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Heightened risks: implications for governance and risk management

Key Points:

1. We find ourselves in a situation of heightened financial and non-financial risks.
2. The current risk landscape is increasingly shaped by geopolitical tensions, increased government debt in particular countries and the risk of rising trade barriers. The impact of these risk drivers on the financial system is difficult to assess. However, they can, for example, directly influence corporate and sovereign credit spreads with implications for all financial institutions.
3. In this environment, we also see increased non-financial risks in the areas of sanctions, money laundering and cyber. These can in turn result in legal, reputational and operational risks for financial intermediaries.
4. Managing and mitigating the growing financial and non-financial risks and their potential consequences form the core of a sustainable business model. This includes an effective corporate governance and risk culture. Scenario analyses and stress tests relevant to institutions' business models are essential to navigating this uncertain environment.
5. Responsibility for adequate corporate governance and risk culture lies with the financial institutions. FINMA intervenes at an early stage if it becomes apparent that supervised institutions are not meeting these responsibilities or do not have their risks under control. FINMA acts in a risk-based manner and is committed to principle-based, proportionate and technology-neutral supervision.
6. Against this backdrop, it is all the more important to remain vigilant, anticipate risks, whether financial or non-financial, and focus on minimizing them.

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Ladies and Gentlemen,

Today we meet once again for our annual dialogue and I would like to begin by thanking Centro Studi Villa Negroni for their excellent organization and hospitality.

In past speeches I have emphasized the importance of effective, principle-based, proportionate and technology-neutral financial market supervision for financial stability and prosperity. Today I will talk about the risk landscape in which financial institutions operate, focusing on the development of financial and non-financial risks. It is essential that financial institutions understand the risks and their potential consequences if they materialize and that they adequately manage and mitigate them. After all, effective management of risks through a strong corporate governance and risk culture is at the heart of a sustainable business model and broader financial stability.

Financial institutions need to be focused on both near-term threats and dangers looming further out on the horizon. It is primarily the responsibility of supervised institutions to identify the risks and where appropriate to take action. Financial market supervision is the “second line of defense”. Supervisors must intervene at an early stage if it becomes apparent that a supervised institution is not fulfilling its responsibilities regarding governance and risk appetite or does not have its risks under control.

But what are the specific risks?

FINMA published its annual Risk Monitor on 18 November. The Risk Monitor provides transparency for supervised institutions and the wider public about how FINMA assesses the risk landscape. The report also describes the focus of FINMA's supervisory activity on the basis of these risks. I would like to take this opportunity to recommend this report to the boards of directors and executive boards of financial institutions.

We find ourselves in a situation of heightened financial and non-financial risks. The former include, for example, credit risks, while the latter include cyber risks.

In the current environment, risks due to geopolitical tensions, increased government debt in particular countries and trade barriers are on the rise. These risks and their impact on the financial system are difficult to assess. Nevertheless, it is essential that financial institutions take the necessary steps to understand their risk exposures and manage the downside. Scenario analyses and stress tests relevant to the respective business models are essential for navigating such an uncertain environment. An institution's risk appetite must be compatible with increased volatility and the potential

for periods of risk aversion and stress in the market. Finally, in times of heightened uncertainty, sufficient capital and liquidity buffers, diversified funding and the management of risk concentrations are essential. Structural changes – in particular digitalization and social media – that can result in a more rapid outflow of liquidity should also be taken into account in institutions' risk assessments.

In the area of financial risks, we see that the risk of interest rate shocks is lower than in the past due to lower inflation, lower key interest rates and the increased probability of a soft landing. We have therefore downgraded this risk in our Risk Monitor. However, caution is still required: Even though the likelihood of interest rate shocks has diminished compared with the previous year, the risk of systemic financial shocks remains high due to the increased geopolitical risks and the impact on corporate and sovereign credit spreads. Indeed, increasing government debt burdens in particular countries can amplify the extent of such shocks. The financial market environment therefore continues to be afflicted by a whole range of uncertainties due to the current financial and geopolitical dynamics.

We also continue to observe a high level of credit risk. Besides the general economic situation, this is due to lag effects, in particular the holdover of the Covid crisis and the recent period of higher interest rates.

It is also important to specifically mention the mortgage sector, where vulnerabilities remain high, as our recent stress tests have shown. Many banks have high concentrations to the residential mortgage market. A number of banks continue to grant mortgages based on unsustainable lending criteria or a high proportion of exception to business policy. There is also valuation risk, as property prices could fall. This is particularly true in the commercial property sector where structural changes (e.g. working from home) have increased the risk of vacant office space. Finally, there are risks of spillover effects to European banks and other financial institutions coming from exposures to the US commercial property market.

The rapidly growing sector of non-banking financial institutions, NBFIs, is an increasing cause for concern at the global level. This sector includes hedge funds, private equity funds and credit funds, all of which may combine lending with leverage. The Financial Stability Board has been increasingly active here. However, we still understand too little about how credit is intermediated via the NBFI sector and how the main players are connected with the banks. Systematic monitoring of risks in the NBFI sector, supported by data collection and analysis, as well as early flagging of emerging risks, is necessary.

In the area of non-financial risks, I would like to focus on those that are growing the fastest. Non-financial risks are typically of a more qualitative nature and thus more difficult to measure and

manage. Nevertheless, it is essential that supervised institutions identify, analyze, and address these risks in accordance with effective, regularly reviewed and documented processes, based on stringent governance practices. They should also be reflected in an institution's risk appetite framework.

The risks in the area of money laundering should be emphasized in particular. The Swiss financial center is a leading global cross-border wealth management hub for private clients. This makes it particularly exposed to money-laundering risks. Accordingly, money laundering risk has remained high in the past year, not only at the larger banks, but increasingly also at medium and smaller banks. The risk is also of increased relevance for other financial institutions such as independent wealth managers and asset managers. Breaches of due diligence and reporting obligations can result in legal consequences and reputational damage for financial institutions both in Switzerland and abroad. In particular, customers from high-risk countries continue to pose an elevated risk. Money laundering risks are also growing in the crypto space. Cryptocurrencies are not only used in cyberattacks, but also as a means of payment for illegal trading on the dark web. The latter is also likely to be relevant for the canton of Ticino, which is experiencing growth in the areas of FinTech, blockchain and cryptocurrencies, which need to be mitigated through enhanced risk control frameworks.

FINMA monitors compliance with due diligence obligations in relation to money laundering through numerous risk-based on-site reviews across all supervisory categories. The focus is on the definition and implementation of risk tolerance and risk management at institutions that have politically exposed customers or customers with links to state or quasi-state companies in high-risk business areas. FINMA has also completely overhauled the audit program for supervisory audits by audit firms to make them more effective.

Another key area of non-financial risks are sanctions, which are on the rise in connection with growing geopolitical tensions. The State Secretariat for Economic Affairs (SECO) is responsible for ensuring that sanctions are enforced in Switzerland. FINMA is responsible for monitoring institutions' risk management and controls related to sanctions risks consistent with financial market laws and regulations. These rules require supervised financial institutions to adequately identify, limit and monitor all risks including legal and reputational risks and to establish an effective internal control system to mitigate sanctions risks. Legal and reputational risks have increased considerably for financial intermediaries who deal with clients affected by Swiss and foreign sanctions. These risks have intensified due to the sanctions on Russia in particular. The ordinance on measures connected with the situation in Ukraine encompasses not only the usual financial sanctions against certain listed individuals and businesses. It also prohibits certain financial services for Russian citizens and individuals and businesses resident in the Russian Federation, and includes sanctions on the trade of certain goods. For a range of goods – particularly defense and dual use goods – the sale, delivery,

export, transport and transit to the Russian Federation, or for use in the Russian Federation, is prohibited. Providing certain related financial services and financing are also prohibited. In particular, the risk relating to business relationships and transactions with persons sanctioned by the US or the European Union is difficult to mitigate and these customer relationships are regarded as very problematic from a risk management perspective. The longer the sanctions regime continues, the greater the chance that sanctioned persons and companies attempt to evade the sanctions. This gives rise to increasing risks for financial intermediaries.

In relation to the sanctions on Russia, FINMA has further expanded its access to data and carries out on-site reviews and investigations of sanctions management at various supervised institutions with higher risk exposures. FINMA coordinates closely with SECO on this issue.

The third area of heightened non-financial risks I would like to highlight is the area of cyber risks. We are observing growing cyber risks, particularly as a result of outsourcing to external service providers. The number of reports received by FINMA about successful or partly successful attacks increased by 30% compared with the prior year. The majority of reported attacks were carried out via external service providers (30%) and via web-based channels (23%) and email (22%). This risk is aggravated by growing concentrations of Swiss financial institutions to a small number of large service providers, many of which are located in foreign jurisdictions.

Mr. Capuano will go into more detail on the topics of cyber risks and outsourcing to external service providers. A growing number of smaller market participants have also been the target of attacks since the publication of the last Risk Monitor.

It is therefore essential for supervised institutions of all sizes to recognize this risk as a separate operational risk that needs to be managed, to define a corresponding risk tolerance and to strengthen mitigation capabilities.

Besides strengthening their resilience, it is essential for financial institutions to test scenarios where an attacker manages to circumvent the protective measures and is able to cause maximum damage to the company. Realistic and tested response plans are an important determinant of being able to mitigate the risk of cyberattacks effectively.

For this reason, FINMA will also emphasize data-based supervision and risk detection and enhance its assessment of supervised institutions' cyber protection policies by deploying suitable tools, such as scenario-based cyber exercises.

FINMA will continue to take a risk-based approach to supervision. This means that FINMA deliberately monitors those areas that are central to the functioning of the financial system more closely than others. It deploys tools and supervisory responses in a balanced and proportionate way. In concrete terms, this means that the chosen supervisory measures must be proportionate to the risks to creditors, consumers, the markets and the financial system.

Allow me to summarize: The financial and non-financial landscape in which financial institutions operate has intensified and become more complex. It is therefore all the more important that financial institutions effectively take these developments into account in their governance and risk management and calibrate their risk appetite accordingly. This is critical to ensuring sustainable business models. FINMA intervenes at an early stage if it becomes apparent that the supervised institutions are not fulfilling their responsibilities with regard to governance, risk culture and compliance or do not have their risks under control. In this regard, FINMA is committed to principle-based, proportionate and technology-neutral supervision.

Managing risks adequately and effectively is a necessary condition for creating trust. And a financial institution that can be trusted is more resilient. Effective risk management, including adequate corporate governance and risk culture, is essential for sound financial institutions, maintaining financial stability and sustainable prosperity in Switzerland.