Eidgenössische Finanzmarktaufsicht FINMA
Autorité fédérale de surveillance des marchés financiers FINMA
Autorità federale di vigilanza sui mercati finanziari FINMA
Swiss Financial Market Supervisory Authority FINMA

FINMA Risk Monitor 2019

Contents

Monitoring risk: central to forward-looking oversight of the financial markets

The Swiss Financial Market Supervisory Authority FINMA is an independent public supervisory authority with the legal mandate to protect investors, creditors and policyholders and ensure the proper functioning of the financial markets. Through this activity, FINMA contributes to enhancing the reputation, competitiveness and future viability of the Swiss financial centre.

The main focus of FINMA's work is the supervision of the financial sector. This is designed to ensure that the supervised financial institutions remain stable and successful going forward, given the possible risks they are facing. Assessing the risk position of individual supervised institutions is therefore a critical part of FINMA's supervisory activity. This makes its supervisory focus essentially forward-looking.

FINMA is publishing a risk monitor this year for the first time. Until now, the monitor has been solely an internal working instrument. It will appear on an annual basis from now on. This will create additional transparency both for supervised institutions and the wider public about how FINMA fulfils its statutory responsibilities.

The risk monitor provides an overview of what FINMA believes are the most important risks currently facing supervised institutions over a time horizon of up to three years. Furthermore, each report will highlight one selected trend with the potential to impact on the Swiss financial market over the long term. The report will also describe the focus of FINMA's supervisory activity on the basis of the risks.

FINMA currently sees six principal risks for its supervised institutions and the Swiss financial centre: the persistent low interest-rate environment, a possible correction on the real estate and mortgage market, cyberattacks, a disorderly abolition of LIBOR benchmark interest rates, money laundering and increased impediments to cross-border market access. The report will also discuss the financial risks arising from climate change as one of the most important long-term risks identified by FINMA.

Note

The risks referred to above and the focal points of FINMA's supervisory activity are not an exhaustive list. Other risks not cited may also be or become very significant. This report is expressly not intended as a basis for investment decisions.

Principal risks

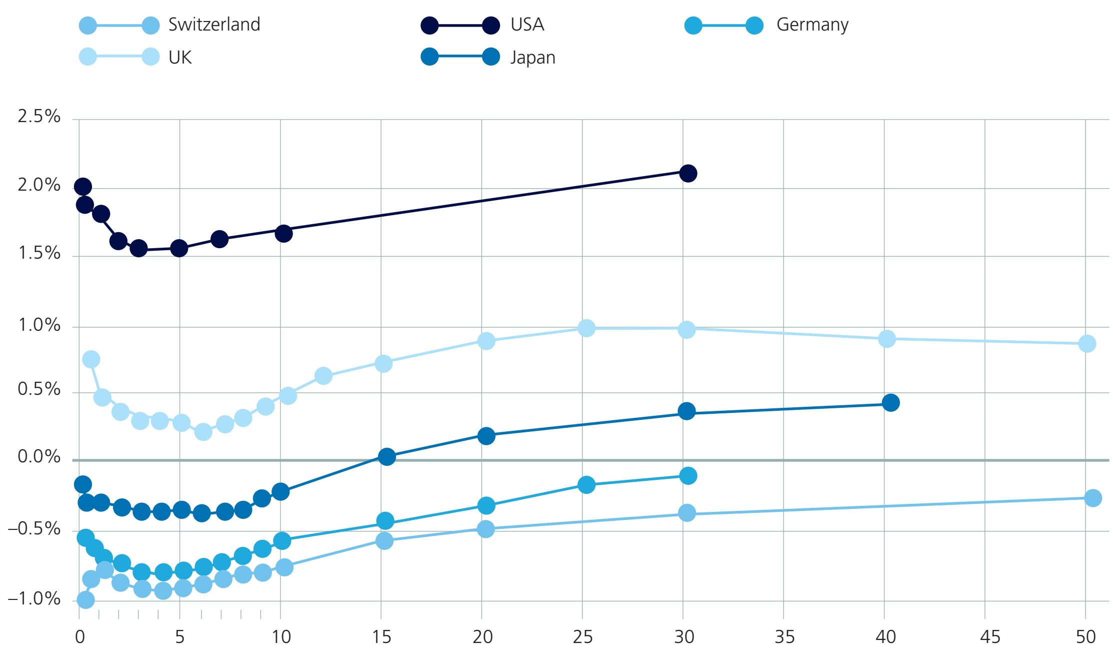
FINMA has a risk-based approach to supervision. The intensity of its supervision is dictated firstly by the risk posed by each financial market participant and secondly by the primary risks in the current environment. This section will discuss the six principal risks identified by FINMA for its supervised institutions and the Swiss financial centre over a time horizon of up to three years.

Low interest-rate environment
Persistently low interest rates in both Switzerland and the European Union (EU) over both short-term and long-term horizons are having a detrimental impact on the profitability of supervised institutions. This situation increases the risk of asset price bubbles and sudden reversals and may potentially undermine the viability of certain business models. FINMA continues to pay close attention to interest-rate risks.

Negative interest rates have been a feature of the Swiss money market since 2011. Initially only short and medium maturities were affected, but since July 2019 negative interest rates have extended to all maturities out to 50 years. Mortgage interest rates have reached record lows during 2019. The potential consequences of the low interest-rate environment affect three areas in particular:

– Profitability: a persistent low interest-rate environment and flat yield curve can pressure the profitability of banks due to the erosion of net interest margins. The chart below shows the yield curves for various sovereign debt markets on 30 September 2019: yields in Switzerland are negative for all maturities and lower than in any other country. In the US, however, yields are positive for all maturities, ranging from 1.5 % to just over 2 %.

Government bond yield curves
on 30 September 2019, in % p.a.



Source: Refinitiv Datastream

- Customer behaviour: the low interest-rate environment could prompt the banks to impose negative interest rates across broader categories of clients. The resulting customer behaviour is difficult to predict. However, it could jeopardise customer deposits as a stable source of funding for the banks.
- Business models: if interest rates were to stagnate at their current low levels for a very long time, this would pose a risk to certain business models. This is particularly true of banks focused on the interest margin business and life insurers. A number of life insurers have already removed products with long-term guarantees from the market, as these can no longer be operated profitably. There is a risk that the steps taken by the financial institutions so far to stabilise profitability will fail to have the desired effect.

Correction on real estate and mortgage market

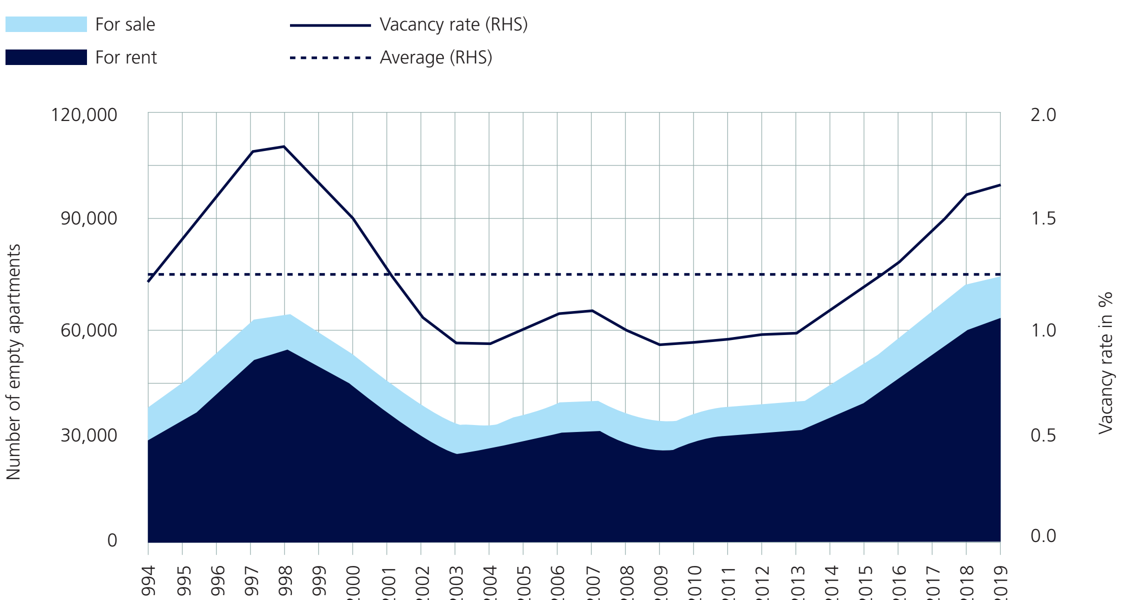
The sharp rise in vacancy rates for investment properties, combined with the ongoing boom in construction activity, is exacerbating the risks in the Swiss real estate and mortgage market. Previous crises have shown that financial institutions which expand their activity in the late phase of an economic cycle are particularly exposed to the risks of an ensuing economic downturn.

Negative interest rates increase the risk of bubbles forming in various asset classes, particularly in the real estate market. The sudden bursting of a bubble can have serious consequences for the financial markets, particularly if the underlying assets have been financed with debt. This is particularly true of the real estate market. Due to the persistently low interest-rate environment, investors have increasingly been seeking out higher-yielding investments. They are therefore increasingly investing in real estate, despite rising vacancy rates and falling rents. The result are ever-lower initial yields as real estate prices are driven up. This increases the risk of valuations falling sharply in the event of rising interest rates and loan-to-value guidelines for debt financing being breached. This would in turn have an adverse impact on lenders' capital adequacy situation. On top of this, the combination of continued robust construction levels and declining net immigration is leading to oversupply in the residential property market. With some regional variations, rental vacancies are at a record high (see chart below), which puts rents and therefore investment returns under pressure. The imbalances are therefore growing along with the risk of a substantial future downturn in prices in the investment property sector. By contrast, vacancy rates in owner-occupied property have remained relatively stable in recent years. The problem of oversupply is less pronounced in this segment.

The consequences of a real estate crisis with a pronounced correction in prices could be significant:

- Rising credit default rates: stagnating demand for rental apartments leads to an oversupply situation. Vacancy rates rise and rents come under downward pressure, thereby reducing investors' returns. A growing number of loan defaults would be likely in such a scenario, which would have to be absorbed by the banks' capital.

– Fluctuations in insurers' tied assets: alongside banks, insurers are also affected by falling real estate prices. As tied assets are measured at market value, any slump in prices would have a direct impact on the coverage of underwriting liabilities. The largest insurers could be hit by fluctuations in their tied assets running into the billions. Moreover, potential movements in asset values also have an impact on insurers' capital requirements, as they are required to hold more capital under the solvency calculations of the Swiss Solvency Test (SST) if volatility is higher.
– Revaluation losses in real estate funds: declining real estate prices would also have a direct impact on the balance sheets and income statements of domestically invested real estate funds. Falling market values would feed through into revaluation losses. At the same time, leverage would rise.



Source: Swiss Federal Statistical Office, Empty dwellings census, 9 September 2019

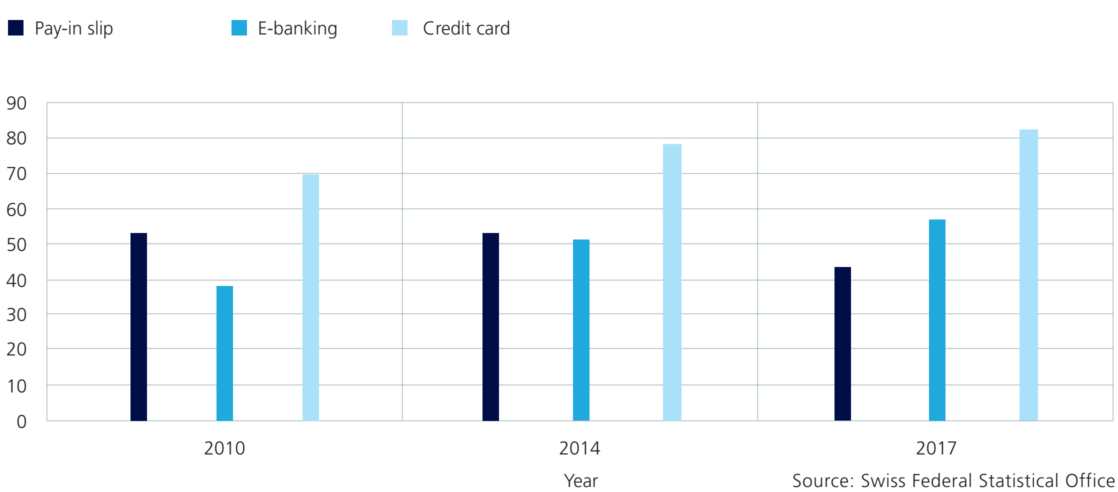
Cyber risks

The high and ever-growing dependency on and interconnectivity of information and communication technologies give rise to pronounced vulnerabilities among Swiss financial institutions. For example, outages of and disruptions to IT systems, particularly those resulting from cyberattacks, can jeopardise the availability of critical services and functions. Depending on the nature of the cyberattack in question, this can have repercussions for individual financial institutions and threaten the functioning of the Swiss financial centre as a whole.

The number and intensity of cyberattacks are growing strongly. For example, there is evidence of an ongoing rise in cybercrime in the area of malware and increased espionage activity. In addition, cyber sabotage of critical infrastructure and the publication of stolen information represent potentially pernicious offshoots of these activities. Furthermore, the parties behind these attacks are becoming evermore professional, as well as increasingly well organised. This makes it all the more important to combat and prevent such activities.

A successful cyberattack can have serious consequences for the functioning of the Swiss financial centre. For example, a cyberattack may result in banks being unable to provide financial services promptly – or indeed at all. When it comes to the functioning of financial markets, institutions that provide integrated or interlinked services are particularly important, e.g. financial market infrastructures, critical service providers of key IT systems for the financial centre, and systematically important financial institutions. A successful attack on an institution of this kind could prove damaging both to other financial institutions and the Swiss economy as a whole. The reputational damage would be significant, and confidence in the Swiss financial centre would be affected.

Payment methods for online purchases and deliveries, development
% of e-consumers (purchase in last twelve months)



Source: Swiss Federal Statistical Office

Discontinuation of LIBOR

LIBOR benchmark interest rates continue to be widely used in financial instruments. Inadequate preparation for the replacement of LIBOR interest rates (envisaged by the end of 2021), including Swiss franc LIBOR, therefore represents a key risk.

FINMA has identified three specific risks in its supervision in connection with the replacement of LIBOR interest rates: legal risk, valuation risk and risks in connection with operational readiness. The legal risks arise in particular from adjustments that may be needed to any agreements or contracts based on LIBOR interest rates which expire after the date on which these rates are replaced, as well as from potential legal disputes with clients that may ensue as a result. Valuation risks arise above all due to the changeover from LIBOR interest rates to alternative interest rates and the associated yield curves combined with the high volumes in the derivatives and credit area. Operational readiness is a further important issue. In other words, systems and processes must be able to deal with the entire end-to-end value chain for all products that rely on alternative benchmark interest rates.

The consequences of LIBOR replacement without proper preparation in the marketplace could be far-reaching. Discussions with banks and auditors have shown that the discontinuation of LIBOR will have major repercussions for supervised institutions due to the high transaction volumes involved and the wide-ranging technical interlinkages. Moreover, analysis based on institutions' FINMA-mandated self-assessments show that the majority of banks are still well behind schedule in their efforts to prepare for the replacement of LIBOR. Last but not least, despite some progress there has been limited adoption of alternative benchmark interest rates so far.

Money laundering

The Swiss financial centre is a leading global cross-border wealth management hub for private clients. This makes it particularly exposed to money-laundering risks. Breaches of the law can result in significant sanctions and reputational damage to financial institutions both in Switzerland and abroad. A number of major international money-laundering cases with a connection to Switzerland in the past underline the risks that exist in this area.

As a result of shrinking margins, financial institutions may take the commercial decision to pursue relationships with profitable new clients from relatively high-risk emerging market nations where there is a significant threat of corruption. Recent global corruption and money-laundering scandals, such as those involving the Malaysian sovereign wealth fund 1MDB and the Brazilian and the Venezuelan oil giants Petrobras and PDVSA, show that the risks for financial institutions involved in the cross-border wealth management business remain high. This is in spite of the fact that many institutions have further improved their money-laundering prevention in recent years, are increasingly identifying suspicious clients and reporting them to the Money Laundering Reporting Office Switzerland (MROS). The financial flows associated with corruption and embezzlement can involve not just affluent private clients, who often qualify as politically exposed persons, but also state or quasi-state organisations and sovereign wealth funds. The complexity of the structures involved, particularly when domiciliary companies are used,[1] can increase the risk of money laundering.

[1] Report of the interdepartmental coordinating group on combating money laundering and the financing of terrorism (CGMF), November 2017.

In addition to these traditional money-laundering risks, the financial industry also faces new risks in the area of blockchain technology[2] and the cryptoassets that are attracting growing interest from clients. Although these new technologies promise efficiency improvements in the financial industry, they also accentuate the threats posed by money laundering and the financing of terrorism due to the greater potential anonymity they involve, as well as the speed and cross-border nature of the transactions. Malpractice by the financial institutions active in FinTech could significantly damage the reputation of the Swiss financial centre and slow down the development of digitalisation.

Market access

Changes and restrictions to the market access regimes in important target markets for the Swiss financial institutions could have significant repercussions for the revenue streams of the Swiss financial centre.

There is a trend towards tougher market access rules for foreign providers in a number of jurisdictions. This is occurring against a backdrop of increasing friction in international trade and uncertainties relating to Brexit. For Swiss financial institutions, this gives rise to legal uncertainties and risks, as well as the possibility of additional costs.

One potential consequence of the restrictions on cross-border financial services is a reduction in business opportunities for financial institutions in Switzerland, which could lead to jobs being relocated abroad. Relocating activities outside Switzerland might not be viable for smaller financial institutions, however, and the survival of these areas of business could therefore be in doubt.

The recent lapsing of stock market equivalence with the EU is an example of a change in Switzerland's market access at European level. The EU could also tighten up its rules for the provision of cross-border financial services to both actively and passively managed EU clients. Equivalence procedures are under a cloud generally at the moment due to the ongoing negotiations between Switzerland and the EU.

[2] Report of the interdepartmental coordinating group on combating money laundering and the financing of terrorism (CGMF), October 2018.

FINMA aligns its supervisory focus with the risks described above. FINMA is keeping a close eye on the following areas in particular:

The **interest rate situation** has been a focus of the supervisory dialogue between FINMA and its supervised institutions for some time now. FINMA regularly identifies banks which are particularly exposed in this area and conducts an intense exchange of views with these institutions with regard to their approach to interest rate risks and their strategies to ensure sustainable profitability. Low interest rates also have an impact on the various sectors of the insurance industry. For example, FINMA analyses the adequacy of the reserves held by insurance providers, particularly life insurers. FINMA monitors the level of reserves and the potential repercussions of any further interest rate cuts.

Another focus of supervisory activity in recent years has been the **real estate and mortgage market.** Whereas initially attention was focused on the owner-occupied segment, it is now primarily the market for investment properties and the associated credit portfolios that are coming under intense scrutiny. This scrutiny will continue, and FINMA will intensify its oversight of financial institutions that exhibit particularly high growth in the mortgage business. In the banking sector, particular attention will be paid to developments in the buy-to-let market. This area of lending activity is not subject to the banks' new stricter self-regulatory rules. In asset management, FINMA will undertake in-depth analysis of the risk management of real estate funds in particular. In the insurance area, FINMA will conduct a stress test with a view to gaining an insight into the impact of properties and mortgages held in investment portfolios on the solvency of insurance companies. Furthermore, FINMA will analyse the external valuation procedures used by insurance companies to value properties for potential modelling risks.

On **cyber risks,** FINMA has kept its regulatory requirements for banks short and concise, built up its expertise on cyber issues and communicated its expectations for addressing such risks to the supervised institutions. It subsequently intensified its supervision of cyber risks. The results of this supervisory activity have shown that the banks have improved the way they deal with cyber risks over the last few years. The issue remains of critical importance, however, and there is still room for improvement. FINMA will therefore focus above all on improvements to the crisis management toolkits of supervised financial institutions and their stakeholder groups. In addition, FINMA will continue to analyse the general threat situation on an ongoing basis. Furthermore, FINMA is monitoring recent incidents of serious cyberattacks closely with a view to obtaining information that may be generally applicable to such incidents. FINMA will also provide an active input to the cross-institutional supervisory coordination platform[3] for combating cyberattacks.

[3] Cf. information on the Federal Department of Finance (FDF) website on the national strategy for the protection of Switzerland against cyber risks (NCS) 2018-2022.

With regard to the impending **abolition of LIBOR benchmark interest rates,** FINMA has published a guidance to increase awareness of the issue among supervised institutions and set out its expectations as to how they should respond to this problem. At periodic intervals it will request updates from the institutions with significant exposure on their current state of preparation. FINMA will continue to work to ensure that supervised financial institutions are well prepared for the replacement of LIBOR and engage in discussions on this issue with the national working group and relevant authorities. As it already has in 2019, FINMA will risk address the worst affected supervised institutions individually and on a risk-oriented basis to verify that they are adequately identifying, limiting and monitoring the risks associated with a possible abolition of LIBOR. FINMA will pay particular attention to ensuring that, where possible, no new contracts or products refer to these benchmark interest rates if the term of the contract in question extends beyond the terminal LIBOR date and fall-back clauses or other suitable legal provisions have not been included in these contracts. In addition, FINMA is working on the replacement of LIBOR in the Swiss Solvency Test (SST).

In its supervision of the **combating of money laundering**, FINMA applies a fully revised approach to auditing. This focuses heavily on material compliance with the obligations set out in Swiss money laundering legislation. However, the scope of each individual audit depends on the risk posed by the financial institution under scrutiny. FINMA will also focus strongly on risk management at financial institutions that look after quasi-state clients. In the area of digital assets, FINMA takes a technology-neutral approach, but requires institutions to comply with at least the same high standards that apply in the analogue business.

FINMA will continue to closely monitor the legal and reputational risks associated with **access to foreign markets** and will raise awareness of this problem at the affected institutions as part of its supervisory dialogue. It also assists the relevant political bodies in Switzerland in their efforts to ensure equivalence at a technical level.

Longer-term trends and risks: climate risks

FINMA has also identified risks that could have an impact on the Swiss financial centre over the longer term. These include risks relating to climate change, which we explore in more detail below. Other long-term risks include an ageing society, the increasing individualisation of insurance based on big data, and risks for wealth management in a market with falling values of financial instruments.

The Paris climate agreement states that the financial industry has a role to play in the transition to a more sustainable economy. On the one hand this presents opportunities, but on the other both climate change and its repercussions also represent potential financial risks for financial institutions.

Given its legal mandate, FINMA's focus here is on finance-related climate risks to financial institutions. These risks can be broken down into two categories, physical risks and transition risks. Physical risks encompass increasing damage and cost to the economy as a result of climate-related natural catastrophes and gradual climate change. Risks of this kind could result in significant losses for insurance and reinsurance companies. Transition risks arise as a result of action taken on climate policy or disruptive technological breakthroughs. These could trigger rapid price adjustments of assets that have not yet been adequately anticipated by markets, e.g. in highly carbon-intensive sectors such as energy, manufacturing or transportation. The more countries delay in taking effective measures to achieve climate targets, the more invasive such measures are likely to be. There is a possibility that the markets will not price in the corresponding risks until a late stage, but will then do so aggressively. The losses on the investments (asset side of the balance sheet) of banks, wealth managers and insurance companies could weigh on their profitability. Climate risks have very specific characteristics, including prolonged time horizons, unclear impact pathways and a number of uncertain variables in the area of climate policy. This makes it difficult for institutions to manage investments appropriately with existing instruments. Financial institutions and supervisory authorities are therefore also working at an international level to integrate climate risks more closely into risk management processes, develop and deploy appropriate approaches and instruments for measuring and mitigating risks, and ensure transparent disclosure of the corresponding risks. In the supervisory authority and central bank context, a leading role in this respect is played by the Network for Greening the Financial System (NGFS).[4]

In the future, FINMA will refine its analyses of climate-related risks in the balance sheets of financial institutions and develop approaches for improved voluntary or regulated disclosure of financial climate risks.

[4] FINMA joined the NGFS in April 2019.

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