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

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Low interest rates as a challenge to the stability of the financial sector

Ladies and Gentlemen,

I would like to talk to you today about an issue that is very important to us and highly topical in view of the current macroeconomic situation, namely the challenges the current interest rate environment poses for the companies we supervise and the stability of the financial sector as a whole.

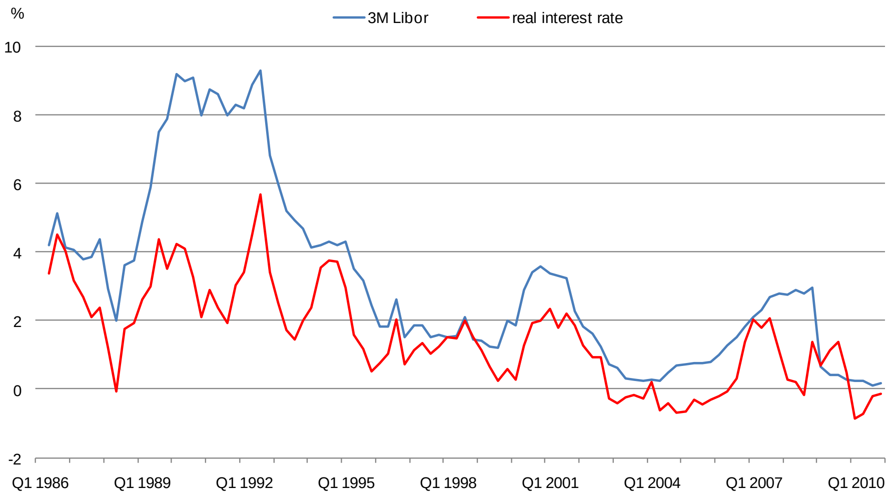
There are in principle two particularly critical scenarios, the first is when interest rates remain at low levels for a protracted period and the second when rates show a sudden and sharp increase.

I will begin by saying a few words about the current state of affairs on the interest rate front and the forecasts. I will then discuss the general impact of expansionary monetary policy on the perception and tolerance of risks on the financial markets. Next, I will address the specific challenges banks and insurers face as a result of the low interest rate environment. To tie in with this, I will explain what action FINMA is taking and what the limitations of its supervisory apparatus are.

Current situation and forecasts

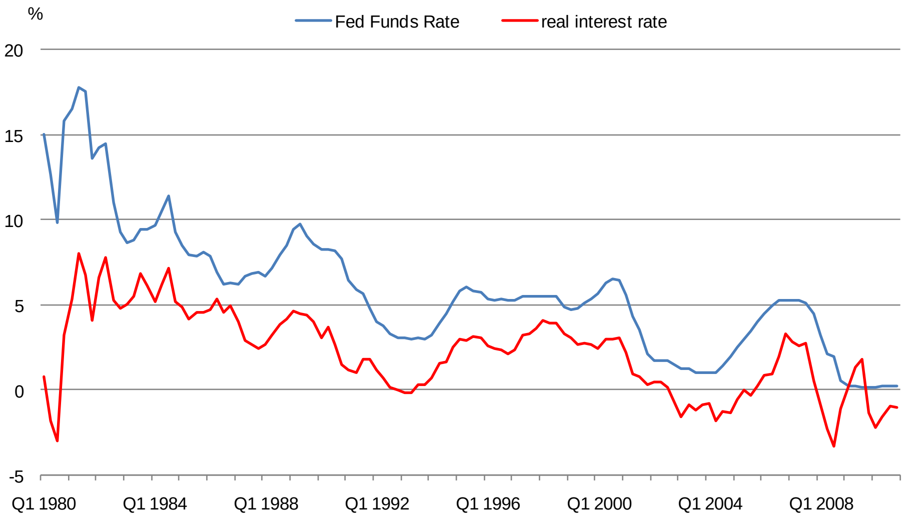
The Swiss National Bank (SNB) has kept its interest rate at a historically low level for the past 23 months, while the European Central Bank (ECB) has done so for 21 months and the US Federal Reserve for no less than 26. The central bank in Sweden is the only one in Europe that has steadily increased its interest rate since last September. In its assessment of the economic and monetary situation published last Thursday, the SNB announced that it is leaving the target range for the three-month Libor rate unchanged. The first signs of rising inflation prompted the ECB to consider a moderate interest rate hike this month. The expected price growth is thus far attributable first and foremost to the rising price of oil. In the present situation, with uncertainty over the economic trend persisting, central banks can be expected to wait until a clear inflationary threat emerges before hiking rates. The current forecasts, therefore, are not pointing to a significant rise in interest rates in the near future – not even in the US. This means that interest rates can be expected to remain at low levels over the medium term.

Fig. 1: Short-term interest rates in Switzerland



Source: Datastream

Fig. 2: Short-term interest rates in the US



Source: Datastream

Low interest rates increase risks on the financial markets

Expansionary monetary policy keeping interest rates low for a long time gives rise to risks for the financial markets. These risks can only be partially dealt with by the instruments of prudential supervision (regulation and monitoring).

In recent years, monetary policy measures have increasingly been seen to entail not only their classic effects of stabilising prices and steering economic growth but also risks for the financial markets. The academic term for this is the “risk-taking channel” of monetary policy. The focus here is on **financial market players’ perception and tolerance of risk**. There are various reasons why greater risks are taken on when interest rate levels are low.

Nominally fixed yield targets can lead to a **search for yield** in phases of low nominal interest rates. However, investment opportunities that offer a higher yield also tend to come with more risk attached. As a rule, the higher the yield, the higher the risk.

Greater risk-taking is also favoured by the effect low interest rates have on the **valuation of assets, income and cash flows**. When considering whether to grant a loan, the lender takes the collateral provided by the borrower and/or the expected return into account. The calculations this involves form the basis for determining the borrower’s creditworthiness and the amount to be lent. Basing the calculations on a low notional interest rate has a positive effect on the creditworthiness, the return and ultimately the loan decision.

When asset values are rising and interest rates are low, the **volatility** of prices tends to fall. Market participants then have a tendency to perceive risks as being lower. This is not merely a subjective phenomenon. Even “objective” risk measurement models signal falling risk levels amid lower volatility.

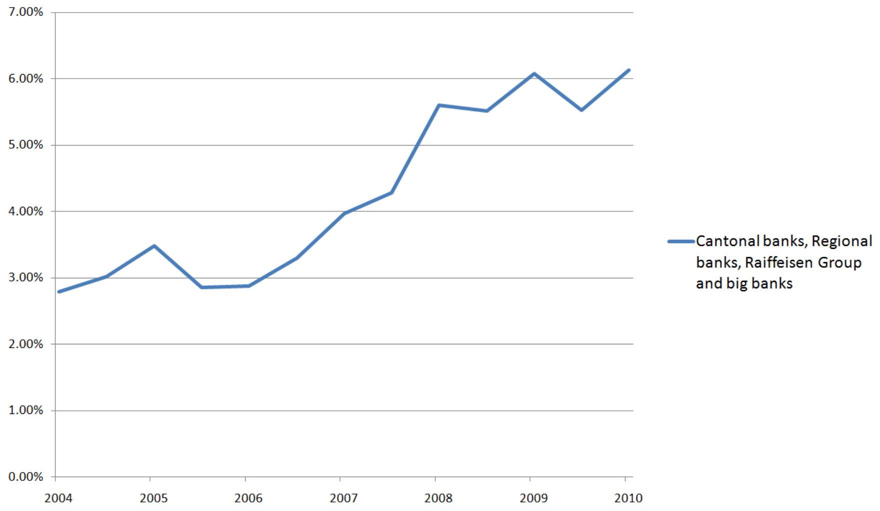
All this shows that expansionary monetary policy essentially makes people more willing to take risks on the financial markets. This even applies when banks do not relax their lending policies.

Challenges for banks

I would now like to look more closely at the interest rate risks faced by banks. Interest rates on account deposits have been at historic lows for months now, and there is no scope for further material reductions. Nevertheless, the banks are recording growth in client deposits and therefore rising costs for client relationship management. As regards lending, fierce competition, especially in the domestic mortgage market, is squeezing interest income. Riskier or alternative forms of investment that offer higher interest rates are available only at the cost of an increased likelihood of default. Overall, this situation is leading to a marked **reduction in net interest income**. Investments made a few years ago at considerably higher interest rates are now maturing, and can only be reinvested at the lower rates on offer today, further depressing earnings.

Even looking ahead, however, the profit situation appears problematic. Mortgage clients want to lock in low interest costs over the medium term, so there has been a marked increase in demand for fixed-rate mortgages over the past few months. Terms in excess of five years are particularly sought after. With interest on fixed-rate mortgages currently higher than that on variable rate mortgages, increased demand for fixed-rate mortgages is generating welcome interest income for the banks in the short term. However, **it also increases their exposure to interest rate risk**. This risk would then translate into an especially strong impact if, following a long phase of low interest rates, rates were to rise quickly and sharply.

Fig. 3: Losses in net present value as a percentage of the eligible capital required for a change in interest rates of ±100 basis points (Source: Interest rate risk report)



Overall, **the banks' mortgage claims rose by approximately 6.5% in 2010**. Almost all of the banks are **exposed to the risk of rising market rates**. A sharp rise in rates would thus lead to significant cuts in income. If rates rise by one percentage point, the equity capital of banks active in the mortgage business is likely to be reduced by an average of more than 6%. Of course, material interest rate risks are not exclusively associated with mortgages. The same problem arises with investments in securities that have long terms to maturity, which entail long-term interest commitments.

FINMA measures with regard to banks

The regulatory requirements do not include a compulsory capital adequacy requirement for interest rate risk. Banks must therefore use their own governance to keep this risk under control. All that FINMA can do under **Pillar 2 of the Basel Committee regulations**, i.e. as part of the institution-specific supervisory process, is impose an additional capital adequacy requirement and further measures. It can also exert an influence on the banks' risk management through its supervisory activities.

FINMA stepped up its analysis of the interest rate risk the banks were taking on and their risk management while the tension in the interest rate environment was still at an early stage. This analysis focuses not only on institutions' risk values and limits, but also on the **assumptions made when calculating interest rate risks**.

These assumptions are needed in particular for so-called core deposits to ensure that interest rate risks are adequately captured and managed. The difficulty with these products, which include savings accounts and variable rate mortgages, is that they have unlimited terms and interest rates that may change. For this reason, FINMA has for a number of years been conducting systematic sensitivity analyses of the relevant assumptions (known as replication keys) as well as cross-comparisons within the banking market. FINMA has been carrying out in-depth situational investigations of both the banking market as a whole and of individual institutions in recent months. The key problems related to interest rate risk have also been highlighted and discussed with audit firms and bank representatives at various specialist events. In addition to the regulatory audits, several on-site visits to banks are planned for this year to look at how they capture and manage interest rate risks.

Conclusion: the situation for banks

As I explained earlier, it must be noted that the continuing phase of low interest rates on the one hand and the prospect of a sudden and sharp rise in rates on the other both pose major challenges for banks. Banks with retail operations are naturally affected the most. It is thus all the more important for banks to maintain adequate risk management in spite of falling interest income and to protect their books sufficiently against possible changes in market interest rates. Banks' board of directors in particular must pay more attention to interest rate risk in their governance. FINMA will be keeping a close eye on this issue and will play an active role in making everyone involved more aware of the problem of interest rate risk. It will also order corrective measures where necessary.

Risks in the insurance sector

Low interest rates also give rise to risks in the insurance sector. Low long-term interest rates pose a threat to the life insurance industry because they mean that insurers can no longer meet the interest costs for their portfolios of classic life insurance products from income generated by (low-risk) fixed-income investments. Besides CHF interest rates, those for the EUR, USD and GBP are also important as insurers hold diversified investment portfolios.

Nominally fixed yield targets are a feature not only of classic life insurance, but also of the obligatory part of occupational pensions subject to a predetermined conversion rate. Since these interest rate guarantees in favour of policy holders are difficult to honour in the current interest rate environment and require a lot of risk-bearing capital due to the high sensitivity to interest rates that comes with long contractual terms, insurers have for some time been looking to break into new markets. These include fund-linked life insurance, life insurance with variable annuities and insurance wrappers, which involve separate current account and custody account maintenance. However, many of these products are not particularly appealing to clients in the current environment, and competition between insurers is putting pressure on margins. There is a danger that insurers may be taking on new risks with these products that are as yet unknown and difficult for them to manage.

A higher yield than that on fixed-income securities could be achieved by putting money into riskier or alternative investments. As regards investment strategy, however, direct insurance is subject to clear restrictions imposed by its own investment guidelines and the Swiss Solvency Test (SST).

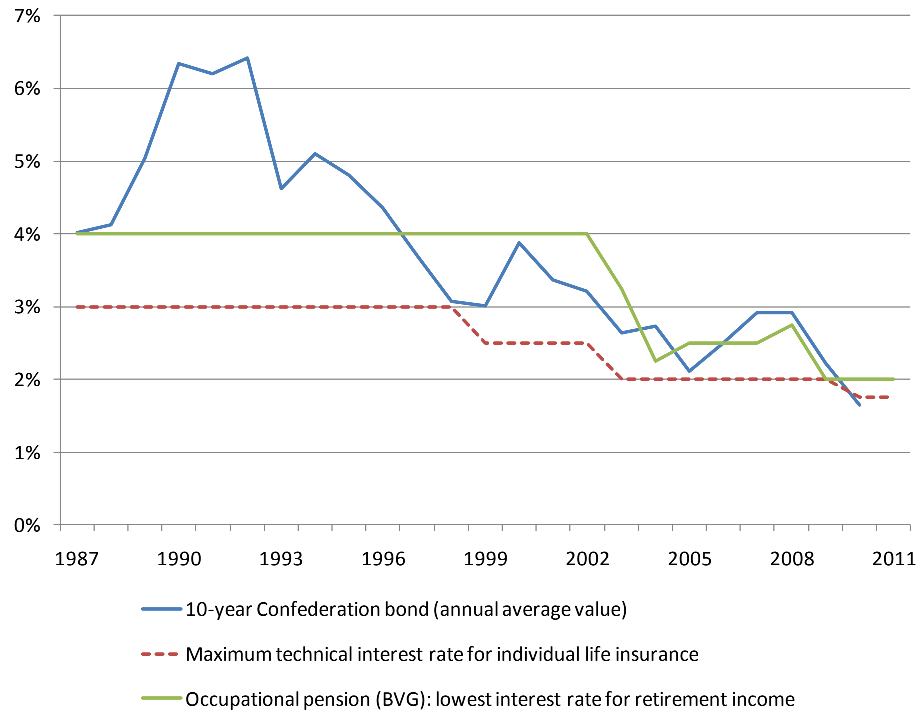
Besides persistently low interest rates, a sudden and rapid increase in interest rates could also bring problems for life insurers. In this scenario, increased surrenders by life insurance clients could be expected. That said, policy holders tend to be cautious when it comes to deciding to surrender their policy, and insurers can reduce the incentive to surrender by adjusting the surplus participation, in other words by paying out more of the surplus achieved to their policy holders.

FINMA measures with regard to insurers

In contrast to the capital adequacy requirements for banks, the SST values both assets and liabilities using market-consistent methods. This means that actuarial liabilities are calculated on the basis of the current interest curve, making each company’s current situation immediately visible and allowing FINMA to take action accordingly in order to protect policy holders. If an insurer is found to display insufficient economic solvency, FINMA can order it to defer dividend payments, share buybacks and surplus participations so as to preserve its capital. In the case of conglomerates, FINMA has in the past also requested that capital be transferred from better capitalised subsidiaries to bolster the undercapitalised one.

The maximum technical interest rate permitted was repeatedly lowered in recent years to reduce the pressure on life insurers in the future.

Fig. 4: Life insurance interest rates



Conclusion: the situation for insurers

FINMA has no influence over the general level of interest rates. Besides domestic interest rates, those of other key currencies are also decisive for Swiss life insurers as regards achieving their yield targets. The conversion rate for obligatory occupational pensions, which is set through political channels, also continues to represent a major burden for the life insurers concerned. FINMA has no say here either.

FINMA's actions regarding individual life insurers are primarily aimed at preserving the company's solvency and thus protecting policy holders. However, unwelcome side-effects, perhaps even with negative consequences for the entire sector over the medium to long term, cannot be ruled out. In cases of insufficient solvency, the deferral of dividend payments, share buybacks and surplus participations will send a clear signal to market participants and can have an effect on new business for the company concerned. These measures, therefore, might well have a negative impact on the company's scope for doing business and thus, in turn, also on its policy holders. An increase in surrenders could then exacerbate the downward spiral.

If interest rates remain low over a longer period, and if an increasing number of life insurers are affected by such exceptional measures, this could also be detrimental to clients' confidence in the sector as a whole. Even companies that are not affected could be confronted with surrenders or a drop in new business. It is thus clear that, while FINMA's supervisory apparatus can offer direct protection to life insurance clients, its negative effects on the whole sector will become more pronounced the longer the interest rate level stays low and the more broadly these measures have to be applied.

Awaiting normalisation

The low interest rates that have now been with us for some years bring with them significant risks for the financial companies we supervise and for the stability of the entire financial sector. As I have shown, FINMA has taken action on a number of fronts, within its remit and using the apparatus at its disposal, to counteract these risks and minimise them wherever possible. However, prudential supervision can only have a limited impact on some of the risks. As I have already said, FINMA will be keeping a close eye on interest rates and will play an active role in making everyone involved more aware of the problem of interest rate risk. A gradual return to average interest rate levels in the near future would bring considerable relief for the financial sector.