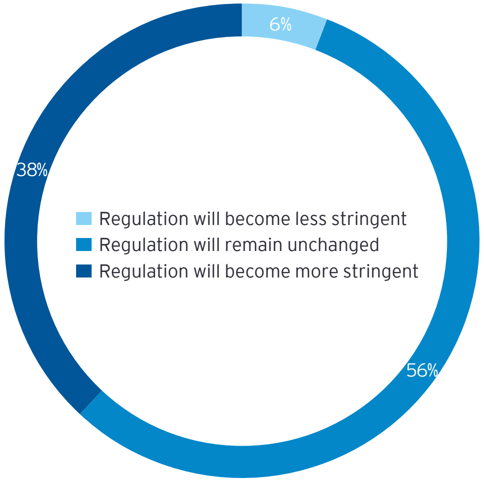
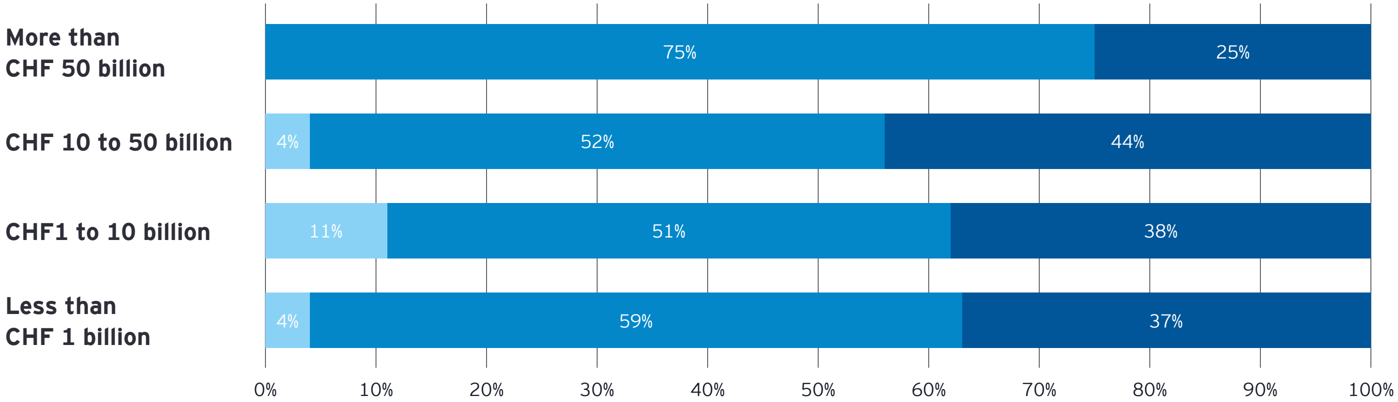
To prevent a credit crunch, the central bank and FINMA initially responded to the coronavirus crisis with relief measures. But additional far-reaching regulatory relief should not be expected.

Patrick Schwaller
Managing Partner
Audit Financial Services

No additional regulatory relief

«Given the economic impact of the Corona crisis, how do you expect regulation of the banking sector will develop in Switzerland in the next 1 to 2 years? »

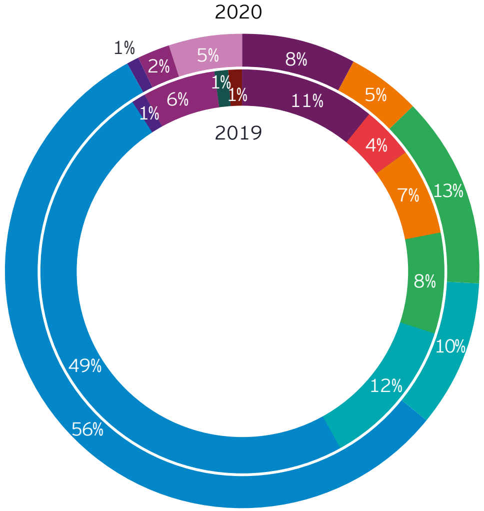


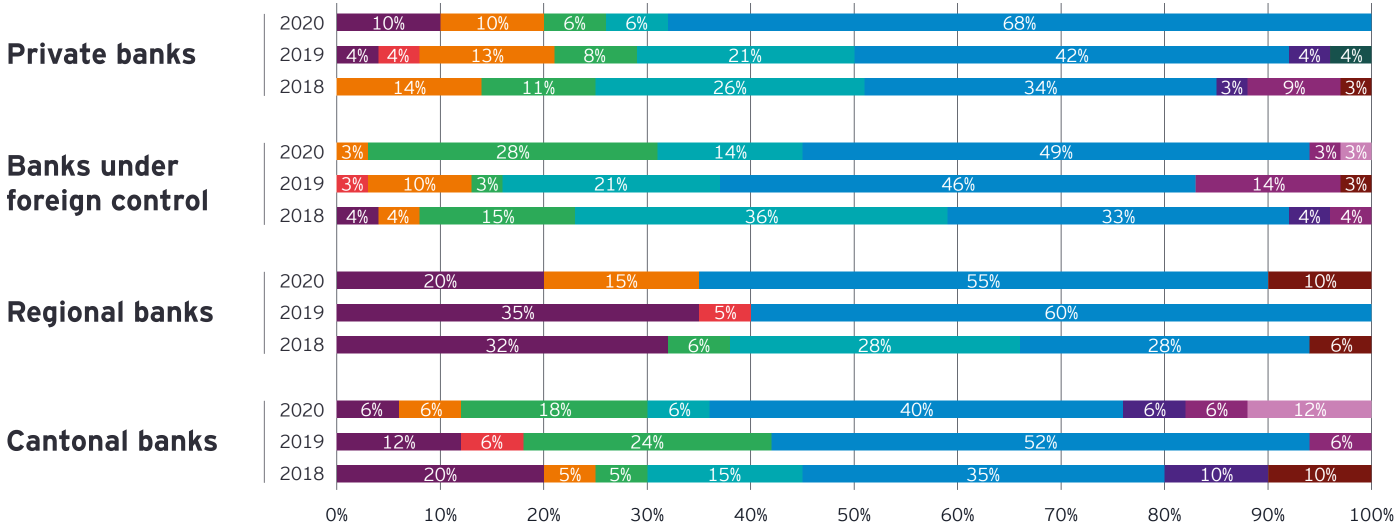


- The Swiss government was quick to respond when the coronavirus pandemic struck and, along with the banks, launched a comprehensive SME loan program with the aim of ensuring companies could access credit and bridge liquidity bottlenecks caused by the crisis. The Swiss Ordinance on Granting Loans and Guarantees in connection with the Coronavirus Pandemic came into force in the country on 26 March 2020.
- The SNB and FINMA also supported this loan program. To give the banks a little more leeway in their lending, they agreed to a number of measures or regulatory relief measures. The main ones are the removal of the countercyclical buffer, the temporary relief in the leverage ratio (initially until 1 July 2021) and the introduction of a specific refinancing facility to grant bridging loans. To further strengthen the banks, the SNB also increased the negative interest exemption threshold on 1 April 2020. This significantly reduces the negative interest burden on banks.
- But hardly any of the banks are expecting further relaxation of the regulations. Half of the banks surveyed (56%) are not anticipating any additional pandemic-related regulatory impact. However, 38% think the reins will be tightened again in the future. Only 6% of the banks are forecasting other relief measures. One would assume another increase in the negative interest rate exemption threshold at the SNB would be at the top of the banks' wish list, as it would at least somewhat alleviate the banks' greatest headache at present: the erosion of margins due to negative interest rates.
- Due to the efforts made in the past few years, the Swiss banks have solid capital and liquidity buffers and have so far proven to be an anchor of stability for the economy during the coronavirus crisis. Based on this position of strength, it seems they are not expecting any further concessions from the supervisory authorities.

Will monetary policy produce the next crisis?

«What do you see as the greatest danger that may cause a next financial crisis?»





- Real estate market crises
- Liquidity crisis due to bank runs
- Stock market crash
- Economic downturn in major markets
- Geopolitical crisis
- Long-term consequences from the expansionary monetary
- Cyber attacks
- Collapse of major financial market infrastructures
- Impact of a global pandemic
- None
- Other

- Central banks around the world responded to the outbreak of the coronavirus pandemic with further support measures on an unprecedented scale, flooding markets with additional liquidity. And the governments' comprehensive relief programs also saved the economy from greater damage.

- Although the vast majority of economists and market players consider these massive measures to be justified, more and more voices are warning of the possible consequences of this ultra-expansive monetary policy. Unsurprisingly, more than half (56%) of the banks see the long-term consequences of the expansionary monetary policy as the greatest risk factor for the next financial crisis. This is 7 percentage points more than in the previous year.

- So concerns about the long-term consequences of monetary policy are overshadowing all other risks. Despite the historic economic slump caused by the coronavirus pandemic, just 13% of the banks, which is only 5 percentage points more than in the previous year, recognize that the greatest risk lies in the consequences of an economic downturn.

7

Lending business

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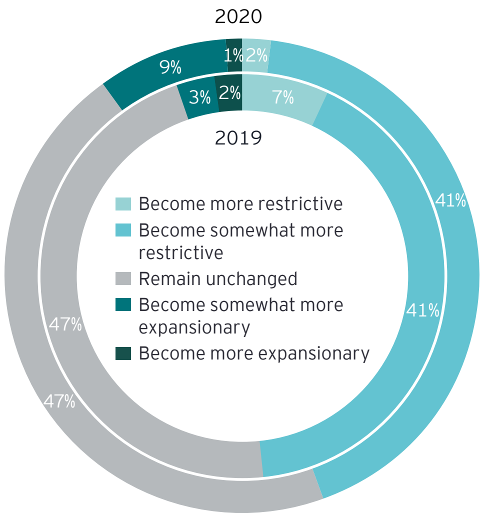
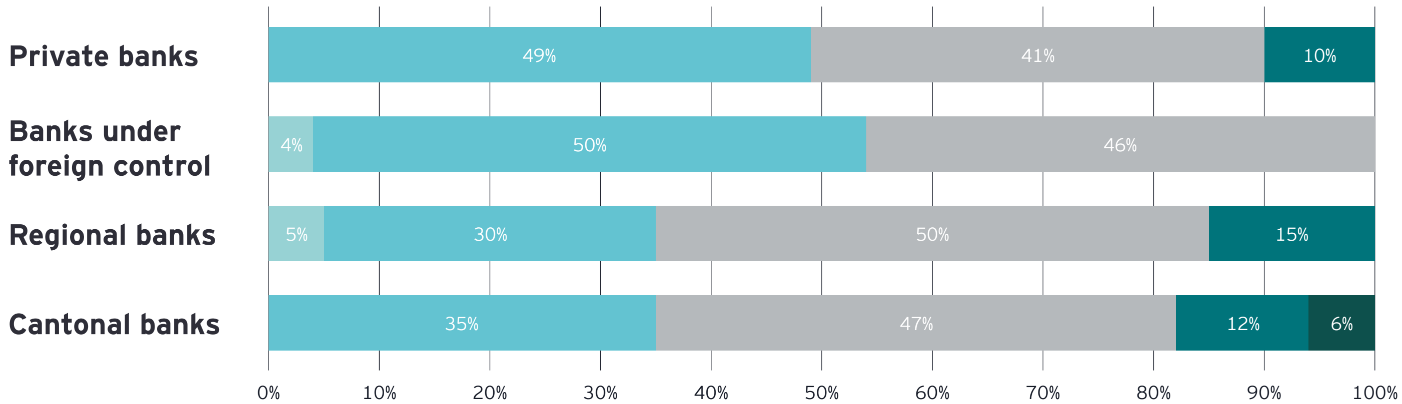
The coronavirus pandemic has had a far-reaching impact on the business performance of Swiss SMEs in many sectors, which could lead to an increase in loan defaults in the medium term. Swiss banks are very resilient and should be able to cope well with any losses.

Timo D’Ambrosio
Director
Financial Services Assurance

Steady growth in mortgage lending

«How do you expect the lending policy of Swiss banks in the residential property segment to develop in the next 6 to 12 months?»





- Despite the coronavirus pandemic, the Swiss banks' mortgage lending volumes continued to grow unabated in 2020 and amounted to around CHF 1,070 billion at the end of August 2020.[9] Whether the steady high growth of recent years will continue in the future remains to be seen. This is because, after the explosion in prices observed in recent years, many households can no longer afford to purchase real estate due to the existing regulations on affordability and equity. In addition, demand for residential property is easing somewhat as net immigration is in decline. And the tightening up of regulations in August 2019 also raised the hurdles for financing investment properties. But due to a lack of investment alternatives, there is still a lot of interest in real estate investment.

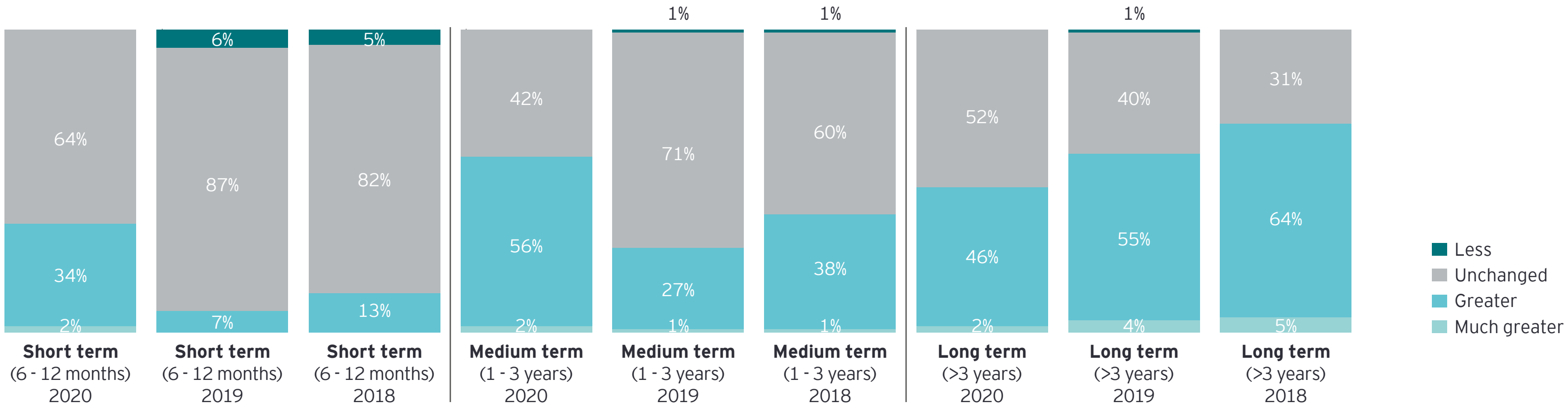
- Unchanged from the previous year, 47% of the banks would like to maintain their current lending policy. 43% of the banks intend to pursue a rather more restrictive lending policy in the future and 10% of the banks (previous year: 5%) even want to increase current levels.

- Despite growth ambitions in other business areas (see Section 4), the lending business will remain the most important pillar for retail banks in the medium term. A not insignificant proportion (cantonal banks: 18% and regional banks: 15%) consequently also expect lending to be somewhat more expansive. This will be unavoidable if the banks want to compensate for future margin erosion.

[9] Source: SNB.

Sharp rise in short and medium-term loan defaults

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



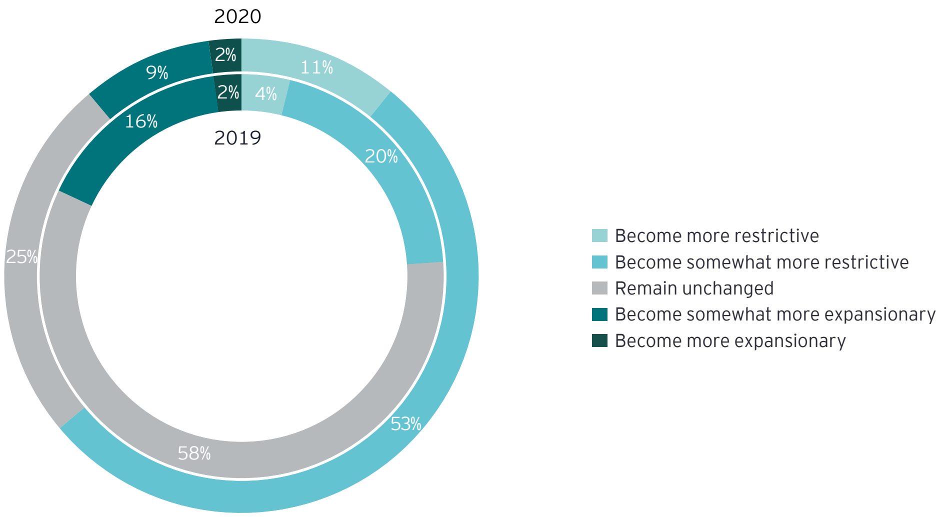
- In the short and medium term, there is a clear increase in the expected impairments on residential loans. 36% of the banks expect higher risk provisions (previous year 7%, up 29 percentage points). In the medium term, as many as 58% of the banks (previous year: 28%, up 30 percentage points) expect impairments to increase.

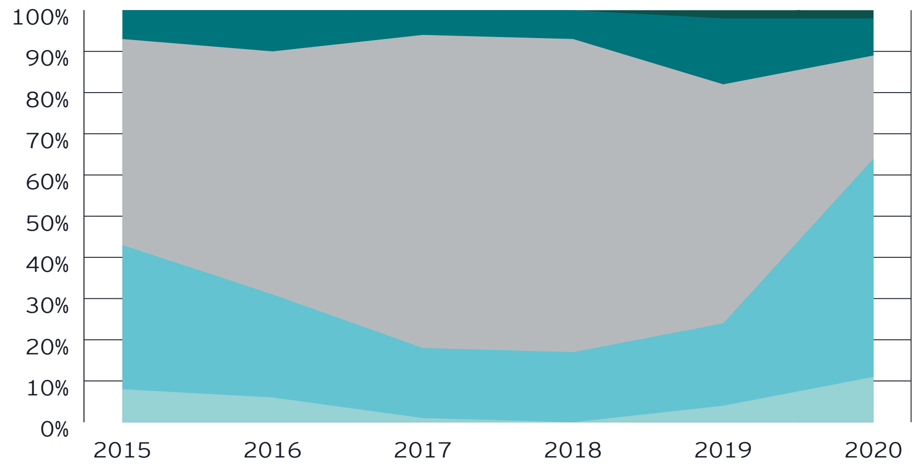
- But this drastic increase must be seen in the context of the extremely low levels loan defaults in the past few years. Based on these historically low levels, a logical consequence of the coronavirus pandemic is an increase in risk provisions. But this will not pose serious problems for the Swiss banks. In the long term though, only 48% of the banks (previous year: 59%) expect risk provisions to increase, while 52% (previous year: 40%) predict impairments will stay the same.

- It is clear the banks believe impairments will only increase in the short and medium term and these will be more on the moderate side, to be followed once again by a period with very low loan defaults, similar to the last few years. But if we look further back in the past, we can see the low loan default rates of recent years have been the exception rather than the rule.

No credit crunch – but lending increasingly selective

«How do you expect the lending policy of Swiss banks in the SME segment to develop in the next 6 to 12 months?»





- The Swiss banks also proved to be dependable partners for the economy during the coronavirus crisis within the framework of the SME loan program launched by the Swiss government and the banks. In the course of this program, the banks had granted loans with a total volume of CHF 16.8 billion[10] by the end of the program on 31 July 2020. This has been one of the main drivers of the CHF 23.8 billion[11], or 5.1%, increase in SME loan limits offered by Swiss banks this year to CHF 487 billion.[12]

- After this major feat, 64% of the banks surveyed now say they will pursue a more restrictive lending policy in the future. This corresponds to an increase of 40 percentage points compared with the previous year. The increased restraint is evident across all banking groups, although it is little less pronounced among the cantonal banks (up 24 percentage points). By contrast, only 25% of the banks still expect their lending policy to remain unchanged (previous year: 58%).

- Given the increased risks, it seems understandable from a credit risk management perspective that the banks want to be more selective in the future. However, per end of June 2020, there were still high unused limits for SME loans (utilization: 71.2%, December 2019: 70.1%[13]), so Switzerland is not facing a credit crunch in the medium term.

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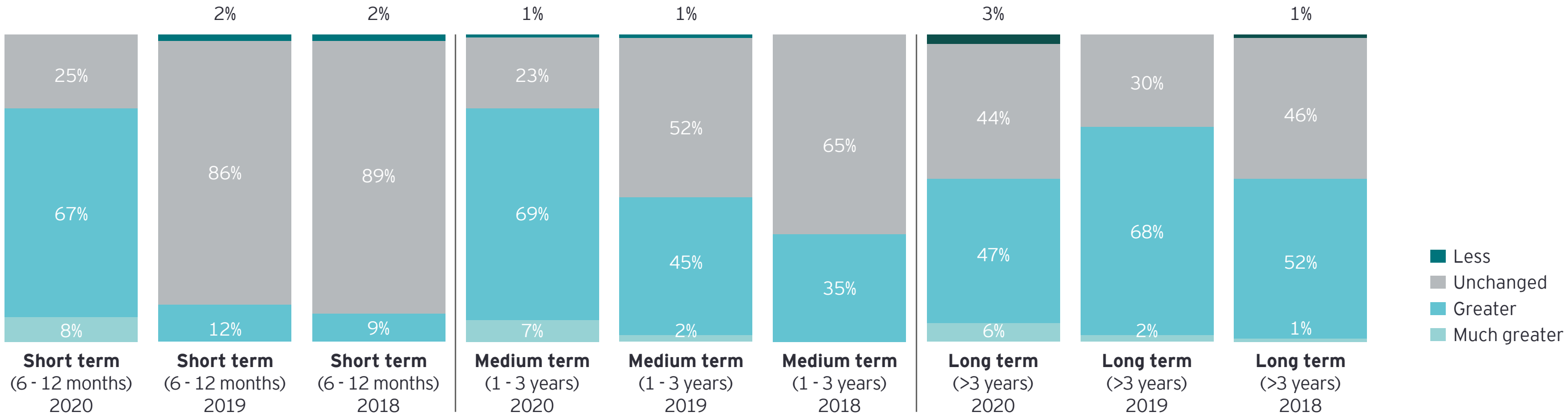
[10] CHF 816.6 million of this had already been repaid by the end of November 2020. The average loan amount was CHF 102,000 for Covid-19 loans (loan up to CHF 500,000) and CHF 2.7 million for Covid-19 loans plus (loan amounting to 10% of annual turnover, from CHF 500,000 to a maximum of CHF 20 million) (source: SECO).
[11] Source: SNB.
[12] Source: SNB (per end of September 2020).
[13] Source: SNB and own calculations.

No panic despite expected loan defaults

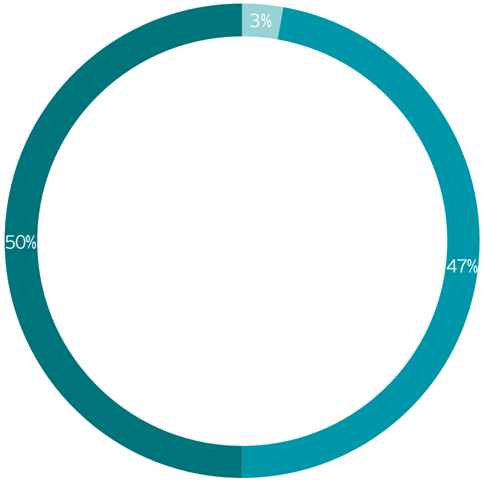
«What level of risk provisioning (impairment losses and provisions) do you expect you will need to cover your SME lending business?»

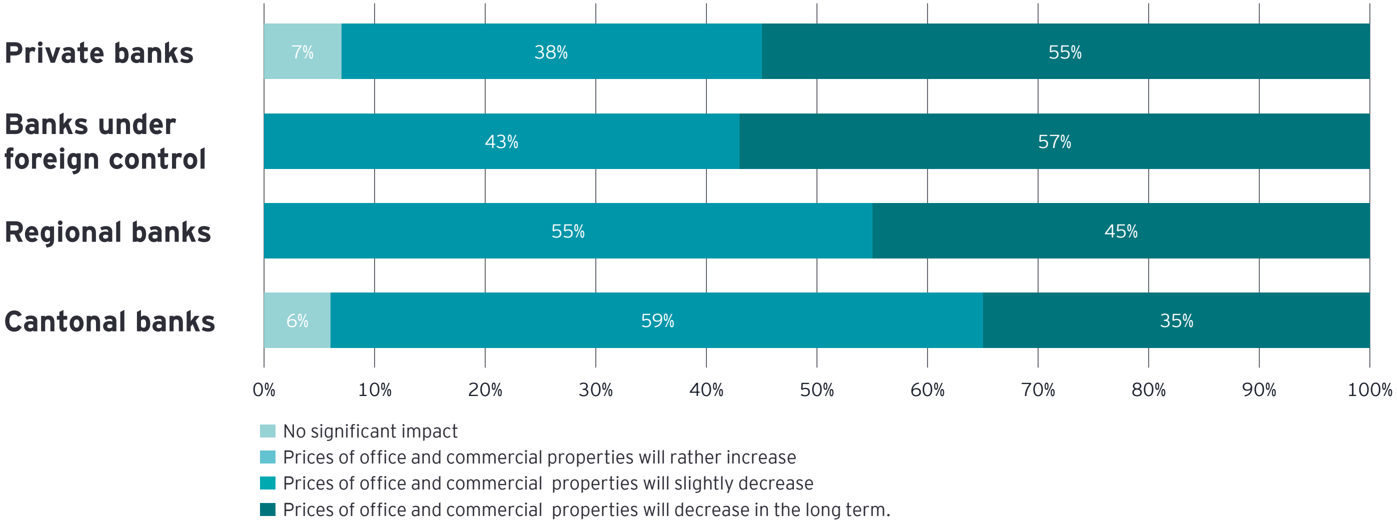


- The economic consequences of the coronavirus pandemic are hitting many SMEs hard. Unprecedented interventions by central banks and governments were initially effective enough to prevent a widespread wave of bankruptcies. But the economic outlook remains fragile and uncertain.
- So impairments of SME financing are increasingly coming into focus. At 75% and 76% respectively, a clear majority of Swiss banks expect risk provisions for SME loans to increase in the short or medium term (previous year: 12% short term and 47% medium term). Particularly in the short term, i.e. in the next 12 months, the expectation jumps by 63 percentage points compared with the previous year.
- Similar to residential financing, banks believe SME loans have better long-term prospects than in the previous year. But more than half of the banks (53%, previous year: 70%) are still expecting higher impairments.
- Swiss banks are a strong partner for the SME economy. But loan exposures to corporate customers account for only a small share of total lending. Moreover, the banks believe Swiss SMEs are resilient – 85% of them expect SMEs to recover from the crisis within the next two to three years (see p. 46) – so that no widespread loan defaults are expected.

Bleak future prospects for office and commercial real estate

«What medium-term impact will the Corona crisis have on the market of office and commercial properties in Switzerland?»





- The shift toward working from home has clearly become more pronounced in the course of the coronavirus pandemic. Around half of Swiss companies would like to make more use of it in the future.[14] The pandemic also left its mark on the retail trade and gave an additional boost to the already observable trend, which has seen business shift from brick-and-mortar retail to online platforms.

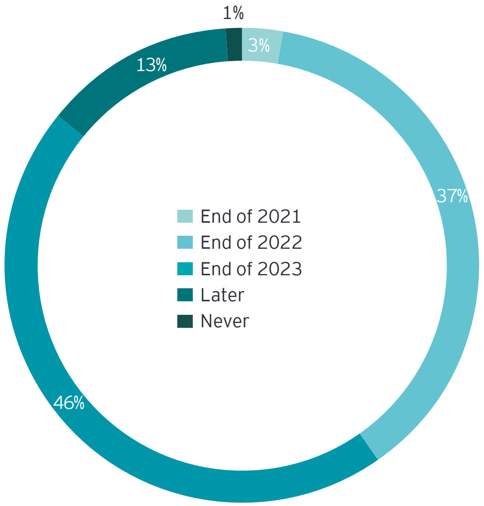
- As a result, it is unsurprising that an overwhelming majority of 97% of banks expect prices for office and commercial properties to fall.

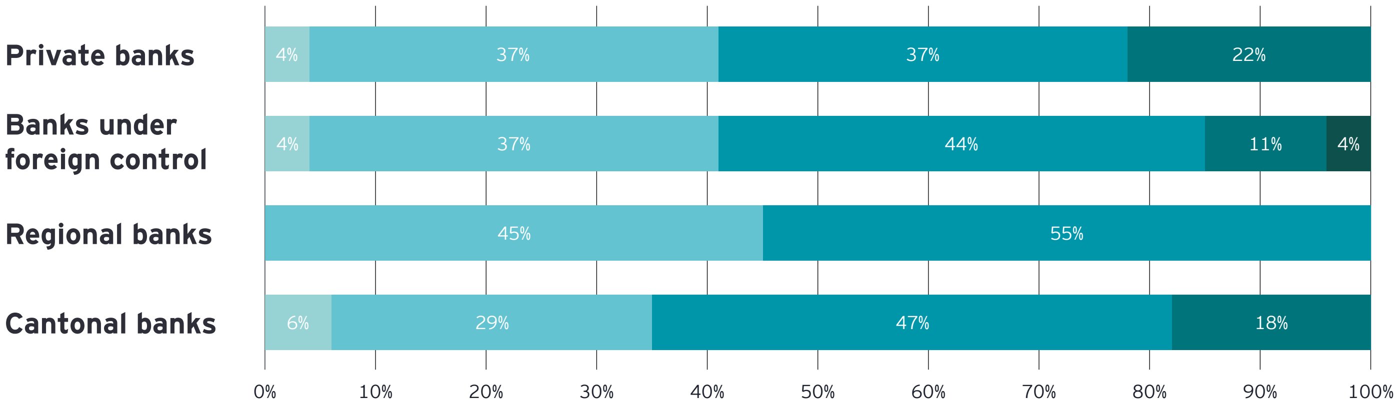
- The retail banks (cantonal banks: 35% and regional banks: 45%), which observe the real estate market particularly closely because of their business models, are anticipating a somewhat less pronounced collapse in prices than the private banks and foreign banks (57% and 55% respectively).
- But even if prices were to fall sharply, there should be virtually no worrying impact on the Swiss banks. According to EY estimates, the share of office and commercial properties in Swiss banks' mortgage portfolios is approximately only 10% (median value).

[14] Source: Survey of 318 Swiss companies by Jones Lang LaSalle (JLL).

SMEs in the quagmire until 2023?

«When do you expect the majority of your SME clients to reach again the pre-crisis economic level?»





- In the short term, Swiss banks believe the prospects for SMEs are bleak. Only 3% of the banks surveyed are expecting a recovery to pre-crisis levels within the next 12 months. This is in line with expectations for short-term SME impairments.
- But the banks are more optimistic in the medium term: 83% expect to see a recovery in the next two to three years, i.e. before the end of 2023.
- The Swiss banks therefore believe that SMEs in Switzerland can get back to pre-crisis levels, but are forecasting a U rather than a V-shaped recovery.

8

Structural change & Fintech

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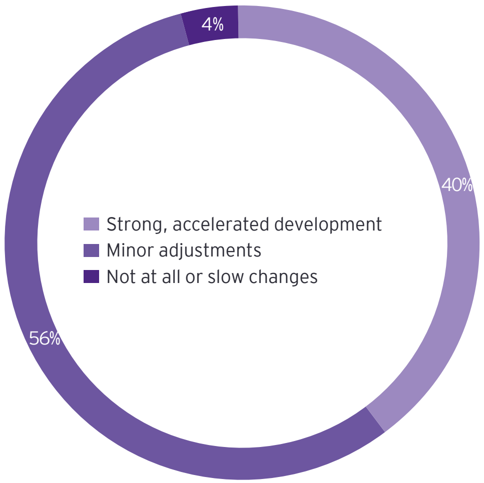
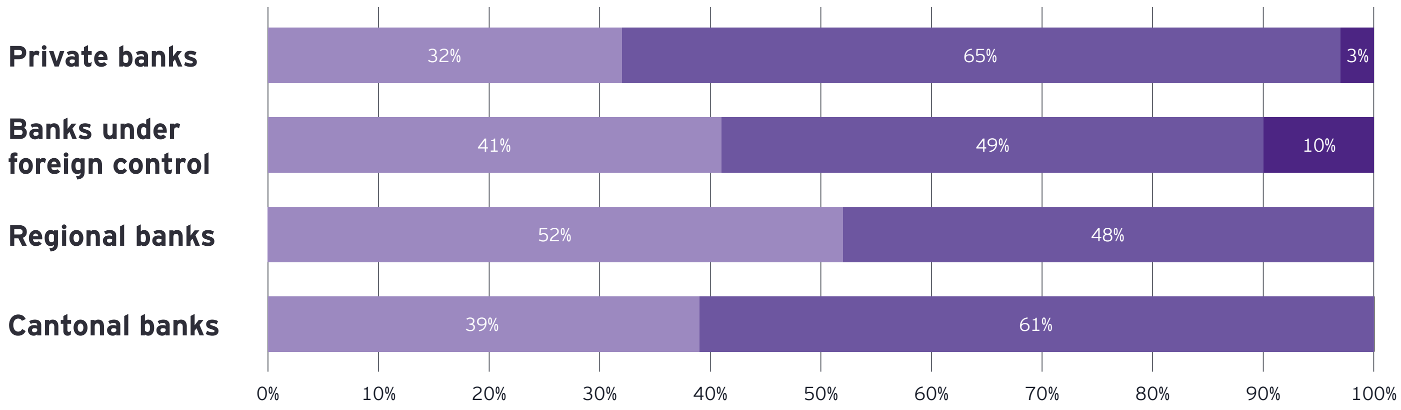
One side effect of the coronavirus pandemic has been an unexpected acceleration in the digitalization of business models and processes.

Olaf Toepfer
Partner
Leader Banking & Capital Markets

The coronavirus crisis has led to an acceleration in the digitalization of business models and processes

«How strongly will the Corona crisis impact the business model of your institution and structural change in banking?»





- 4% of the institutions questioned estimate the direct impact of the coronavirus crisis on their business model and structural change in Swiss banking to be non-existent, while 56% are expecting minor structural change and 40% are expecting structural change to be accelerated by the crisis.

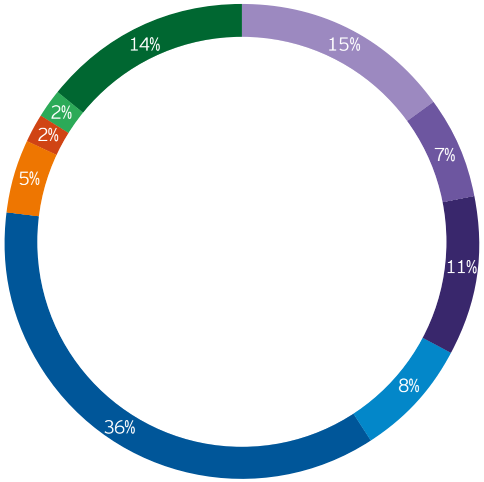
- The banks had to switch to working from home in a very short time and they mastered this challenge quite successfully and without any significant problems. At the same time, the Swiss banks were heavily occupied with crisis management in 2020 and in some cases pushed transformation projects down the priority list in the short term.

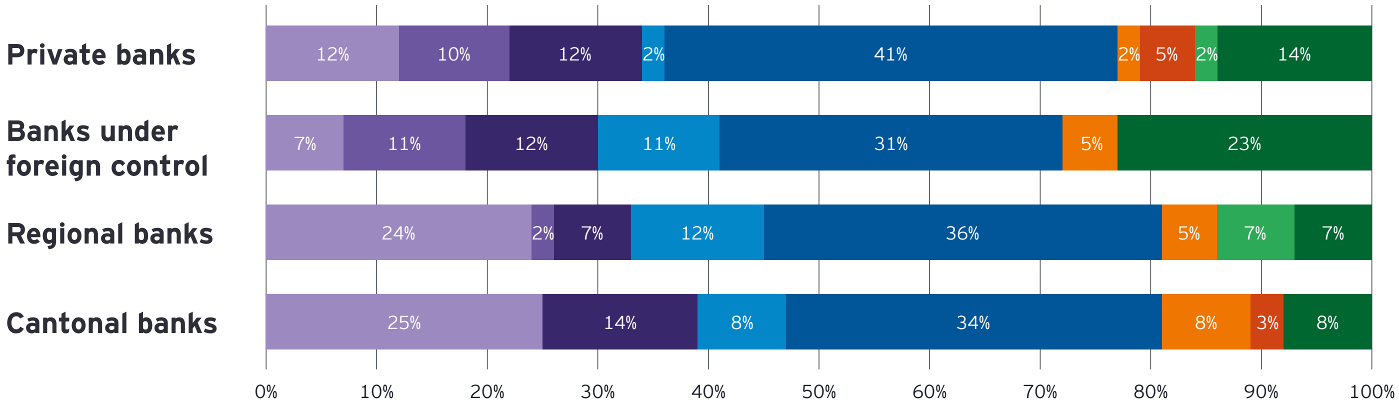
- But it is a fact that customer behavior with regard to the use of financial services has changed as a result of the health crisis and the protective measures brought in. All customers (including those who are very reluctant to use electronic channels) were forced to switch to digital channels to do their banking. It is safe to assume that a large proportion of customers will maintain this behavior.

- The change in the channels customers prefer to use may not be sufficient on its own to accelerate structural change, but the increasing willingness to use digital channels will create strategic opportunities for banks to further develop their value propositions and service offerings (e.g. hybrid advisory). The latter is clearly a core concept for future business models in banking.

Should banks optimize existing structures rather than further develop business models?

«In your opinion, which are the most important medium-term effects due to the Corona crisis on Swiss banking?»





- Increase in value adjustments and losses in the lending business
- Consolidation wave in Swiss banking
- Stronger focus on cost reduction and efficiency gains measures
- Decreasing physical presence of banks
- Acceleration in the digitalization of business models and processes
- Further development of business models
- Streamlining business models through increased focus
- Increasing cooperation between market players
- New working model combining home and office work as industry standard

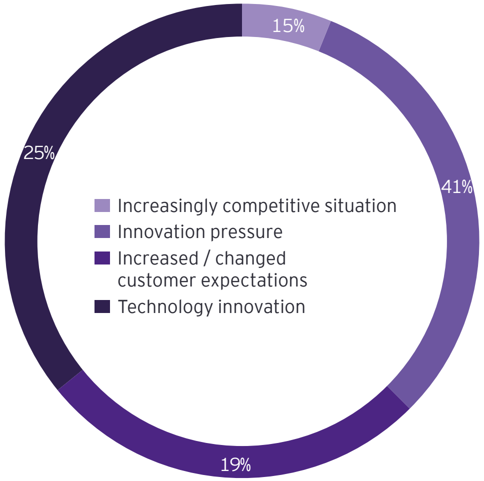
- The "acceleration in the digitalization of business models and processes" is the most frequently cited medium-term impact on Swiss banking from the coronavirus crisis and is cited by 36% of respondents.

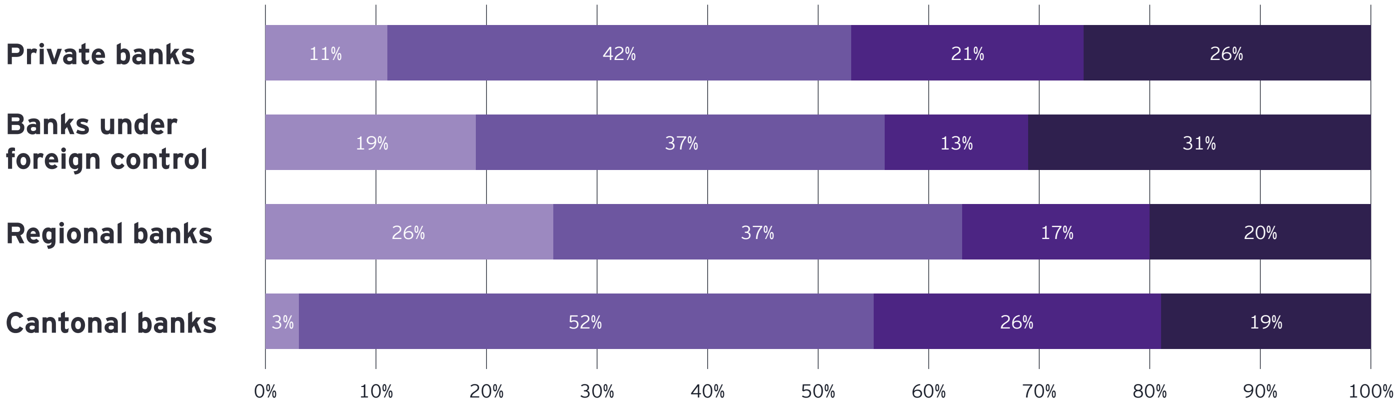
- The banks hardly consider predominantly structural issues and topics – such as the "further development of business models and building up additional sources of income" (5%) and the "reduction of business model complexity" (2%) – to be a priority in the short and medium term.

- If we examine individual statements by banking category, this is not surprising. But it is notable that structural changes (especially cooperation agreements, consolidation and further development of business models) are not considered so important. At the same time, the banks agree that they urgently need to develop new sources of income in order not to lose their earning power in the future (86% agree or rather agree). Is the industry in a bind here?

Pressure to innovate due to contracting margins

«Which are currently the drivers of structural changes in banking in Switzerland?»

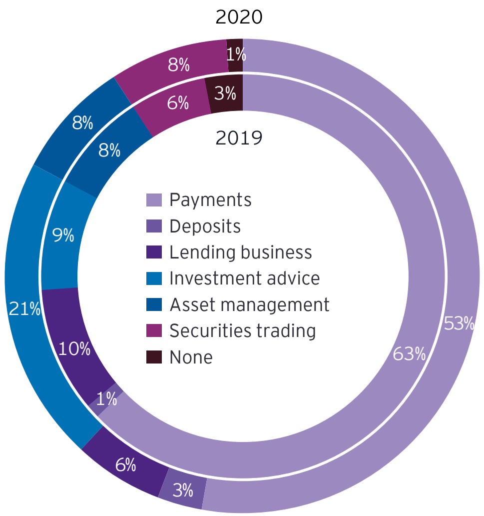




- The banks see the "pressure to innovate as a result of falling margins in the interest differential business and in the commission and services business" (41%) as the biggest driver of structural change in Swiss banking
- The results imply that the Swiss banks are predicting a supply-side driven structural change. According to their assessment, the structural changes are being primarily triggered by institutions and not by customers (customer expectations and behavior).
- Besides coping with the current crisis, the banks are therefore busy investing even more in the digital transformation of their business models or in their digital range of banking services.
- To ensure these transformation projects and the investment to expand digital offerings also have a positive impact on profitability and value creation, banks must fundamentally take customer expectations, needs and behavior into account.

Is it true payments are still the business most severely affected by structural change?

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



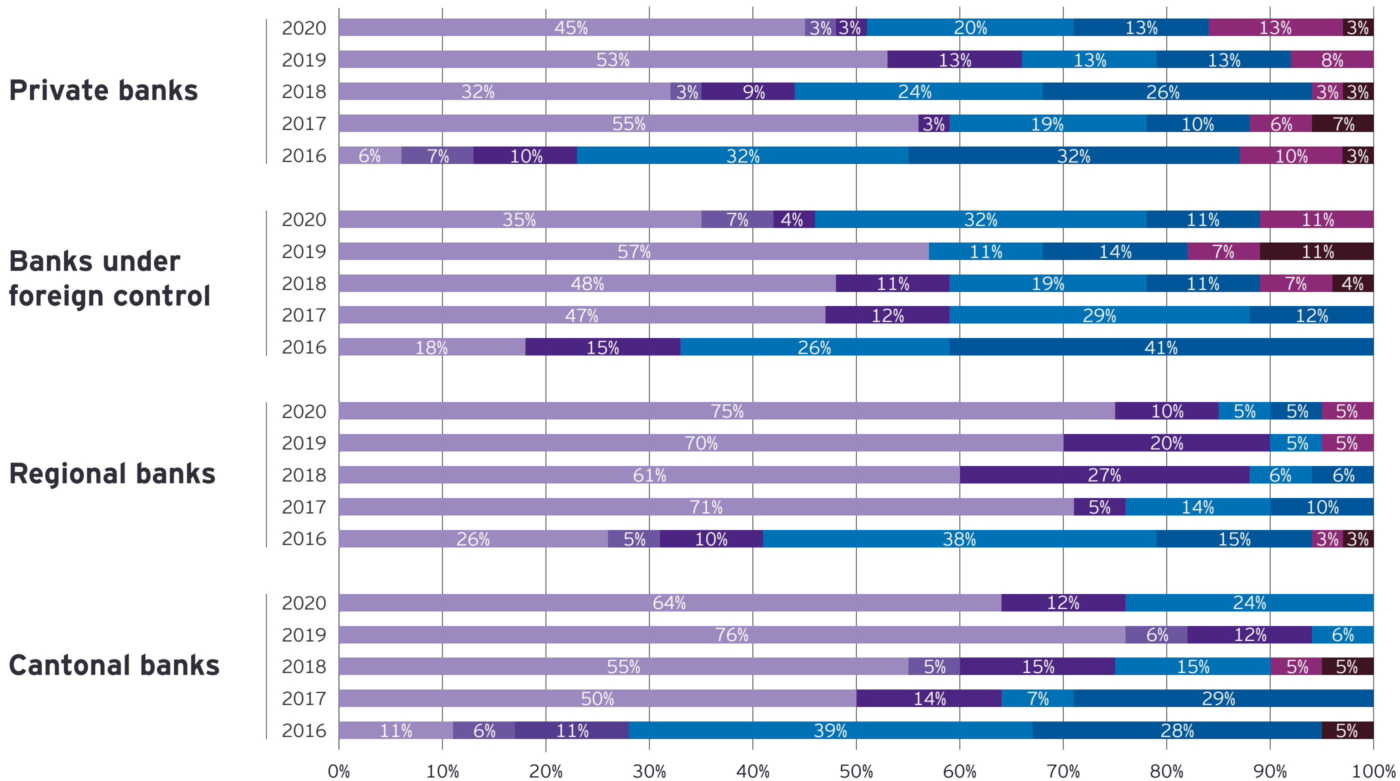
- When asked which business is most likely to be affected by structural change, payment transactions are by far the most frequently mentioned (53%), as has been the case for the past few years. The topic of investment advice was mentioned by 21% of the banks this year, moving it up considerably higher in the importance rankings (previous year: 9%).

- Indeed, various developments can be observed that confirm structural changes are underway in payments. The number of cashless and contactless payments continues to increase, payments-focused FinTechs are enjoying rapid growth, and cash withdrawals from ATMs and branches are decreasing year by year, corporate customers are pushing for real-time international payments, etc.[15]

- The key question is, however, how relevant and decisive these developments really are when it comes to the banks' ability to develop themselves to create value and to refine and hone their structures. Further margin erosion in the foreign exchange business is a possibility as customers will no longer be willing to pay fees on foreign transactions in the future. But whether a customer pays with a credit card or the smartphone (using a stored credit card) is not so important for the banks' value creating potential.

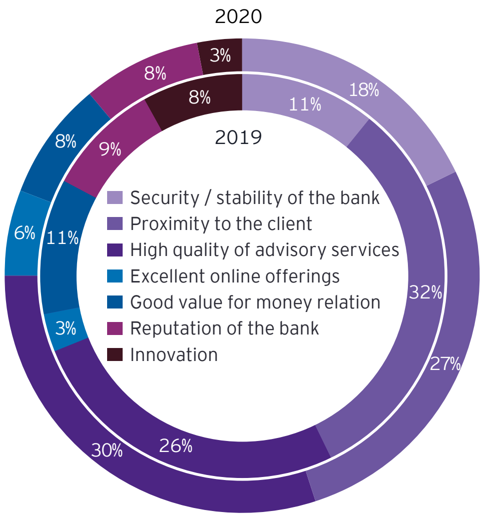
[15] See EY's "End of Cash" series of articles.

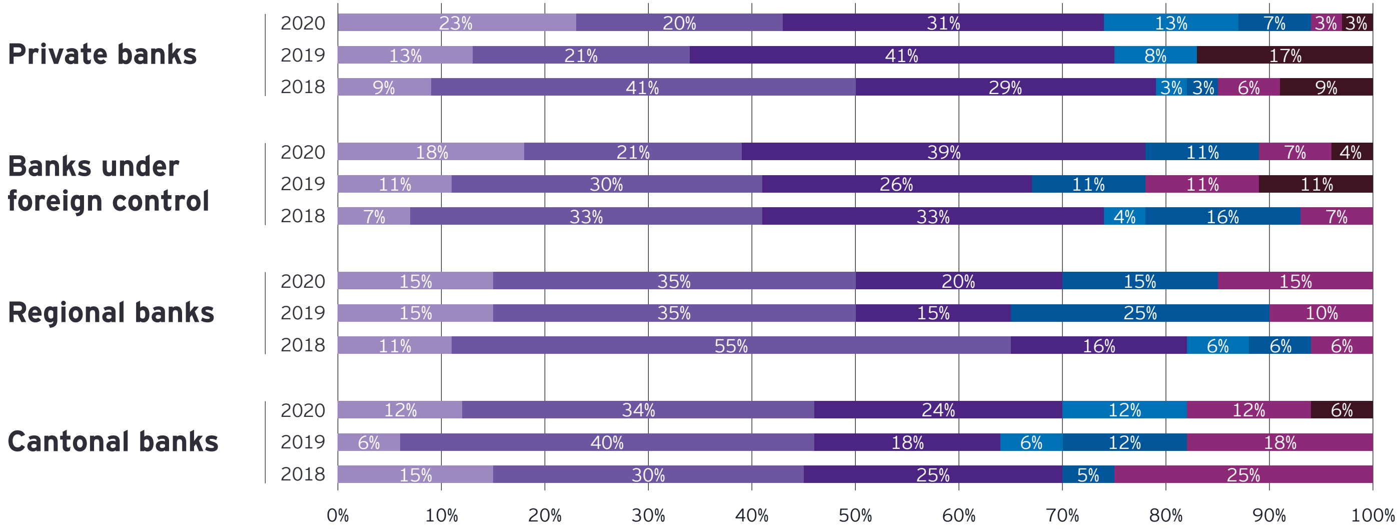
- It is crucial to think about possible scenarios and implications for the core business (interest income business and commission and service business). Most banks think their greatest potential lies in the investment business and have large growth ambitions to match.
- It is unclear how added value for customers in financial domain, which has not yet been addressed by banks, can be provided in the future. As soon as the right key concepts are found for making this a reality, structural changes can also be expected in other business areas, with more significant implications for the banks' capacity to create value.



High-quality advice and customer proximity remain key drivers of customer loyalty

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

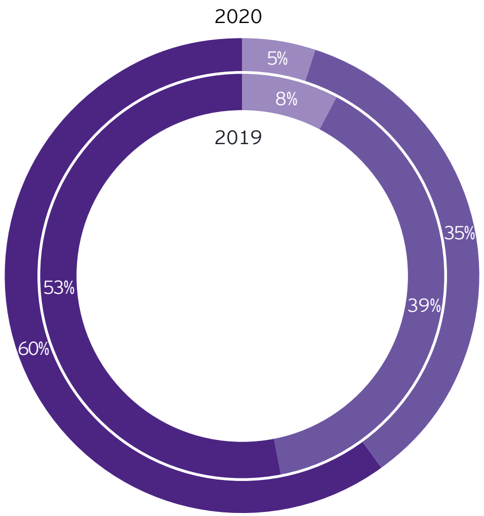


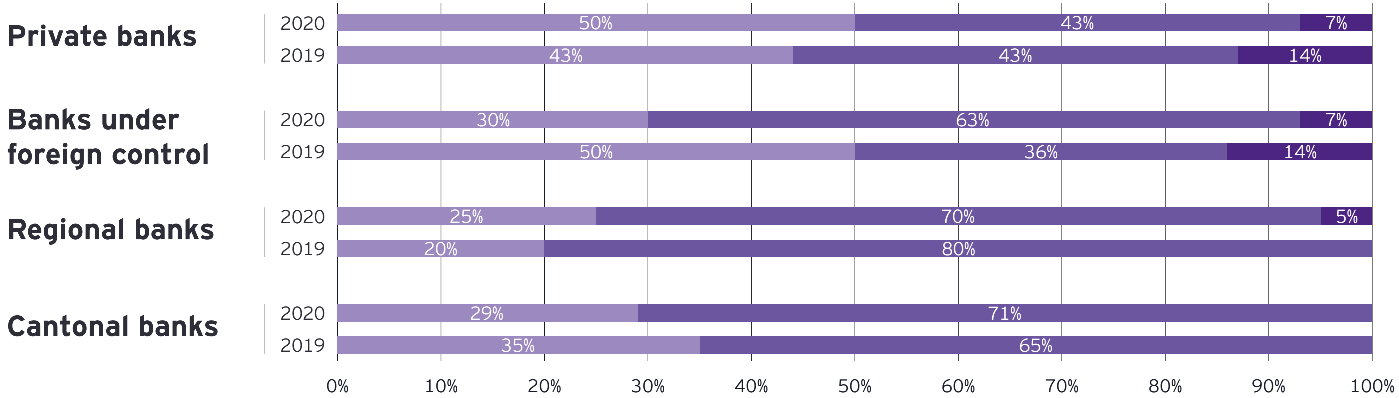


- According to the banks surveyed, the "high quality of advice" (30%) and "customer proximity" (27%) are still the most important factors for ensuring customer loyalty in the future. The "security/stability" factor has gained in importance compared with the previous year; this assessment by respondents is probably due to the current crisis situation.
- But how can customer proximity be measured and systematically built up? To be close to a customer, a bank must be relevant to the customer in terms of achieving their personal financial goals and be able to play a central role in clarifying key issues at important life moments and transitions.
- This is based on a precise mapping of the respective key phases and moments in the customer's life as well as the corresponding needs and requirements per phase. If the bank can succeed in adding value in a customer's decisive moments in life, especially through its advice, and in providing quality products and solutions, it can increase customer proximity and loyalty on a more permanent footing.

Cantonal and regional banks are experiencing declining customer loyalty

«How do you assess customer loyalty for your organization?»





- High level of customer loyalty – competitors' offers are only taken in exceptional cases
- High level of customer loyalty, however noticeably decreasing – rising uncertainty about our capability to creating customer loyalty
- Low level of customer loyalty – customers increasingly taking offers from different providers

- The banks consider the loyalty of their customers to be strong. But 60% of the banks surveyed (previous year: 53%) are increasingly doubtful about their ability to keep customers loyal.

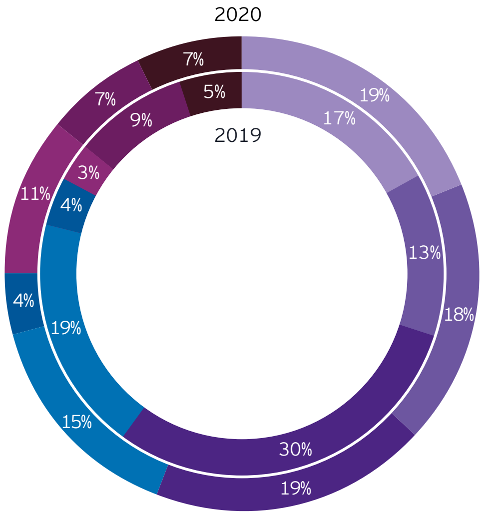
- This uncertainty is more pronounced among the cantonal banks (71%) and regional banks (70%) than among the banking groups that are primarily active in the investment or asset management business. This result is not surprising, as customers are increasingly comparing prices, especially in retail banking, and switching to a new provider can now be done in just a few clicks.

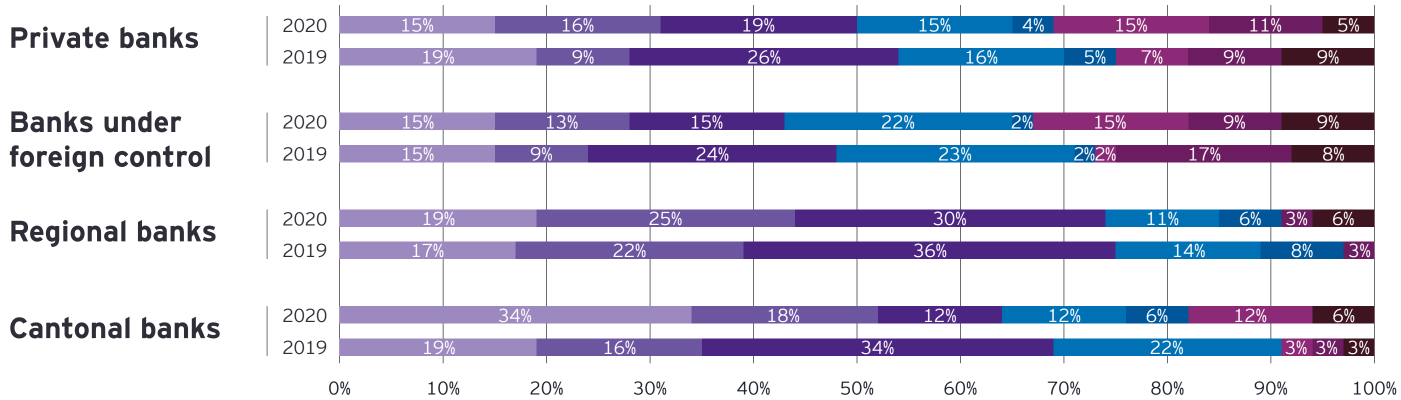
- Developments in recent years indicate that about half of banking customers are open to at least trailing financial services from FinTechs and technology companies. While customers' reluctance to change is common in Switzerland, it is clearly decreasing.

- A similar development can also be discerned in the investment and asset management business; more and more institutions are identifying and using key life moments and transitions to capture "assets in motion" and systematically win over customers in these phases.

Customer centricity as key

«Which are the two major levers for profitable earnings growth in your organization?»





- Improving customer experience (especially at digital points of contact)
- Increasing conversion rates in sales through a better understanding of customers' needs
- Streamlining activities related to customer acquisition, development and retention
- Improving the range of products and services by pooling various services
- Increasing fees
- Developing sustainable investment solutions
- Acquiring additional account managers
- Acquiring other providers (inorganic growth)

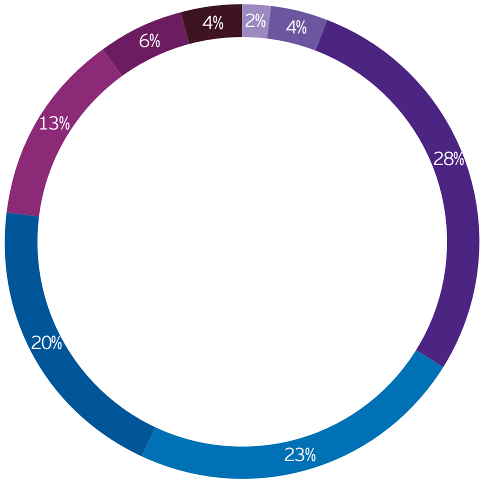
- As in previous year, the banks see additional potential to achieve profitable growth especially in customer-centric levers. 56% of the surveyed banks mention the category with the customer-centric levers "Improving the customer experience" (19%), "Increasing the conversion rate through improved customer understanding" (18%) and "Systematizing customer acquisition, development and retention" (19%).

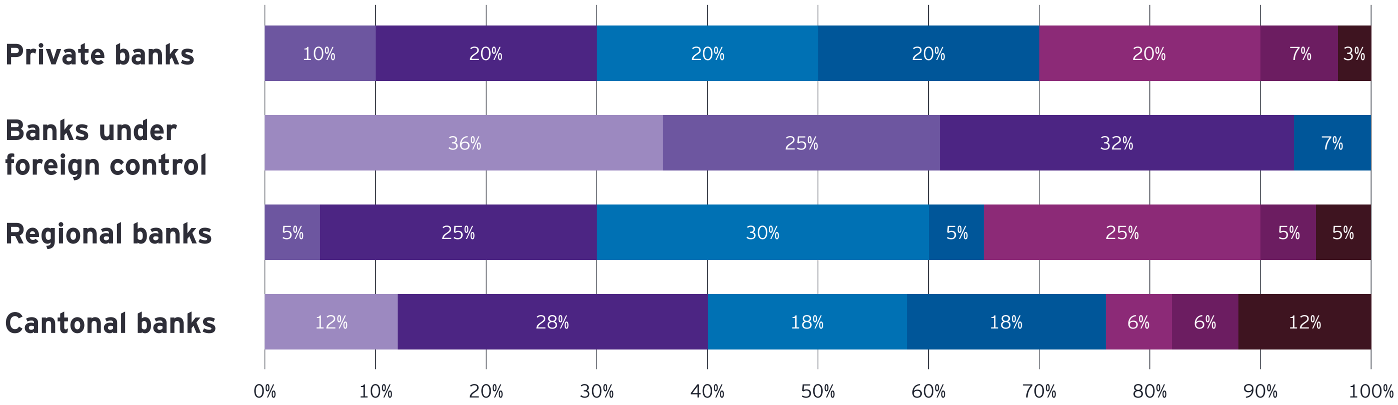
- The results confirm that the banks have initiated the shift to a customer-centric paradigm in Swiss banking. But there are obviously still greater challenges in actually implementing this paradigm shift.

- Customer understanding, which should be used as a basis for any implementation options, is strikingly weak compared with other industries. It also still seems largely unclear what the key concepts are for integrating customer-centric levers into existing business models and systematically aligning them with profitable revenue growth.

Different approaches for Generation Z

«In your opinion, what is the crucial factor to attract the next generation of banking customers (generation Z) for your bank?»

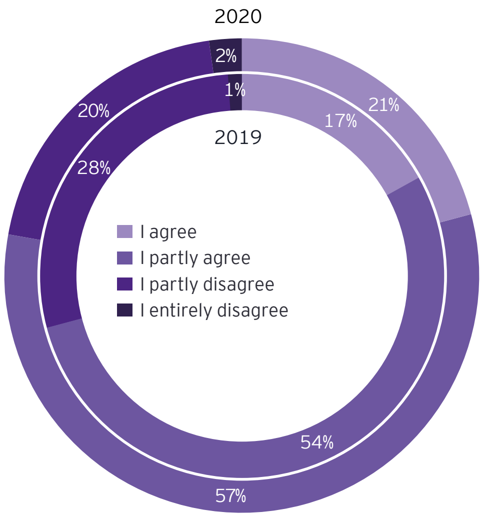


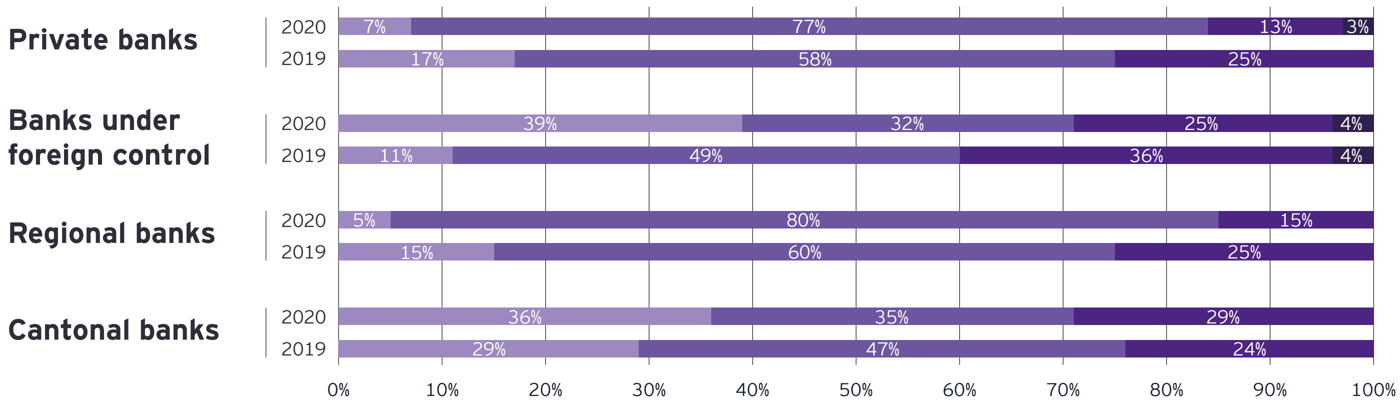


- The next generation of banking customers (born between 2000 and 2010) will be very different from previous generations due to the economic, political and cultural conditions prevailing at the time when they were young, and especially as a result of the use of digital media.
- Swiss banks are divided on the approaches of how to attract this new generation. The institutions surveyed most frequently mention their role as a financial coach (28%), followed by digital market platforms (23%) and a credible positioning on the topic of sustainability (20%).
- While most foreign banks kept to the three most frequently mentioned concepts, the other banking groups answered more broadly. But 20% of the private banks and 25% of the regional banks believe it is crucial to customize offerings. Interestingly, the cantonal banks are the only banking group to mention the importance of having a physical presence and being close (branch network) as a factor.
- Although the value chain in banking is becoming increasingly digitalized, the key question of how to provide a convincing service offering for a (hybrid) financial coach is still unanswered. Generation Z uses smartphones with a level of performance that the previous generation could only dream of, with artificial intelligence and machine learning capabilities built into the processor, excellent voice control and increasingly intelligent apps. The question is when the first bank will build the first digital financial assistant that makes systematic use of technology and creates perceived added value as a personal financial coach that inspires.

Decreasing remuneration expected

«Do you agree with the following statement? In the medium to long term, remuneration in the financial sector will decrease significantly.»





- Over the past ten years, remuneration in the banking sector has remained relatively stable despite the challenging environment. The average salary per employee has fallen by only 3.3% since 2010.[16]

- But given the increasing margin erosion in the banks' core business, stagnating earnings and the underperformance of bank shares over many years, there are definitely also good reasons for declining remuneration in the banking sector. Banks evidently share this opinion, with 78% of the organizations surveyed (71%) expecting remuneration in the financial sector to downtrend in the medium to long term.

[16] Source: SNB.

9

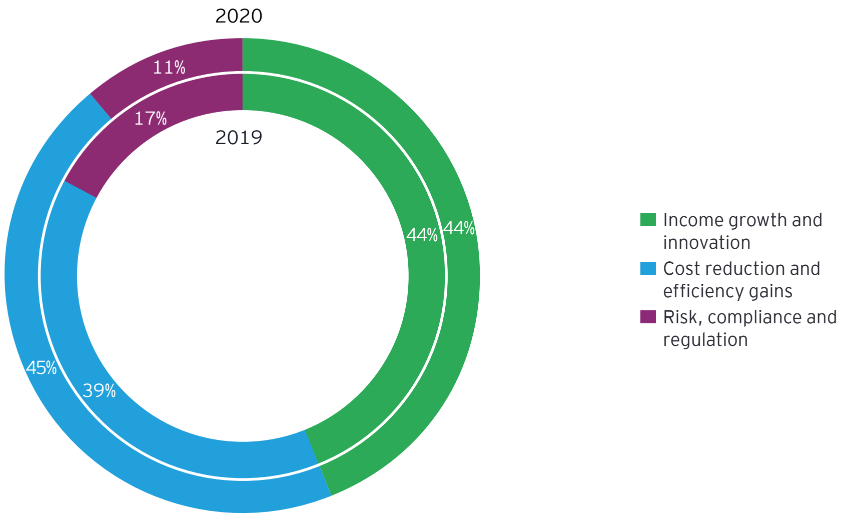
Priorities for 2021

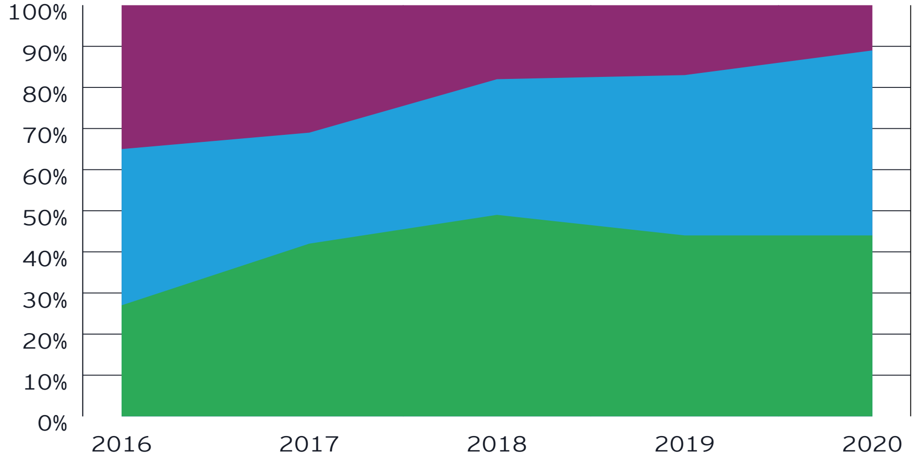
"These experiences from the coronavirus crisis have brought new perspectives on costs and innovation, which can be of service given the challenges lying ahead.

Patrick Schwaller
Managing Partner
Audit Financial Services

In search of the right balance

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





- When it comes to defining strategic priorities and ambitions, the topics "cost reduction and efficiency increase" (45%) and "growth and innovation" (44%) are once more almost on an equal footing this year, and a tendency toward a stronger focus on cost management is discernible (plus 6 percentage points).
- This shows the central challenge facing banks in the long term: finding the right balance between growing revenues and increasing profitability. The survey results underpin the banks' ambition to really get to grips with both topics.
- With the threat of loan defaults, gradual margin erosion in the lending and investment businesses, increasing competition from challenger banks and FinTechs, and a largely saturated domestic market, it is unsurprising that the banks want to focus primarily on cost cutting over the next 6 to 12 months.
- Interestingly, the topic of "risk, compliance and regulation" has lost strategic importance despite the fact that the coronavirus pandemic has raised risks. At 11%, there is a clear (6 percentage point) decrease in the weighting compared with the previous year. This also shows the banks' self-confidence. They have spent years preparing for a new crisis and have now been able to impressively demonstrate that these efforts have paid off: stronger capital and liquidity buffers, no significant loan defaults due to a prudent lending policy, a healthy credit structure, no systemic disruptions and no negative headlines.

Banks continue to focus on largely the same topics

«Which of the following topics and activities do you expect to be of the most importance for the financial industry over the next 6 to 12 months?»

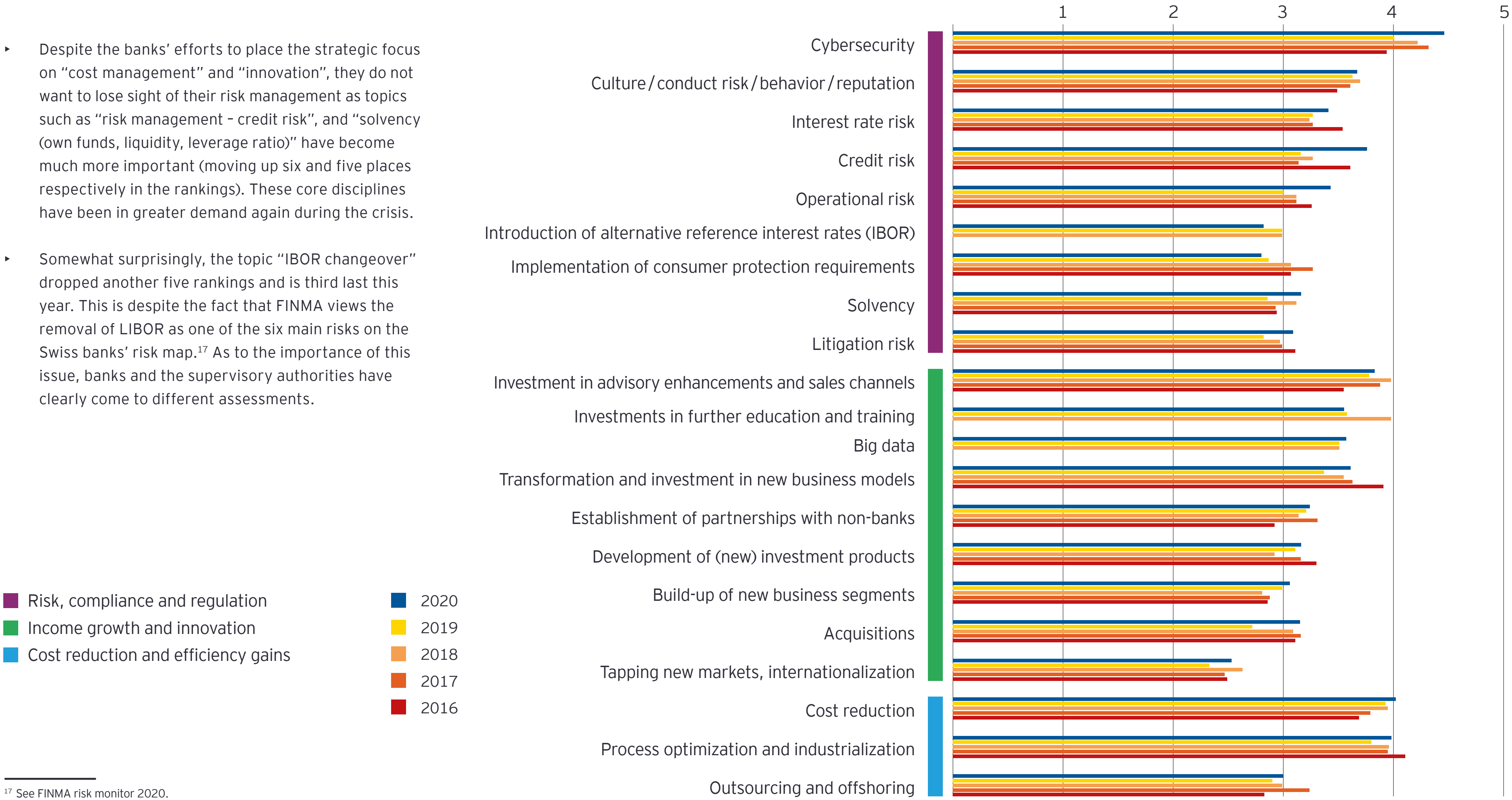
Ranking	2020	2019	2018	2017	2016
Cybersecurity	1	1	1	1	2
Cost reduction	2	2	5	4	4
Process optimization and industrialization	3	3	4	2	1
Investment in advisory enhancements and sales channels	4	4	2	3	6
Credit risk	5	11	9	13	5
Culture / conduct risk / behavior / reputation	6	5	6	6	8
Transformation and investment in new business models	7	8	7	5	3
Big data	8	7	8	-	-
Investments in further education and training	9	6	3	-	-
Operational risk	10	13	13	14	10
Interest rate risk	11	9	10	8	7
Establishment of partnerships with non-banks	12	10	11	7	15
Solvency	13	18	12	16	14
Development of (new) investment products	14	12	19	11	9
Acquisitions	15	20	14	12	11
Litigation risk	16	19	18	15	12
Build-up of new business segments	17	15	20	17	16
Outsourcing and offshoring	18	16	16	10	17
Introduction of alternative reference interest rates (IBOR)	19	14	17	-	-
Implementation of consumer protection requirements	20	17	15	9	13
Tapping new markets, internationalization	21	21	21	18	18

- Risk, compliance and regulation
- Income growth and innovation
- Cost reduction and efficiency gains

- As in the past three years, the topic of "cyber security" in the area of risk and regulation is at the top of the list of the specific topics that the banks are dealing with in their daily business and focusing on.
- The continued focus on cyber security is unsurprising, as the coronavirus pandemic has increased dependence on information and communication technologies, while at the same time increasing the potential target area due to employees working outside the office. But it can also be said that the financial institutions were able to switch to home working relatively well and without major problems. The investments in technology in recent years have paid off here. The topic of remote working has not been identified as the biggest risk by the banks in connection with the coronavirus crisis (see p. 27).
- In addition, a large number of successful and publicized ransomware attacks on Swiss companies last year meant that the topic of cyber security was also omnipresent in the media, clearly demonstrating the vulnerability of the companies affected by it.
- But the topic of cyber security is also still a pressing issue when it comes to emerging technologies, particularly developments in the area of cloud computing. Many banks are currently heavily involved in cloud initiatives where risk aspects in general and possible cyber security implications in particular are playing an important role.
- In second and third place, as in the previous year, are the topics of "increasing efficiency and reducing costs" and "process optimization and industrialization." This comes from the banks' ambitions to pay more attention to the cost side.

- Despite the banks' efforts to place the strategic focus on "cost management" and "innovation", they do not want to lose sight of their risk management as topics such as "risk management – credit risk", and "solvency (own funds, liquidity, leverage ratio)" have become much more important (moving up six and five places respectively in the rankings). These core disciplines have been in greater demand again during the crisis.

- Somewhat surprisingly, the topic "IBOR changeover" dropped another five rankings and is third last this year. This is despite the fact that FINMA views the removal of LIBOR as one of the six main risks on the Swiss banks' risk map.[17] As to the importance of this issue, banks and the supervisory authorities have clearly come to different assessments.



[17] See FINMA risk monitor 2020.

10

Sustainability

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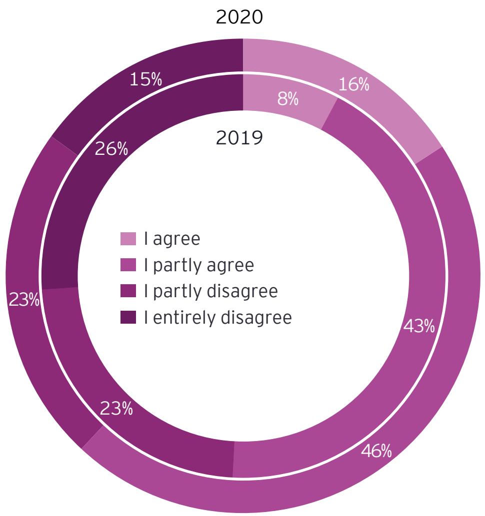
Banks can gain strategic market advantage by considering climate-related financial risks in risk management and disclosure early on.

Corina Grünenfelder
Senior Manager
Business Consulting

More transparency and better comparability

«Do you agree with the following statement? To exploit the full potential of sustainable investments for climate protection, further regulatory requirements – such as binding standards to create a definition of sustainability – are needed.»



- Customers increasingly want to be able to assess to which extent environmental and sustainability factors are considered by the banking sector. But one of the biggest challenges is that ESG criteria are not yet standardized, are difficult to measure, and many companies have different levels of transparency regarding their climate-related financial risks.

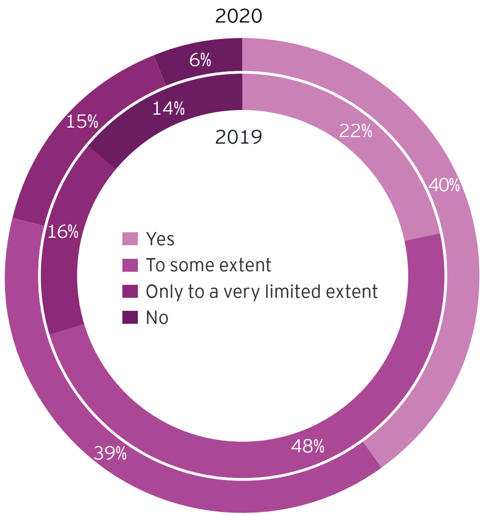
- In June 2020, the Federal Council set the goal for the Swiss financial center to become a leader in sustainable financial services[18]. To promote more detailed and uniform disclosure of climate-related financial risks in the financial system, the Swiss Financial Market Supervisory Authority FINMA has opened a public consultation on its amended "Disclosure – banks" circular[19].

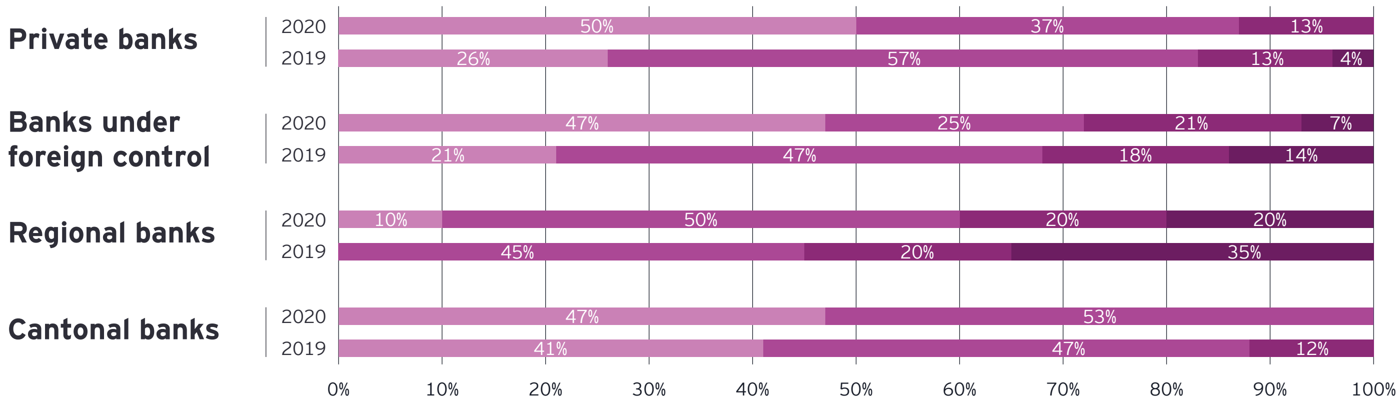
- It is therefore not surprising that almost two-thirds of banks (62%) believe that more far-reaching regulatory requirements are needed in order to exploit the full potential offered by sustainable investing for climate protection.

[18] Source: bafu.admin.ch: Switzerland should be a leading location for sustainable financial services.
[19] Source: FINMA: Transparency obligations for climate risks – FINMA opens consultation.

Are banks trendsetters of transformation?

«Does your organization have the intention to significantly expand the range of sustainable investment offerings in the future?»

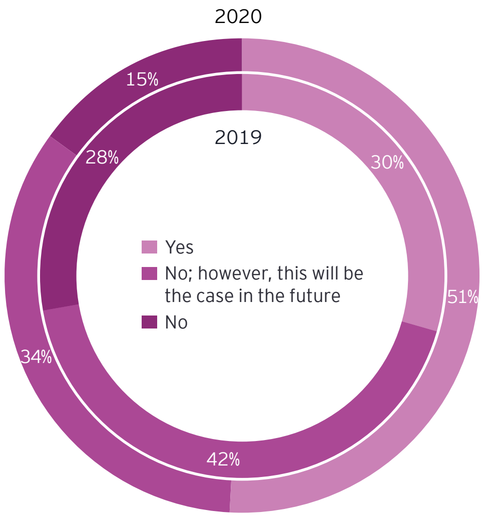


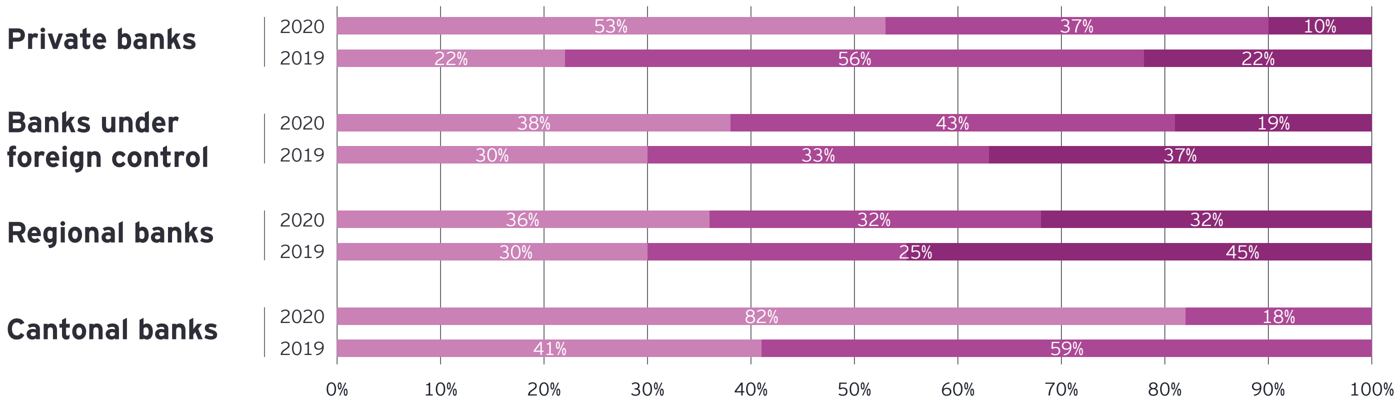


- A growing majority of banks want to significantly expand their range of sustainable investments. This year, 79% of the banks surveyed expressed this intention, which is another increase of 8 percentage points on last year.
- ESG challenges banks to rethink their strategic positioning. Besides the need to revise risk models and governance structures, embedding ESG criteria into investment advice also offers new opportunities. It will allow banks to strengthen customer loyalty and their own market position and reputation by taking individual customer needs into account with regard to sustainable investments.
- Therefore, sustainable investments have great potential for banks and customers from a business perspective and can at the same time make a real contribution to achieving global climate goals and a sustainable economy.
- This trend seems to have been gradually catching up with the regional banks as well, even though they are still bringing up the rear when it comes to this issue. Only 40% of the regional banks now have no ambition to expand their range of sustainable investments. However it should be noted that many regional banks do not create their own investment products, rather they buy them from third parties.

Green wave on a roll

«Do you agree with the following statement? In our organization, the topic of sustainability is integrated in investment advice or is a mandatory topic in the advisory process.»



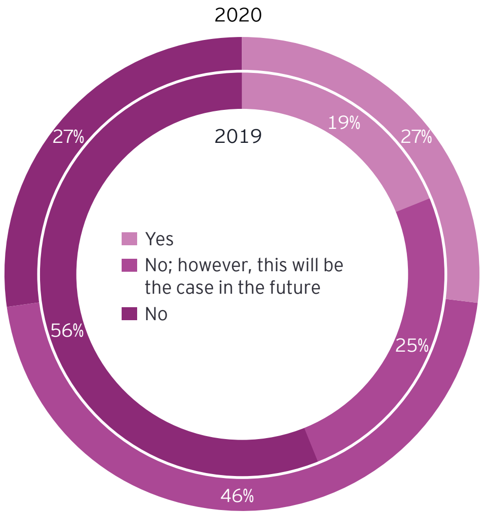


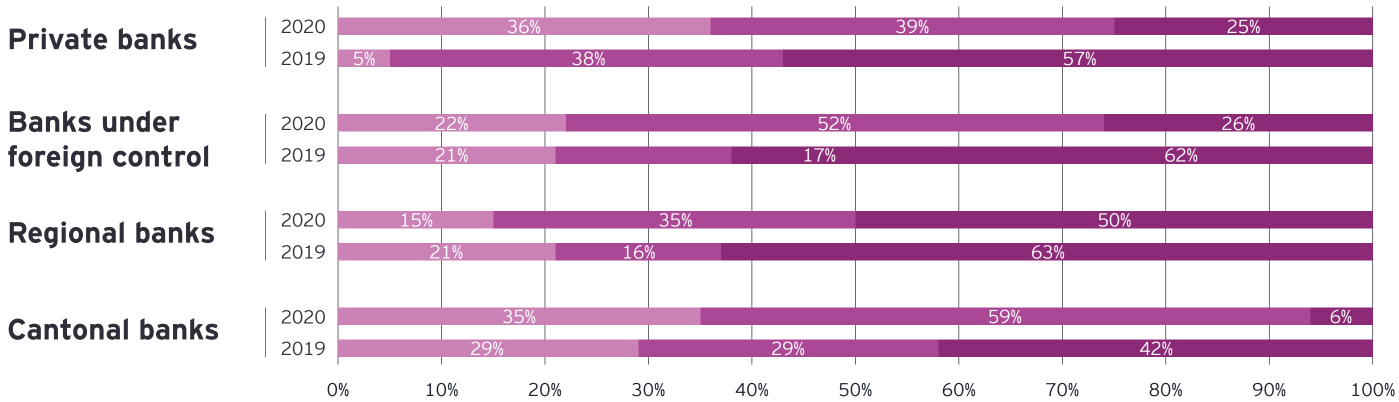
- Where 30% of the banks said last year that they had integrated the topic of sustainability as a mandatory component in the investment advisory process, the figure today is half of all banks (51%).
- Only a minority of 15% of the banks indicate that they do not or will not include the topic of sustainability as a mandatory component of investment advice. This is a significant decrease on the previous year, a fall of 13 percentage points. This year, too, it is the regional banks (32%) that are most reticent about the trend toward sustainable investment advice.
- In 2020, the PACTA study examined how aligned the Swiss financial sector is with the climate targets under the Paris Climate Agreement. Significant improvements have been seen since the study was last conducted in 2017. Especially compared with other sectors, the banks have made their mark by successfully integrating the topic of sustainability into customer business (Pacta Study, p. 101[20]).

[20] Source: PACTA Switzerland – Bridging the Gap (transitionmonitor.com).

ESG has now also caught up with the lending business

«Do you agree with the following statement? Our organization considers sustainability / ESG factors in its lending activities to commercial customers.»





- Sustainability has now caught up with banks in all business areas. Traditional risk categories such as market, credit and operational risks are directly or indirectly influenced by ESG risks. The lending process is playing a central role here: sustainability risks are changing the criteria for granting loans. The systematic integration of sustainability factors into financing decisions and products will create promising opportunities for the banking sector. As this happens, the sector will also support commercial customers in the transition from emissions-intensive to more sustainable business models in particular. And by considering ESG risks, it will be possible to differentiate on a more broader basis between borrowers in terms of risk.
- Where 56% of banks confirmed last year that they do not take sustainability/ESG factors into account when granting loans to commercial customers, the figure is now only 27%. This drastic decline in just one year really highlights the urgency of integrating ESG into lending. But embedding sustainability factors into lending also poses new challenges for banks, such as being able to systematically apply ESG criteria.

11

Appendix

Market environment

Gross Domestic Product

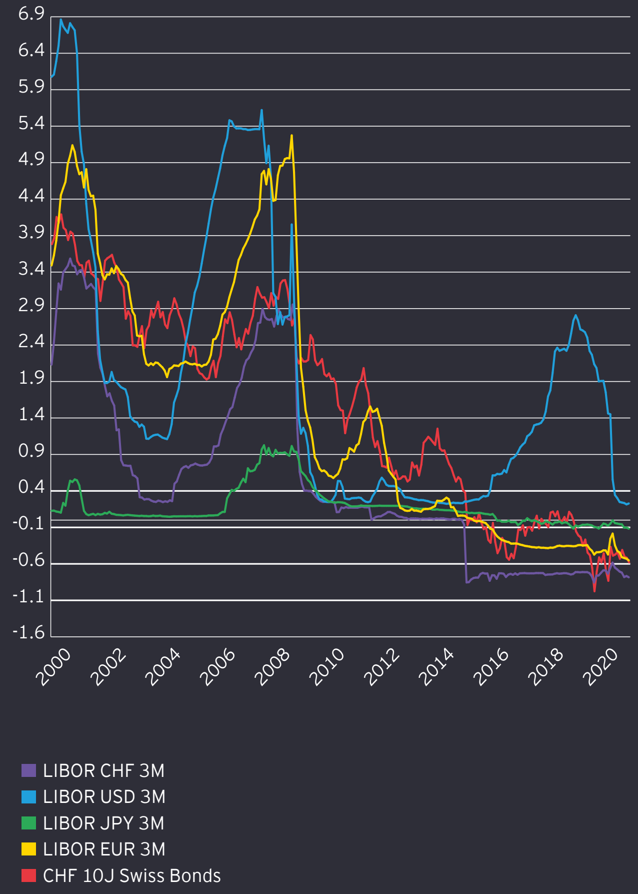
Quarter over quarter changes in %

Source: OECD

Interest rates

in %

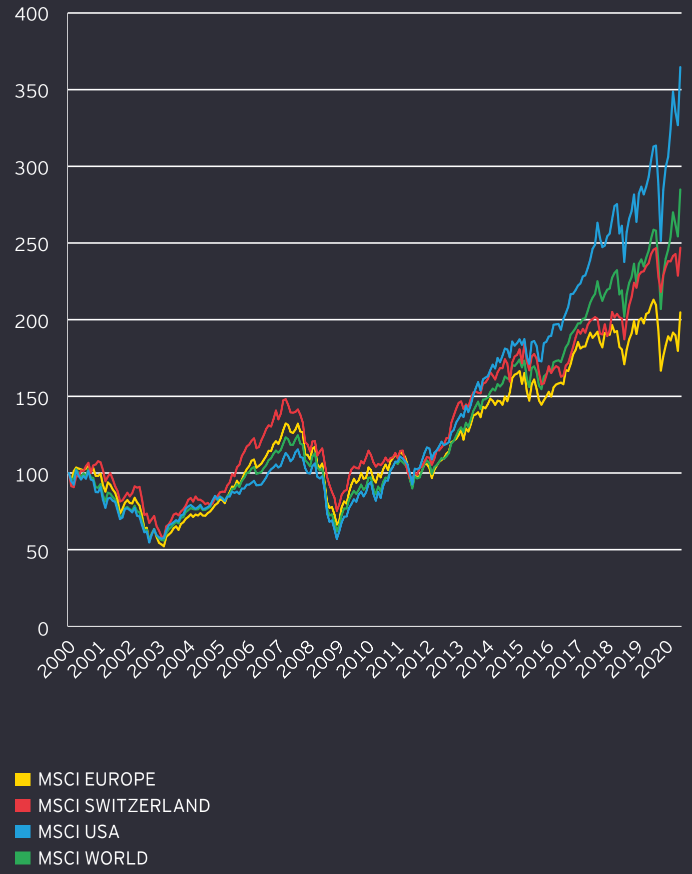
Source: SNB



Stock markets

Indexed, 1.1.2000 = 100

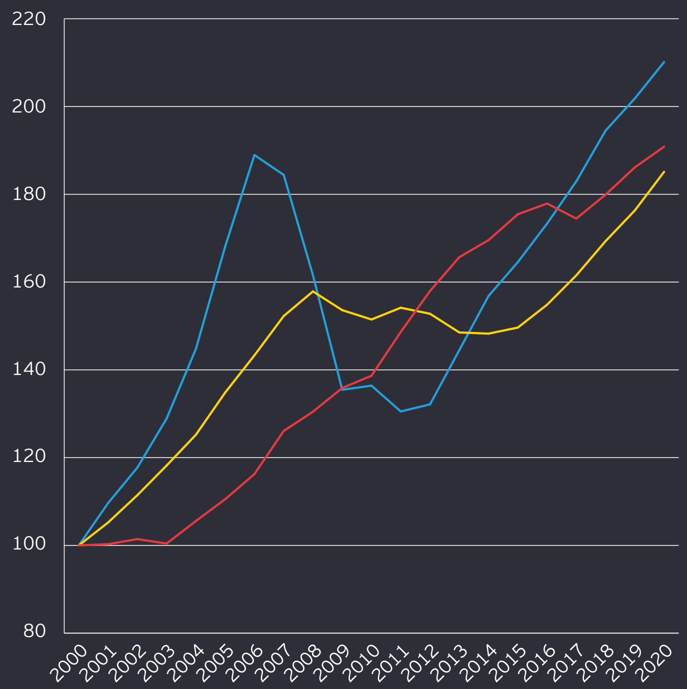
Source: MSCI



Real estate

Indexed, 1.1.2000 = 100

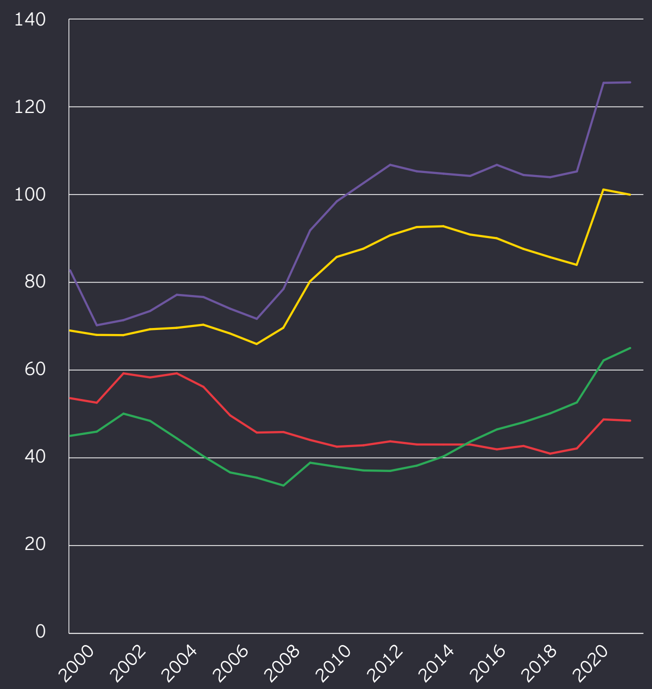
Source: BIS



USA
Switzerland
Europe

National debt as % of GDP

Source: IMF

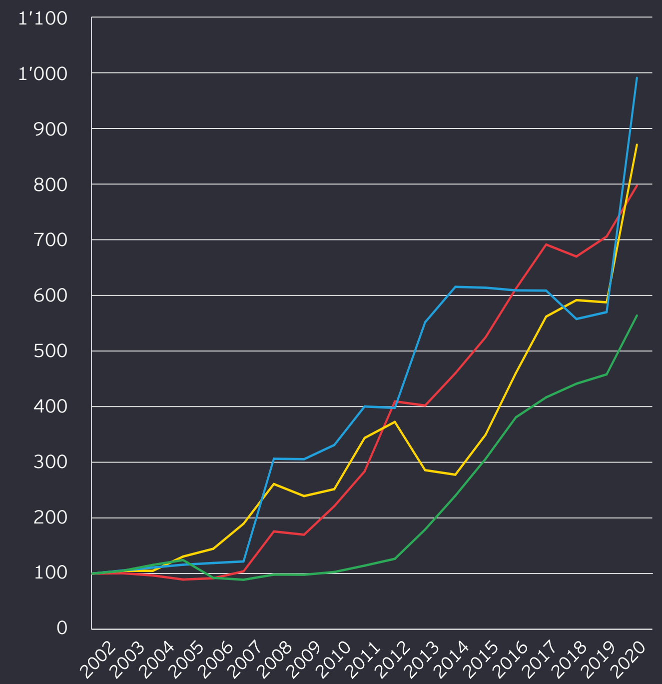


Switzerland
Advanced economies
Emerging Market and Middle-Income Economies
Euro area

Total assets of central banks

Indexed, 1.1.2002 = 100

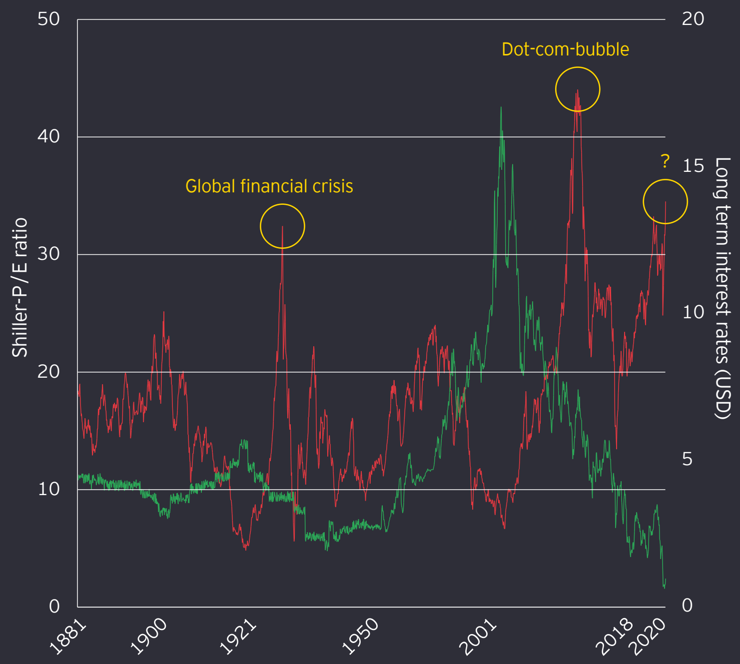
Sources:
SNB, EZB, St. Louis FED, BoJ



Swiss National Bank
European Central Bank
Federal Reserve System
Bank of Japan

Shiller-P/E ratio and interest rates

Source: SNB

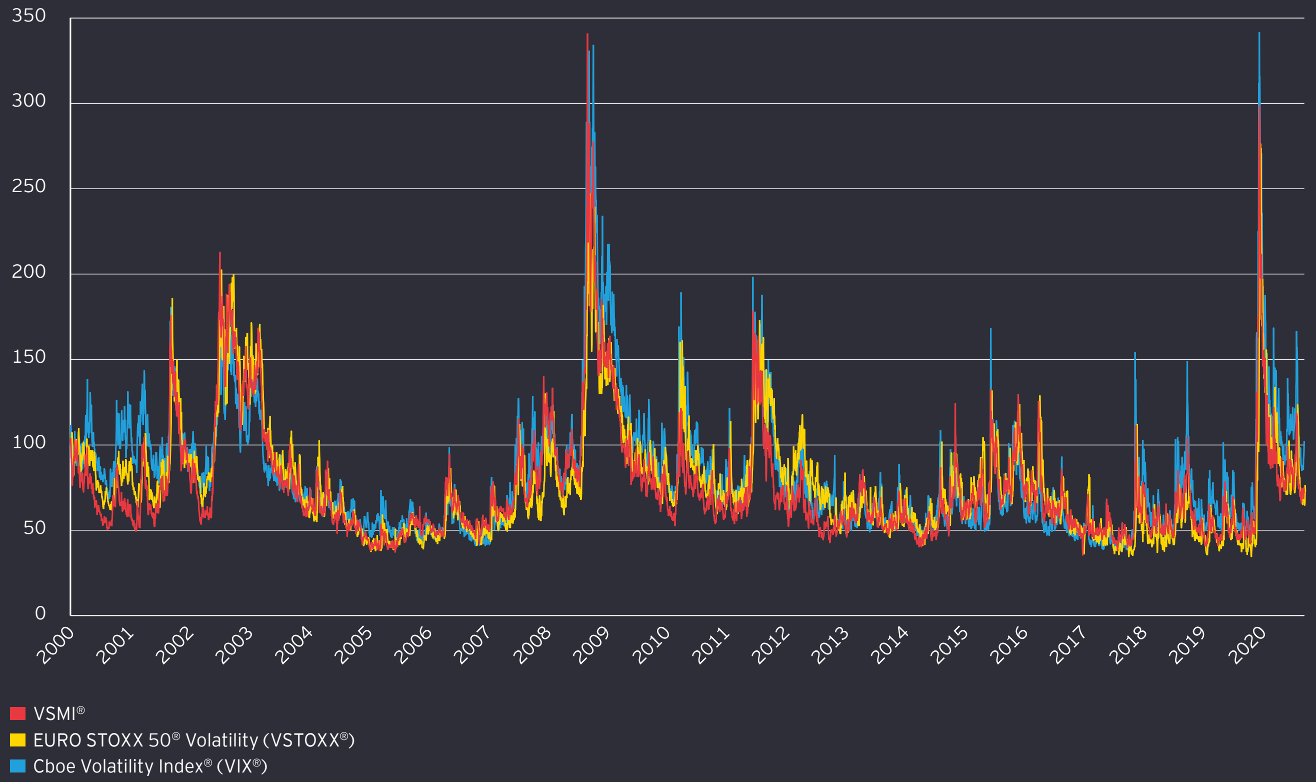


Shiller-P/E Ratio S&P 500
Long term interest rates (USD)

Volatility

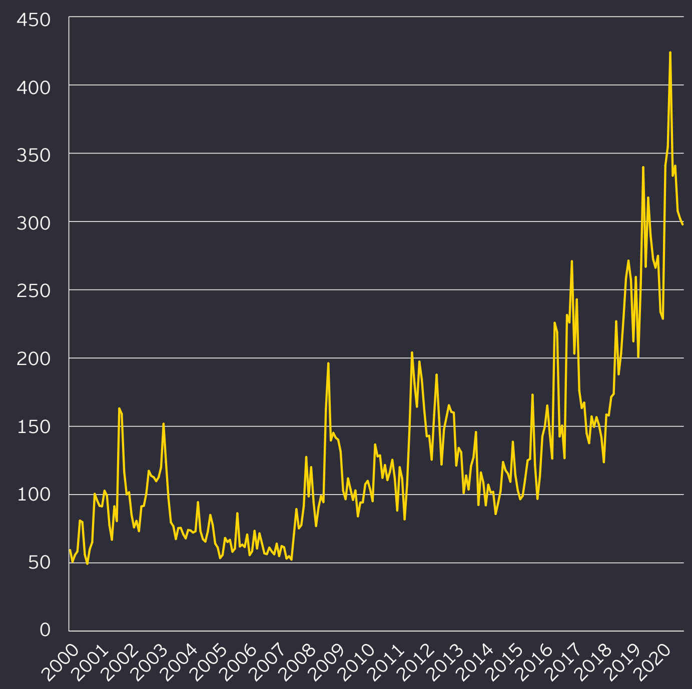
Indexed, 1.1.2000 = 100

Sources: SIX, STOXX, Cboe



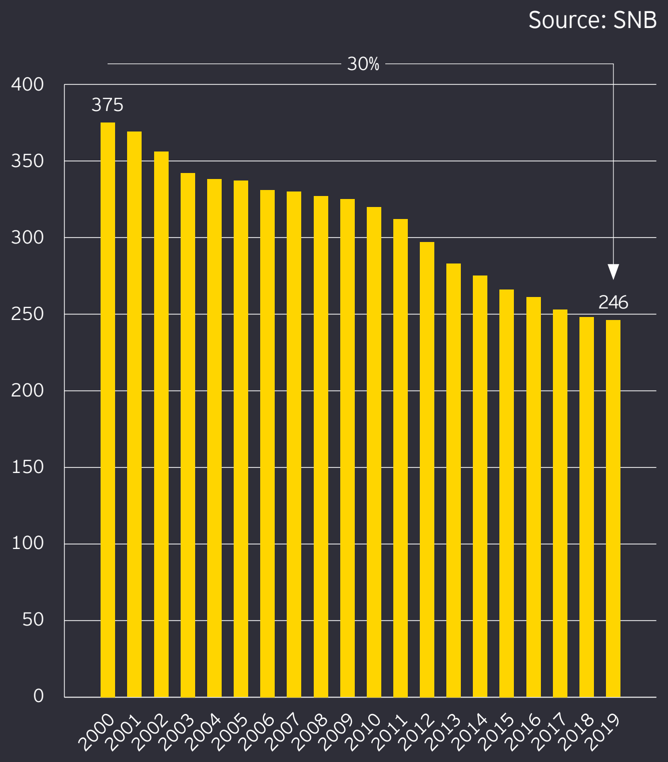
Economic Policy Uncertainty Index

Source: Davis, Steven J. (Policyuncertainty.com)

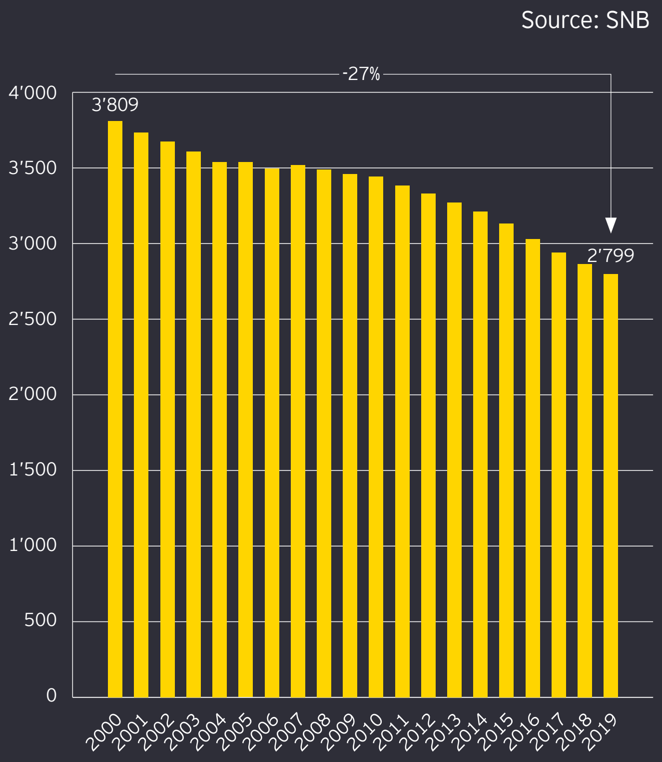


Bank landscape

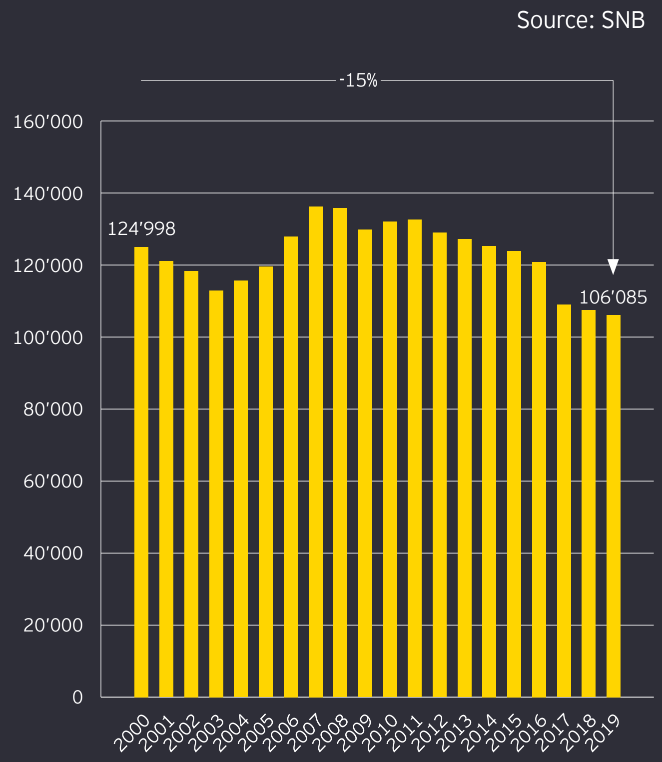
Number of banks



Number of branches



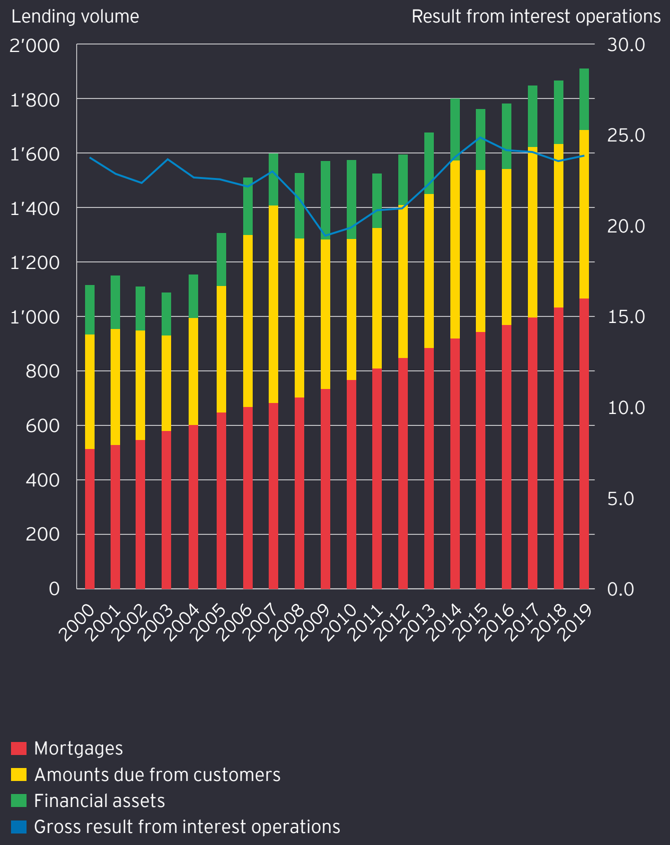
Number of employees



Value creation and profitability

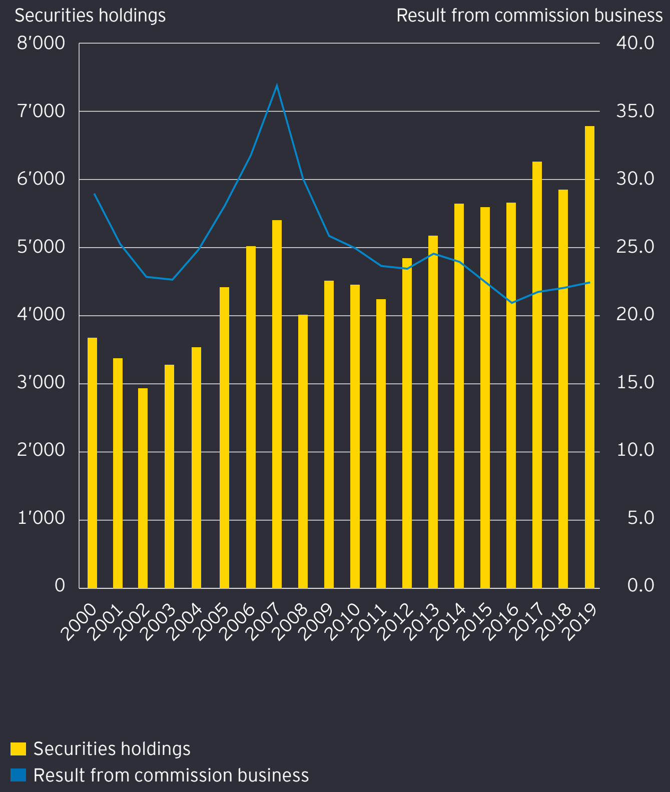
Interests and lending volume

in CHF billion Source: SNB



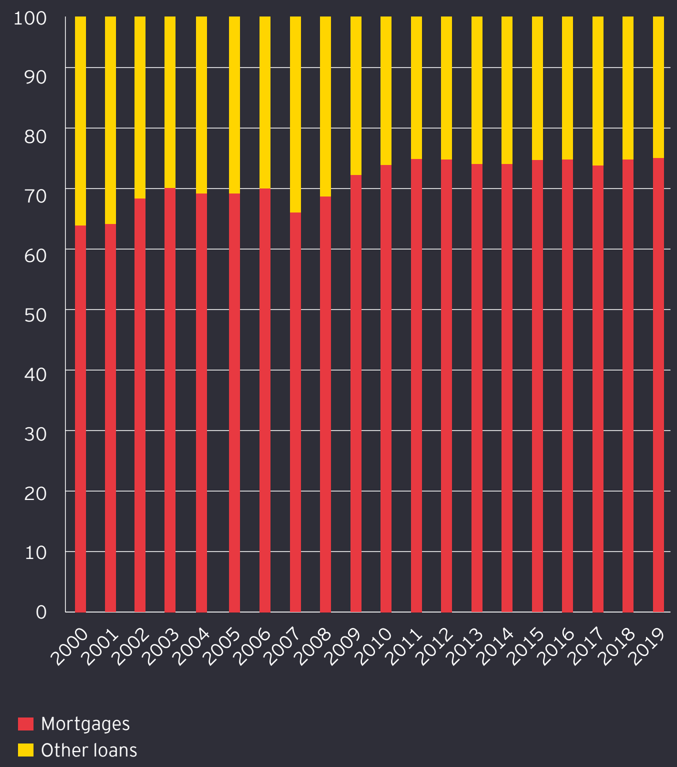
Securities holdings and result from commission business

in CHF billion Source: SNB



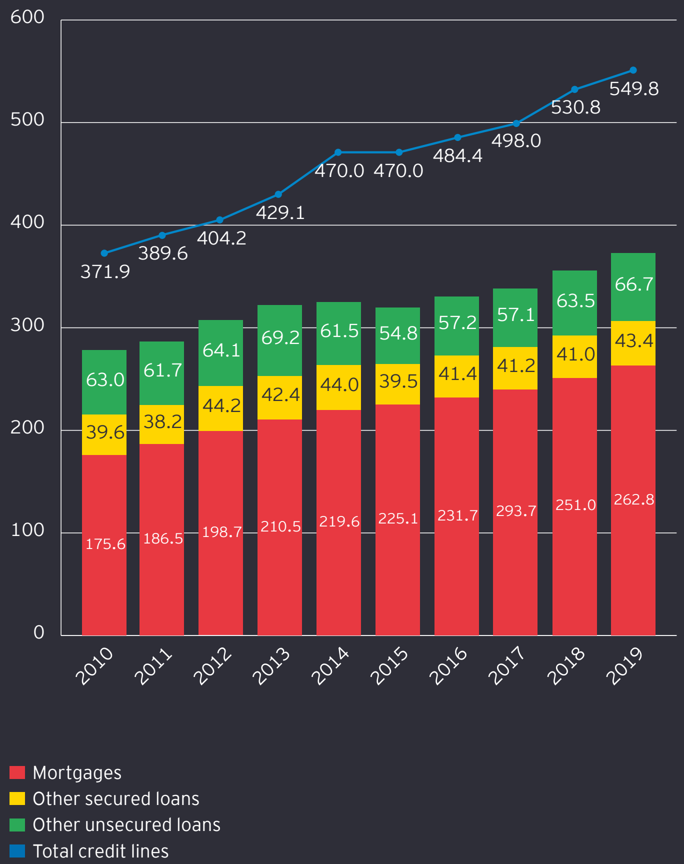
Structure of loan portfolios

In % Source: SNB



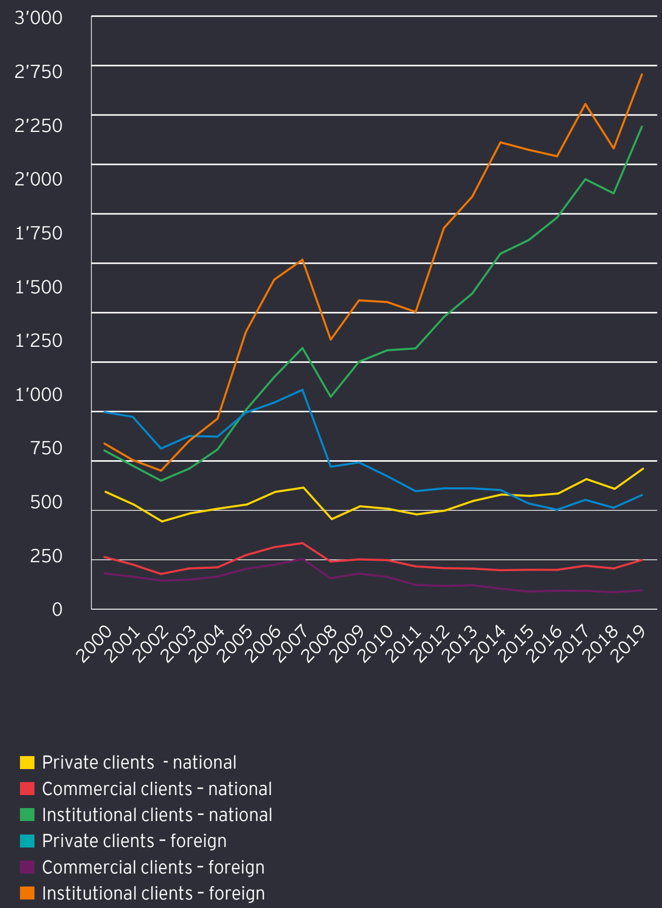
Loans to corporate customers

in CHF billion Source: SNB



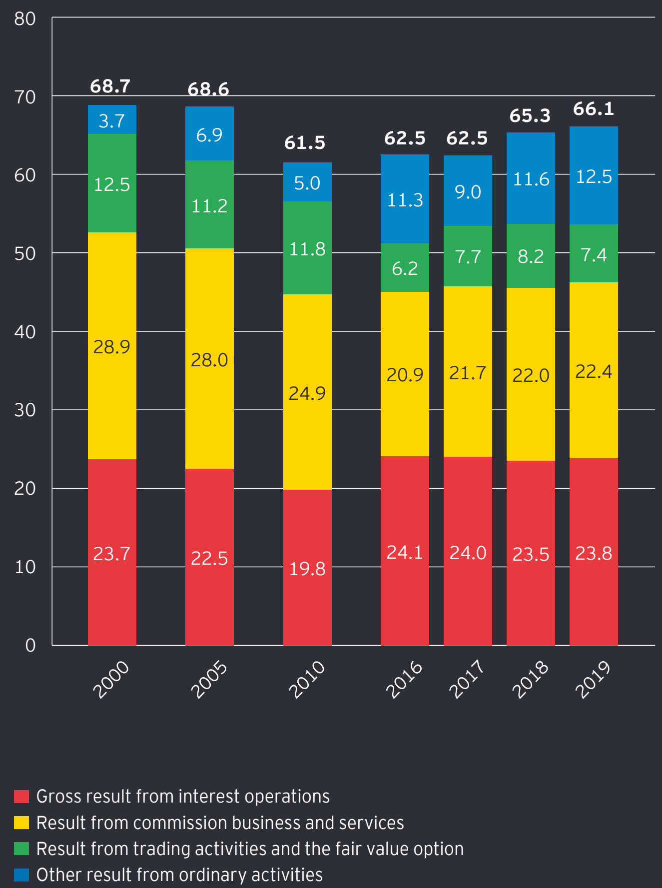
Customer deposits

in CHF billion Source: SNB



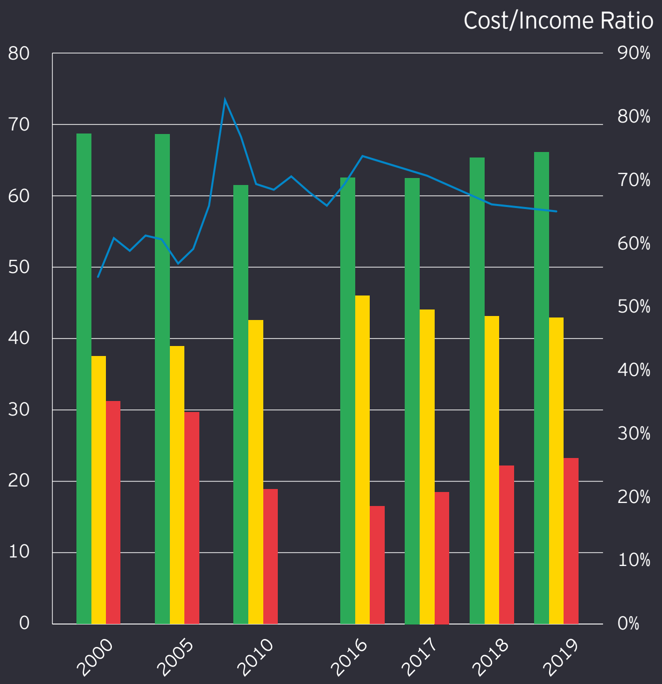
Results by business area

in CHF billion Source: SNB



Result, Expenses, Profit, Cost Income Ratio

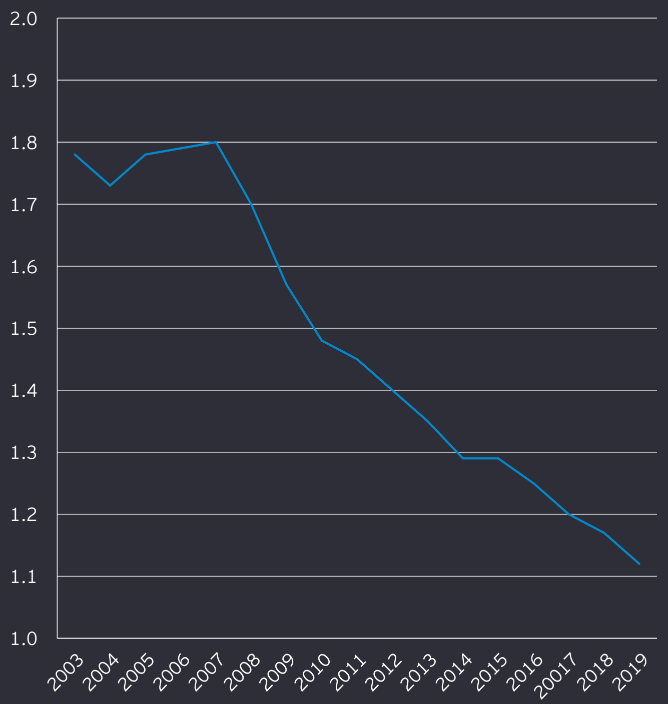
In CHF billion Source: SNB



- Operating result
- Operating expenses
- Profit from operating business
- Cost Income Ratio

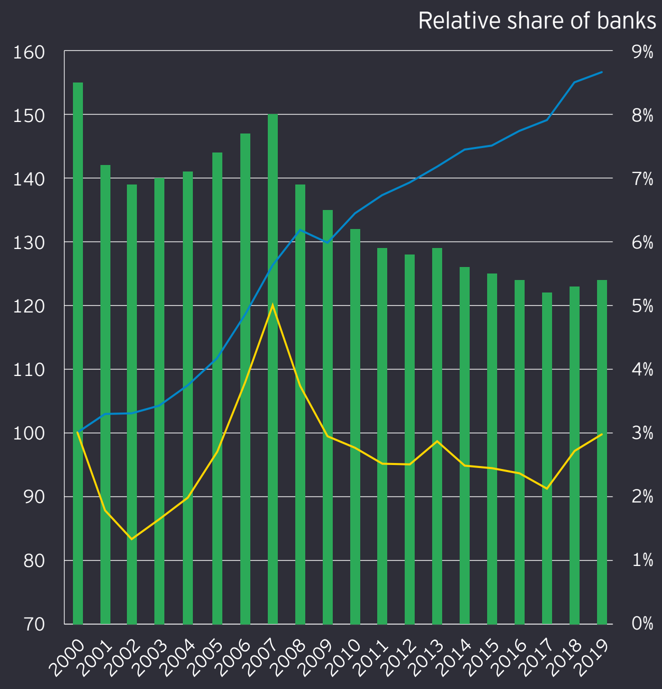
Interest rate margin of domestically focused banks

In % Source: SNB



Value creation banks

Indexed 1.1.2000 = 100 Source: SECO

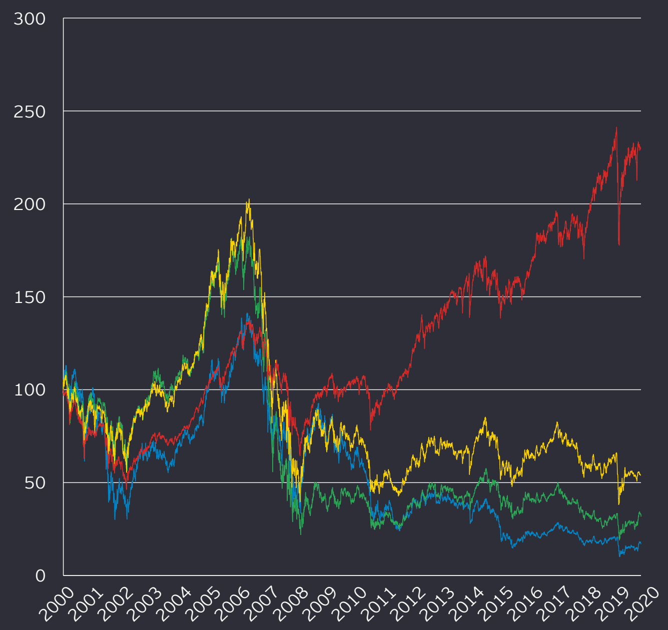


- Relative share of banks in %
- Economy
- Banks

Stock performance banks versus market

Indexed, 1.1.2000 = 100

Source: SIX, Investing.com



- Swiss Performance Index SPI TR
- SPI ICB Supersector 8300 Banks Total Return
- UBS
- Credit Suisse

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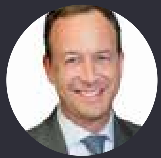

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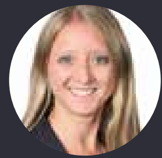

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