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The consequences of a low interest rate environment from a supervisory perspective

Even if the news headlines had calmed down for a while, the economic environment is still far from returning to normal. Many industrial countries are still experiencing weak economic growth and risks remain in the banking sector. The current situation in Cyprus makes this particularly clear. Companies operating in the financial sector and households continue to focus on reducing the high debt levels they accumulated before the crisis.

At the same time, central banks are resorting to every possible means to boost the economy. They have cut interest rates to almost zero and continue to employ unconventional measures such as buying bonds and injecting liquidity. This expansive monetary policy has contributed positively to financial stability. In the medium term, however, persistently low interest rates can give the wrong incentives for investment and lead to an economic bubble. In other words, the side effects are becoming more pronounced.

Life insurers, mortgage lending and resolution regime

In light of the low interest rate environment, it has become increasingly difficult for many market players in the financial sector to remain profitable and honour the obligations towards their clients, some of which were entered into years or decades ago. This holds particularly true for life insurance companies that have sold mixed policies with interest guarantees. In the second part of my presentation, I will take life insurers as an example and illustrate how FINMA is dealing with the major challenges they are facing.

But first, let me address mortgage lending. Low interest rates are tempting many people to buy their own house or private apartment despite the sharp rise in prices. But will these new buyers be able to cope with a higher interest burden if interest rates rise? Or will they be able to come up with their own capital if the value of the house drops below the loan-to-value ratio? Will banks be stable enough to absorb any default by the mortgage holders?

It is FINMA’s task to control compliance with statutory and supervisory requirements for granting loans and ensure that the banks’ lending portfolios are sufficiently hedged. This explains why we supervise banks and intensively monitor their money lending business policies. I will enlarge on this point in the second part of my presentation.

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Yet, although FINMA is tightening up requirements and performing intensive supervision, it remains clear that there are no absolute crisis-proof solutions. Businesses operating in the market that do not do their business should still be allowed to fail. It is important, nevertheless, to ensure that the threat of bankruptcy is credible and effective, and that the losses are borne by the shareholders and creditors, and not the tax payers. This should apply to all companies in the financial sector, including the largest and most interconnected enterprises. To this end, we have pushed forward a restructuring and resolution strategy for large banks. Even if we have still not reached our goal, we made considerable progress in 2012 to which I will refer in the third part of my presentation.

The consequences of low interest rates for life insurers

And now let us turn back to life insurance companies. The low interest rate environment is posing enormous challenges for life insurers to honour the long-term guarantee made to policyholders. The Swiss Solvency Test (SST) has illustrated the increasingly tightening economic conditions within which life insurers must operate. Since the SST comprises the entire balance sheet, it realistically captures the risks, and values assets and liabilities at fair market value. Thanks to this modern instrument, the insurance industry can take measures to strengthen its financial base and reduce risks. With European authorities still striving to introduce a modern solvency regime, insurers in Switzerland have had, since the introduction of the SST, a more solid basis to operate from than their European counterparts.

Nevertheless, the situation remains tense. The average SST ratio of all life insurers has dropped from a relatively comfortable 145% in 2011 to 105% in 2012. This is not surprising considering the even lower interest rate environment. The return on 10-year Confederation bonds in 2011 was still at 1.8% only to drop to 0.7% one year later. This explains why it is essential for FINMA to supervise life insurers with a higher degree of intensity, and this we managed to do in 2012 by concentrating our audits on certain key issues to establish whether those companies are in a position to meet their service payments even in a low interest rate environment.

In view of the difficult circumstances for life insurers, FINMA decided to relax the SST conditions temporarily. This allows insurance companies to value, temporarily, their old portfolios less stringently: for the first time, they are allowed to calculate their obligations from in-force business by using interest curves with counterparty credit risk instead of using the return expected on Confederation bonds. In order to prevent these adjustments from leading to even more immense challenges in the future, they apply to only in-force, not new business. When writing new business, life insurers must look the economic realities in the face. This period of low returns may well last into the foreseeable future. Moreover, FINMA only intervenes if insurers fall below their threshold values. These measures apply for a period of three years.

The insurance industry must rethink its strategy so that it does not provide a high level of guarantees in the near future. The product mix offered by insurance companies has to change to deal with the current risky low interest rate environment.

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Low interest rates and the mortgage market

While the low interest rate environment puts insurance companies under pressure, it has, at the same time, shored up the economy as a whole. It has promoted consumerism and encouraged the consumption of residential property. What is FINMA's estimation of the current situation in mortgage lending? Our focal point is the quality of the loan portfolios offered by Swiss banks. While strong growth can point towards a deterioration in credit quality, it does not necessarily have to be so.

It was a clever move, but one, I believe, that was almost overdue, when the Federal Council adopted self-regulatory measures in late summer of last year alongside those taken by the Swiss Bankers Association to contain risky mortgages and back such loans with more capital. In addition, since the beginning of this year, high-risk mortgage loans must be in accordance with the revised Capital Adequacy Ordinance and be underpinned with more equity capital. This is an incentive for banks to be more conservative when it comes to granting risky mortgage loans.

Moreover, FINMA has introduced a new rule for banks that calculate their capital requirements by using internal models – in other words, the so-called IRB banks. Since the prices on the Swiss housing market have been increasing steadily for almost 20 years and have risen notably in recent years, credit defaults have been low. This has resulted in capital requirements at IRB banks not fully reflecting the risks contained in their real estate portfolios which stress tests have brought to light. We therefore decided to introduce a multiplier for IRB banks whereby capital requirements calculated with an internal model are multiplied by a percentage factor to correct the procyclical effect and match the true economic risks. The advantage of internal models, that is to say their differentiated risk analysis, has still been retained.

In terms of prudential supervision, the mortgage market was and still is one of the main issues we addressed during the past years. By conducting stress tests, we analyse on an on-going basis whether mortgage loans are backed by enough equity. In face of heightened risk, we ordered specific increases in own funds at certain institutions. In addition, FINMA carried out directly at the banks 11 on-site controls focussing on the mortgage business in the three years spanning from 2010 up to the end of 2012. This year we intend conducting six such on-site controls relating to the same issue. The analyses made mainly focussed on private and owner-occupied real estate mortgages. Recently, however, our audits have focussed more on investment properties. FINMA is currently examining whether additional measures to curtail risks should be taken in this business segment.

All in all, we did not come across any large-scale imprudent lending policies. There are, nonetheless, distinct regional differences, as well as, to a certain degree, considerable differences in the lending policies practised by the various banks. The spectrum is broad and ranges from 'careful' to 'risky'.

FINMA does not just look at banks when it comes to the mortgage market – it also assesses the activities of insurance companies in this area. We regard their activities as posing a lower risk, however, since they have clear investment guidelines and exercise enough caution when limits are narrowly defined. We expect insurance companies to continue to adopt a conservative approach to the current market and that they adhere to the rules on financial sustainability and loan-to-value ratio set down in the revised self-regulatory requirements issued by the Swiss Bankers Association.

Credible resolution and restructuring

What happens if an institution gets into serious financial difficulties despite adequate supervision and despite having well-defined internal risk and control processes? In such cases, we, as a supervisory authority, need to be able to restructure and, if necessary, even liquidate small and large institutions alike, and in particular, systemically important supervised institutions. We have taken important steps in this area in 2012.

As regards insurance supervision, we put the new Insurance Bankruptcy Ordinance into effect last December. Prior to that, FINMA had transferred the new international requirements made after the financial crisis to Swiss insurance companies. In Switzerland, we are therefore one step ahead of international developments.

With the coming into force of the new Banking Insolvency Ordinance, we have also made progress in banking supervision which attracted a lot of international attention. This Ordinance sets out the process to be followed so that not only shareholders but also bondholders contribute towards restructuring. As part of its restructuring plan, FINMA can order a compulsory conversion of bonds or a waiver of claims. This is known as a bail-in: it ensures that banks can still continue to operate and safeguards financial stability. In the case of systemically important large banks, additional safety measures have been taken, and here I mean the use of convertible capital which is commonly referred to as CoCos. This involves a two-stage approach which, as a first step, converts CoCos into equity capital. If this measure to sustainably stabilise the bank proves insufficient, the next step is resolution at the highest group level by means of a bail-in.

International recognition of the Swiss resolution approach is necessary

Internationally, FINMA is thus well-positioned. An officially ordered conversion of debt into equity capital or a waiver of claims have become in the meanwhile accepted approaches and have been adopted in important countries such as the US, the UK and also in the EU. Even if the legal basis is not yet in force, this approach will hopefully soon belong to the restructuring repertoire of many supervisory authorities around the globe. During this year, we intend continuing our work on institution-specific restructuring plans for large banks.

At the international level, we must ensure that Swiss insolvency measures are recognised by competent authorities in serious situations. By participating in international supervisory committees and bilateral interactions with important foreign authorities, we will continue working intensively in this area. In view of the fact that our country has two systemically important banks and other large financial institutions, Switzerland has a strong interest in getting such institutions to develop effective approaches to restructuring. Only by ensuring that the threat of bankruptcy is credible and effective will the right incentives finally be given, market forces restored, and tax payers and depositors be protected from potential financial losses.

Confronting reality

So, to conclude - life insurers are under pressure, the mortgage market is in a precarious situation, business models are being radically changed, and restructuring and resolution plans for large banks are within reach – these are just some of the many topics with which FINMA dealt in 2012. We are not going to resort to wishful thinking that 2013 will be any easier. Nor for that matter should Swiss financial institutions engage in any such wishful thinking in light of the persistently demanding economic environment.

Thank you for your attention.