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 2024

Contents

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

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

The main focus of FINMA's work is the supervision of the financial sector. It seeks to ensure that the supervised financial institutions are not destabilised by potential risks, either now or in the future. Assessing the risk situation of individual supervised institutions is therefore a critical part of FINMA's supervisory activity.

The Risk Monitor creates transparency both for supervised institutions and the wider public about how FINMA fulfils its statutory responsibilities. Firstly, the Risk Monitor provides an overview of what FINMA believes are the most important risks facing supervised institutions over a time horizon of up to three years. Secondly, FINMA sets out its supervisory expectations in relation to the risks discussed in the Risk Monitor.

The macroeconomic environment is the foundation for identifying many of the main risks. Inflation remains above the central banks' target ranges in many countries but has continued to fall in recent months. Against this backdrop, a number of central banks have eased monetary policy again after the tightening cycle in recent years. The Swiss National Bank also cut interest rates by a further 0.25 percentage points to 1% in September 2024. These rate cuts came in the context of falling inflation expectations. The Swiss Federal Statistical Office (FSO) is forecasting inflation of 1.4% in 2024 and 1.1% in 2025 (Source: FSO). Due to the geopolitical tensions and regional conflicts, the financial market environment continues to be afflicted by a whole range of uncertainties.

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 Risk Monitor is expressly not intended as a basis for investment decisions. The occurrence of extreme events ("tail risks") is always possible, including in connection with risks that FINMA has categorised as less serious and therefore not included in the Risk Monitor.

Most of the risks previously identified by FINMA remain high. The arrows indicate changes compared to last year's Risk Monitor: the risk increased (↑), stayed the same (→) or decreased (↓). The likelihood of interest rate shocks has diminished compared with last year given the current level of interest rates and the fall in inflation. This year, FINMA therefore no longer classifies interest rate risk as a principal risk. The principal risks for 2024 are as follows:

– **Risks associated with real estate and mortgages (→):** There has been a slowdown on the Swiss real estate market since the publication of the last Risk Monitor, but the risk of overheating remains high. A number of banks continue to grant mortgages based on unsustainable lending criteria or a high proportion of exception-to-policy (ETP) business. There is also valuation risk, as property prices could fall, particularly in the commercial property sector where structural changes (e.g. working from home) have increased the risk of vacant office space. Supervisory focus: FINMA deploys its supervisory tools to understand the lending criteria at institutions that have come to its notice and will impose capital surcharges where required. FINMA will continue to keep an eye on how principles-based regulation is being applied in this area and – depending on how the risks evolve – may consider imposing rules-based regulation.
– **Credit risk: other loans (→):** Declining earnings and falling market valuations can lead to losses on Lombard loans and corporate lending, particularly if market conditions change unexpectedly and timely settlement of transactions becomes more difficult. Supervisory focus: FINMA continues to monitor the leveraged finance positions at UBS intensively after the takeover of Credit Suisse (CS). It conducts supervisory discussions and on-site reviews on the corporate lending business in Switzerland and monitors the Lombard loan business with a particular focus on risks that could emerge from concentrated or more illiquid collateral.
– **Market risk: credit spread risk (→):** Higher sovereign or corporate credit spreads could lead to significant losses in the portfolios of supervised institutions. This could hit profitability and undermine confidence in them. Supervisory focus: FINMA monitors this risk through its regular loss-potential analysis at larger institutions.
– **Liquidity and funding risk (→):** A loss of confidence by investors can lead to a rapid outflow of liquidity and trigger a downward spiral that leads to a further deterioration in a bank's liquidity. This could potentially destabilise the entire financial system. Supervisory focus: FINMA monitors banks' liquidity and funding risks on an ongoing basis and carries out both regular and situation-dependent analyses. In addition, it regularly analyses compliance with the special provisions for systemically important banks.
– **Market access (→):** Restrictions on access to important foreign markets, particularly in the European Union (EU), could adversely affect the profitability of Swiss financial institutions. Developments in cross-border market access remain shrouded in legal uncertainty. Supervisory focus: FINMA assists the Swiss authorities in their efforts to achieve recognition of equivalence.
– **Money laundering (→):** Breaches of due diligence and reporting obligations can have legal consequences and cause considerable reputational damage. In particular, customers from high-risk countries continue to pose an elevated risk. Money laundering risks are also growing in the crypto space. Supervisory focus: FINMA monitors compliance with anti-money laundering due diligence obligations via numerous on-site reviews. The focus is on 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.
– **Sanctions (↑):** Trade sanctions on goods are an area where risks are seen to be increasing. Providing certain related financial services or financing is

prohibited and poses a risk of sanctions violations for financial intermediaries. Legal and reputational risks have increased considerably for financial intermediaries who deal with clients affected by foreign sanctions. Since last year they have intensified for the sanctions on Russia in particular. Supervisory focus: 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 high exposures.

– **Outsourcing (→):** Outsourcing of critical functions to third-party providers remains a key source of operational risk in the financial sector. Outages or malfunctions at third party providers, particularly in cloud services, could have a severe impact on the stability of the Swiss financial market. Supervisory focus: FINMA monitors outsourcing risk by means of specific checks and on-site reviews – both at supervised institutions and service providers – and by evaluating supervisory and audit data.
– **Cyber risks (→):** The Swiss financial sector continues to be a regular target for cyberattacks. Weaknesses in IT infrastructure, inadequate security measures and lack of awareness increase financial institutions' vulnerability. Cyber incidents in connection with outsourced services and functions remain relevant. Supervisory focus: FINMA will emphasise data-based supervision and enhance its assessment of the maturity of supervised institutions' cyber protection policies by deploying suitable tools, such as scenario-based cyber exercises.

Principal risks

FINMA takes a risk-based approach to supervision. The intensity of its supervision is dictated firstly by the risks the financial market participants are exposed to and, secondly, by the primary risks arising from the current environment. This section will discuss the nine principal risks identified by FINMA for its supervised institutions and the Swiss financial centre over a time horizon of up to three years.

Risks associated with real estate and mortgages (→)

FINMA monitors mortgage credit risk closely. There has been a slowdown on the Swiss real estate market since the publication of the last Risk Monitor. The rate of price increases decelerated in the residential segment, while prices stagnated in the investment segment. However, due to the current environment and the rise in property prices over many years, the risk of overheating on the market remains high. ***The biggest risks for the institutions supervised by FINMA are in the areas of credit risk and market (i.e. valuation) risk.***

Mortgage lending by banks in Switzerland continued to rise and reached around CHF 1.2 trillion in June 2024; growth rates in the investment property segment are still higher than in the residential segment. Insurance companies and pension funds also engage in mortgage lending, but their market share is low at 3% and 2% respectively of the overall mortgage market. Insurance companies' market share has even been declining for several years. However, life and general insurers generally increased their exposure to real estate in the low interest rate environment of recent years. The volume of mortgages amounted to 24% of the investment portfolios for life insurers and 8% for general and health insurers. Life insurers therefore have a substantial exposure. In addition, real estate funds also invest directly in property. 75 Swiss real estate funds with net assets of CHF 68.45 billion are currently under FINMA's supervision. The Swiss real estate funds mostly invest in Swiss property.

Mortgage credit risk is two-fold:

- Firstly, there is a risk that customers are unable to meet their interest and amortisation obligations, resulting in a credit default for the lending institution. The risk of default is higher when affordability is worse, i.e. the higher the ratio of ongoing expenses (interest, amortisation and living expenses) to the borrower's income. Principles-based regulation of the affordability calculation has led to banks having considerable leeway with the affordability criteria, as they can define these themselves. **For example, FINMA frequently observes that the projected interest rate is set too low or the affordability limits too high.** This can mean that the banks overestimate borrowers' credit capacity. **On top of this, many banks grant too many ETP loans, i.e. loans that are outside their own lending criteria.** These are loans that are granted even though the borrowers' financial assessment deems them to be not affordable. Under the self-regulation system, these cases should represent an exception. **Overestimating credit capacity and frequent ETP business can increase credit risk and runs counter to cautious and prudent lending practices.** FINMA deploys its supervisory tools (see section "FINMA's supervisory focus", page 20) to understand the lending criteria at institutions that have come to its notice and will impose capital surcharges where required. However, the requirements for credit capacity and affordability are still principles-based even under the revised self-regulation. FINMA will continue to keep an eye on how principles-based regulation is being applied in this area and – depending on how the risks evolve – may consider imposing rules-based regulation.
- **Secondly, there is a risk that the value of the property that serves as collateral for the loan falls in the event of default and the lending institution therefore incurs losses.** The conditions for further price increases in the residential

segment are still in place. The Swiss economy is growing moderately, the rate of housebuilding is low, immigration remains consistently high, and inflation is falling. There are higher risks in the commercial property sector. Due to the continuing trends towards working from home and online shopping there is a process of structural change underway in the office and retail segment with high vacancy rates in some regions. To minimise valuation risk, financial institutions should value properties cautiously and require borrowers to put up sufficient equity and agree adequate amortisation payments. The banks' self-regulation only sets minimum standards in this area. **Due to the risks, FINMA recommends that the banks do not raise the loan-to-value ratios for investment properties, including buy-to-let mortgages.** FINMA conducted a survey of 27 banks and 18 insurers on real estate valuations and found that many institutions do not regularly validate or critically review the valuation models they use. Standards and requirements for valuation models are not covered by the Capital Adequacy Ordinance and are dealt with by the industry's own self-regulation. **The institutions have been informed that they are expected to carry out appropriate and regular validation of their models.** Under the revised self-regulation for banks, which enters into force on 1 January 2025, valuation models must be validated at least once a year. Finally, FINMA surveys show that the minimum capitalisation rates used to value investment properties are sometimes set at low levels, which can lead to high valuations. This in turn increases the risk of a downward revaluation of the properties pledged as collateral.

"A number of banks continue to grant mortgages based on unsustainable lending criteria or a high proportion of exception-to-policy business. There is also valuation risk, as property prices could fall, particularly in the commercial property sector where structural changes (e.g. working from home) have increased the risk of vacant office space."

Financial institutions that invest directly or indirectly in real estate are exposed to valuation risk, i.e. the risk of price movements. For insurers, the mark-to-market valuation of the balance sheet in the Swiss Solvency Test (SST) means that a downward correction in property prices reduces the value of assets and leads to a deterioration in solvency. In real estate funds significant corrections in property prices lead to rising borrowing ratios, which could result in the fund exceeding the maximum loan-to-value thresholds for real estate funds under certain circumstances. If the fund is confronted with redemptions by investors at the same time, liquidity risk also rises sharply. The fund can then be forced to raise liquidity in a challenging market environment to reduce the borrowing ratio and enable it to honour investor redemptions in a timely manner. This can often only be achieved by selling properties and can lead to the fund being liquidated in a worst-case scenario.

A real estate crisis would clearly have a serious impact on the Swiss financial centre. FINMA stress tests show that it could result in total losses of well over

CHF 10 billion. **A number of banks would hold too little loss-absorbing capital to cushion the losses from their mortgage portfolio.** The expected losses would be particularly high in the investment property segment, above all in the commercial segment. These segments are very interest-sensitive, which is why they also display higher loss rates in FINMA's stress scenarios. **Due to the risks, FINMA recommends that the banks do not raise the loan-to-value ratios for investment properties, including buy-to-let mortgages. Some banks are also active in real estate markets abroad, where interest rates have risen much more sharply than in Switzerland.** In these countries, valuation losses could therefore have a bigger impact on credit quality, and FINMA expects the banks to carry out appropriate risk management in the segments concerned.

Credit risk: other loans (→)

The lending business depends to a large degree on the general economic situation. Growing geopolitical tensions and unexpected monetary policy decisions could adversely impact the real economy and jeopardise borrowers' capacity to pay. This increases credit risk. ***Declining earnings and falling market valuations can lead to losses on Lombard loans and corporate lending.*** *However, this depends on uncertain economic developments.*

During the long period of low interest rates, lending volumes increased significantly and remain high. In spite of a slowdown in inflation, the macroeconomic environment remains challenging for the credit markets and will affect supervised institutions in the following ways:

– None of the Swiss banks is particularly active or exposed to the traditional commercial lending business outside Switzerland. Although globally active Swiss banks such as UBS lend to corporate clients outside Switzerland, they only do so on a relatively small scale. These loans (or loan facilities) are typically designed either to generate revenues from other business activities with these corporate customers (for example bond or equity issuance or advisory services). In this case, the risks of loan default remain at least partly on the banks' balance sheets. Alternatively, the banks bundle and syndicate these loans to investors. For example, UBS is particularly active in the leveraged finance segment which involves lending to companies for leveraged corporate acquisitions and syndicating these to investors. **This can involve risks, particularly if the market environment changes quickly and unexpectedly, and as a result the banks can no longer complete transactions within a reasonable timeframe.**
– In leveraged finance, UBS slightly increased its risk appetite after the takeover of CS. In the event of a deterioration in the macroeconomic situation

there is an increased risk of UBS having to selectively write down loans or no longer being able to sell them to investors at their face value.

- The **Lombard loan portfolio** makes up a significant part of the large **international banks**' assets. Due to the volatile markets, the securities pledged as collateral are exposed to large price movements, particularly downwards. **The haircuts applied by the banks to the value of this collateral may be too low, meaning that the loans may not be sufficiently backed by collateral**. If customers are unable to meet margin calls when the value of collateral falls, and the loans cannot be repaid by realising the collateral, this could lead to significant loan defaults and associated losses for the bank. Concentration risks can also arise if loans are secured against individual securities (single-stock lending) or less diversified collateral, or a large number of banks have extended Lombard loans against similar collateral.

"Declining earnings and falling market valuations can lead to losses on Lombard loans and corporate lending, particularly if market conditions change unexpectedly and timely settlement of transactions becomes more difficult."

- The **domestically focused banks** are heavily engaged in the Swiss SME and corporate lending business. **In the current market environment, FINMA expects them to identify rising credit risks in their loan portfolios in good time and take the action necessary to limit credit losses.** The current slowdown in the Swiss economy is having differing effects from sector to sector, but both the export-oriented and thus exchange rate-dependent sectors as well as a number of sectors dependent on domestic consumption are affected. Although rates of bankruptcy are currently rising, they are still below those that prevailed before the Covid pandemic. Apart from a few exceptions, there has not been a sharp increase in loan losses in bank balance sheets yet. This is partly due to the fact that the increases in interest rates in Switzerland were lower than in other countries and did not reach the scale that led internationally to significant stress on borrowers and falling market values in the commercial property sector. In the current economic environment, FINMA considers forward-looking and prudent risk management by the banks in the commercial lending business – including the early and comprehensive recognition of value adjustments using the parameters of an expected loss approach – to be particularly important.
- As earlier crises and the events surrounding Archegos demonstrate, non-bank financial institutions (NBFIs) can transmit significant shocks to the banking sector if they fail, as they are closely intertwined with it. This can trigger systemic risks such as spillover effects and herding behaviour – particularly if bigger or multiple NBFIs fail at the same time.
- While credit risk at banks materialises mostly through loan defaults, insurers and asset managers are more affected by credit downgrades or higher default rates among bond issuers. Insurers are less active in the lending business, but hold significant portfolios of fixed-income securities. These are subject to country and counterparty risk.

Market risk: credit spread risk (→)

Credit spread risk is the risk of losses due to changes in credit spreads. Credit spreads on corporate bonds initially continued to narrow at the start of 2024. However, in the course of the year they rose again, particularly for high yield borrowers. ***The continuing sluggish growth outlook, high sovereign debt levels, and geopolitical uncertainties could lead to a resurgence of risk aversion and thus higher sovereign or corporate spreads.***

Higher spreads on corporate or sovereign bonds can have a significant impact on supervised institutions.

- **In the event of a rapid and substantial widening of credit spreads, banks could experience direct falls in the value of their portfolios.** This would affect a wide range of financial products such as bonds, securitisations, and leveraged loans (loans to highly indebted counterparties).
- Furthermore, higher yield spreads can lead to credit valuation adjustments on derivative transactions. This can undermine the confidence of counterparties and customers and potentially spark outflows of assets and deposits.
- Banks can also be adversely affected if the cost of rolling over hedges against credit defaults increases.
- **Widening credit spreads on banks' funding transactions can have a severely negative impact on profitability.** This applies particularly to banks with a short-term funding profile, or if there is an idiosyncratic loss of confidence and an institution-specific widening of spreads.
- At insurance companies, substantial widening of sovereign or corporate bond spreads leads to a fall in asset values and thus capitalisation, as these assets are marked to market for solvency purposes (SST). Bonds held in tied assets are usually valued at amortised cost. In this case, the value of a bond is only affected if there is a deterioration in its creditworthiness or in the event of default, but not for movements in interest rates.

> "Higher sovereign or corporate credit spreads could lead to significant losses in the portfolios of supervised institutions. This could hit profitability and undermine confidence in them."

Liquidity and funding risk (→)
Liquidity and funding risk refers to the risk that in a crisis financial institutions will not have sufficient liquid funds to meet their short- to medium-term obligations. This can have various causes, such as elevated demand for collateral by counterparties, rating downgrades, inadequate or limited access to central bank liquidity, or increased demand for liquidity due to rapid outflows of customer funds. ***Furthermore, individual or systemic events can lead to trading partners and investors only providing liquidity on less favourable terms or even withdrawing liquidity.***

"A loss of confidence by investors can lead to a rapid outflow of liquidity and trigger a downward spiral that leads to a further deterioration in a bank's liquidity and could potentially destabilise the entire financial system."

The turmoil in the banking sector in 2023 and various historical banking crises have shown how significant the consequences of a crisis caused by liquidity shortages are.

- **If investors lose confidence in a bank's ability to meet its liabilities, this can quickly lead to a significant outflow of liquidity,** triggering a stress situation with an unstoppable downward spiral – a bank run – as other market participants also become more cautious and less willing to provide liquidity. **This can lead to a rapid deterioration in a bank's liquidity and – depending on the size of the bank or the number of banks affected – destabilise the financial system.** The turmoil in the banking sector in March 2023 highlighted a number of challenges for banks' liquidity risks. The challenges related in particular to the speed and scale of deposit outflows, the concentration in the funding structure as well as the role of social media and the digital financial system. Since 20 August 2024 around 60 of the larger banks have enabled their customers to receive instant payments, and this service will become mandatory for all banks from the end of 2026. The larger banks will gradually introduce outgoing instant payments, which could pose a further challenge to liquidity management, particularly intraday liquidity.
- Significant corrections in financial markets could lead to an increased risk of illiquidity at insurance companies. Falling market values of liquid assets reduce available liquidity. For insurance companies that are active internationally, issues such as a funding requirement for subsidiaries can put additional pressure on liquidity.
- The solvency calculation for insurers (SST) has a one-year horizon and requires insurance companies to be able to raise funding on the capital markets at short notice if necessary. If an insurance company suffers a significant loss during the year and the markets experience a substantial downward correction at the same time, this can lead to higher funding costs for the firm in question. Thus, insurers are heavily exposed to turbulence on the markets.

Liquidity risks for real estate funds with daily redemption and funds that invest in less liquid asset classes diminished due to the rate cuts by various central banks. However, some real estate funds still need to raise liquidity to meet redemption requests made by investors last year.

Market access (→)

Restrictions on market access or changes in access to important foreign markets have an impact on the profitability of Swiss financial institutions. The risk of restrictions on market access remained high in 2024.

FINMA is observing fragmentation in the regulation of certain financial markets, which contributes to a more restrictive market access regime. Furthermore, regulatory harmonisation, as in the EU's case, can put up growing barriers to firms from other countries, including Swiss financial institutions. In addition, the Swiss financial institutions often have to fulfil a long list of requirements before being granted market access. This can relate to obtaining legal opinions or the amount and frequency of information requested by the foreign authorities. The latter involves both the Swiss financial institution sending information directly to the foreign supervisory authority and disclosure and cooperation obligations between the supervisory authorities themselves, which market access is normally tied to.

There is a particular focus on the EU's access regime, as these are important markets for the Swiss financial industry. During the revision of the EU Capital Requirements Directive there were concerns that it would become mandatory for non-EU banks to set up branches within the EU, but this was avoided in favour of a compromise proposal. On the other hand, there has been a trend towards more stringent checks and additional requirements in the existing access regime on an equivalence basis. In addition, under the European Market Infrastructure Regulation (EMIR 3.0), EU banks will be required to maintain active accounts at EU-domiciled central counterparties (EU CCPs) and at least partly clear euro-denominated derivatives through these counterparties.

By contrast, the agreement with the UK on mutual recognition in financial services will lead to improved market access. The Swiss federal government adopted the dispatch on the agreement on 4 September 2024. The agreement is designed to facilitate additional cross-border business activities for Swiss financial institutions, particularly in asset management.

Overall, however, developments in the area of market access for cross-border business remain shrouded in legal uncertainty, which could give rise to additional costs for financial institutions and thus adversely affect profitability. These restrictions on the provision of cross-border financial services could lead to jobs being shifted abroad and thus cause lasting damage to the Swiss financial centre.

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. Money laundering risks therefore remained high in the year under review. ***Breaches of due diligence and reporting obligations can result in legal consequences and reputational damage for financial institutions both in Switzerland and abroad and harm the reputation of the Swiss financial centre.*** *Financial institutions must ensure they comply with the risk tolerance they have defined, which must be commensurate with their business activities, and mitigate the remaining risks effectively with suitable control systems.*

"Breaches of due diligence and reporting obligations can result in legal consequences and considerable reputational damage both in Switzerland and abroad. In particular, customers from high-risk countries continue to pose an elevated risk."

The Swiss financial centre has not been left unscathed by money laundering scandals in the past. A whole host of cases have shown that financial intermediaries' compliance capabilities must keep pace with the risks they incur. The annual money laundering risk analysis plays an important role in this. An effective anti-money laundering policy is based on the financial intermediary's executive management striking the right tone from the top and setting a clearly defined risk tolerance. This includes not doing business with particularly risky clients, countries of origin, or services. Firms must ensure that the tolerated risks can be monitored and limited effectively at all times.

Clients from high-risk countries (e.g. public officials or leading figures in state or quasi-state companies) pose particularly high money laundering, legal, and reputational risks. If large assets are accumulated in such circumstances, there is a risk of becoming involved in predicate offences to money laundering, such as embezzlement, bribery, or fraud. Stringent requirements must be set for the information to be obtained by financial intermediaries for such clients. The origin of the funds must be investigated in detail, and the institution must ensure that the funds derive from legal sources.

Alongside the money laundering risks in cross-border asset management, risks in the crypto space are becoming increasingly apparent. Cryptocurrencies are often used in cyberattacks or as a means of payment for illegal trading on the dark web. Some analyses have also shown a big rise in the use of stablecoins[1] for illicit transactions, particularly in relation to sanctions evasion (see also "Outsourcing", page 16 f. on sanctions). Money laundering risks can be considerable for financial intermediaries with a crypto offering. Financial intermediaries active in this area without adequate management of money laundering risk can seriously damage the reputation of the Swiss financial centre.

The conflict in the Middle East has demonstrated that preventing the financing of terrorism is an important task in financial intermediaries' anti-money laundering policies. Alongside money laundering risks, weaknesses in this area pose increased legal and reputational risks.

[1] See FINMA Guidance 06/2024 Stablecoins: risks and challenges for issuers of stablecoins and banks providing guarantees, 26 July 2024.

Sanctions (↑)

Risks associated with sanctions – primarily legal and reputational risks and operational risks – are high for Swiss financial institutions. Economic relations with Russia and Belarus are not expected to return to normal in the medium term. 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. ***Legal and reputational risks have increased considerably for financial intermediaries who deal with clients affected by foreign sanctions.***

The State Secretariat for Economic Affairs (SECO) is responsible for ensuring that the sanctions are enforced, while FINMA is responsible for monitoring the organisational rules contained in financial market law. The organisational rules require supervised financial institutions to adequately identify, monitor and mitigate all risks and establish an effective internal control system. This includes legal and reputational risks and dealing with Swiss and foreign sanctions.

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 goods trade. For a range of goods – particularly defence 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 SECO's interpretation, providing financial services and financing is not just prohibited for companies domiciled in Switzerland, but also applies to Swiss financial intermediaries performing these services for customers based outside Switzerland (see the SECO guidelines "Red Flags zu den Sanktionen im Zusammenhang mit der Situation in der Ukraine" [available in French and German only]). The risk is increased if the customer is based in a country that does not implement the sanctions on the Russian Federation or transactions are carried out via such countries. Due to the complexity of the sanctions on goods and the fact that a large proportion of the world does not apply the sanctions on Russia, it is a challenge for financial institutions to identify unambiguously when payments by corporate customers are covered by sanctions.

"Legal and reputational risks have increased considerably for financial intermediaries who deal with clients affected by foreign sanctions. Since last year, they have intensified for the sanctions on Russia in particular."

The risks relating to the sanctions on Russia have risen sharply due to the introduction of secondary sanctions by the US. Sanctions of this kind are designed to stop people outside the US from initiating or continuing to maintain a business relationship with the targets of unilateral US primary sanctions.[2] The risk relating to business relationships and transactions with persons sanctioned by the US is difficult to mitigate, and these customer relationships are regarded as very problematic from a risk management perspective. If the risks are realised, the consequences for the individual institutions and the reputation of the financial centre can be very serious. These customers are usually also people who are classified as high risk from a money laundering perspective, for example as politically exposed persons.

2 OFAC guidance.

Outsourcing (→)

Outsourcing of significant functions to third parties is a driver of operational risks at supervised institutions. Financial institutions are increasingly dependent on service providers to perform important or critical functions. Outsourcing has continued to grow in recent years due to digitalisation and a focus by financial institutions on their core business. It offers many advantages such as flexibility, innovation, and improved operational resilience. ***However, outages of critical functions and malfunctions at key service providers can also pose significant risks. In extreme cases they could affect the stability of the financial market.***

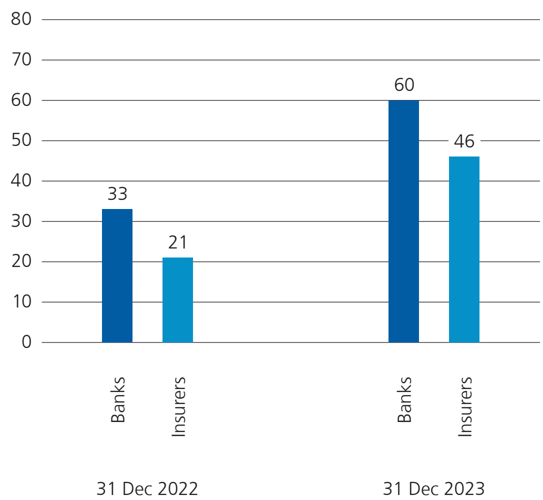
> "Outsourcing of critical functions to third-party providers remains a key source of operational risk in the financial sector. Outages or malfunctions at third-party providers, particularly in cloud services, could have a severe impact on the stability of the Swiss financial market."

Financial institutions have been using external service providers to perform core tasks for many years. Outsourcing has continued to increase in recent years, with a growing number of significant outsourced services per supervised institution. The number of sub-outsourcers is also rising, which means the supply chain is becoming more complex.

Financial institutions typically at least partly outsource business processes such as payments (65% of banks), settlement or IT infrastructure and operations (80% of banks, 60% of insurers). Nine out of ten banks report that they have outsourced at least part of a critical function to a third party. Hence, they are significantly dependent on third parties to perform their services and continue their business activities. They are responsible for monitoring the service providers and ensuring they take appropriate action where needed and maintain the availability of functions that have been outsourced to them. The fact that one in three cyberattacks on financial institutions are still directed via third parties underlines the risks involved (see the next section on cyber risks).

Many financial institutions outsource a small number of important functions to the same few service providers. One example is outsourcing of IT infrastructure, particularly the use of cloud services, which grew rapidly last year (see chart on cloud outsourcing below). This increases the operational dependence

Number of significant outsourcings to a public cloud service provider



Source: FINMA

of the financial market on this small number of service providers. **An outage or data breach at these critical service providers could have a very serious impact on the Swiss financial market.** A malfunction at a software provider in July 2024, for example, led to widespread outages of IT infrastructure worldwide. Although only a few Swiss financial institutions were directly affected, the case provided a vivid example of global vulnerabilities and the potential damage from such outages. It also showed that risks can emerge from any third party and not just from "significant outsourcing" as defined in FINMA Circular 2018/3 "Outsourcing".

Monitoring and managing service providers and the associated risks are critical to ensuring financial institutions' ability to function operationally. Responsibility for proper business conduct cannot be delegated and therefore applies equally to outsourced functions (FINMA Circular 2018/3 margin no. 23). Financial institutions must therefore have the knowledge to suitably manage and monitor the outsourced functions and be able to take action when needed. This is also required by FINMA Circular 2017/1 "Corporate governance – banks" (margin no. 60 ff.). FINMA has found that supervised institutions have room for improvement in identifying their entire supply chain and the resultant risks. In addition, the risks associated with significant outsourcing are not adequately identified, monitored, and controlled in some cases.

Cyber risks (→)

The Swiss financial sector continues to be a regular target for cyberattacks. The number of reports received by FINMA about successful or partly successful attacks increased by 30% compared with the prior year. ***Cyber risks remain among the main risks for the institutions supervised by FINMA, and the risk is at a consistently high level.*** *In FINMA Guidance 03/2024, FINMA highlighted key findings from its supervision of cyber risks.*

> "The Swiss financial sector remains a regular target for cyberattacks. Weaknesses in IT infrastructure, inadequate security measures, and lack of awareness increase financial institutions' vulnerability."

The Swiss financial centre remains a focus for international cybercrime, including for well-known international ransomware groups such as PLAY, AKIRA, and Lockbit 3.0. At the same time, with its increased supervision of smaller market players such as independent asset managers and untied insurance intermediaries, FINMA has registered a growing number of cyberattacks on these entities.

Supervised institutions across all supervisory categories increasingly reported cyberincidents in connection with business email compromise (BEC)[3] and forms of cyberfraud such as CEO fraud.[4] In some cases, the incidents involved large sums for the institutions concerned and their customers. SIM swapping attacks[5] were also reported to FINMA.

Email traffic remains the most common infection vector for smaller institutions in a cyberincident.

[3] See Business E-Mail Compromise (admin.ch).

[4] Fraudulent payment request from an attacker impersonating a senior manager, see also CEO-Fraud (admin.ch).

[5] Form of identity theft to circumvent multi-factor authentication, where a digital SIM card is created or stolen, see also Week 19: SIM swapping – how a SIM card can be stolen online (admin.ch).

Root cause analysis has shown that these supervised institutions had limited or less sophisticated cyber-protection arrangements in place. This encompassed both a lack of technical defences and an urgent need to raise awareness.

Inadequate processes to identify and repair software weaknesses within the technology infrastructure and gaps in configuration management were further entry points for attackers. For example, they were able to circumvent multi-factor authentication due to configuration errors or the institutions concerned were not using two-factor authentication across the board.

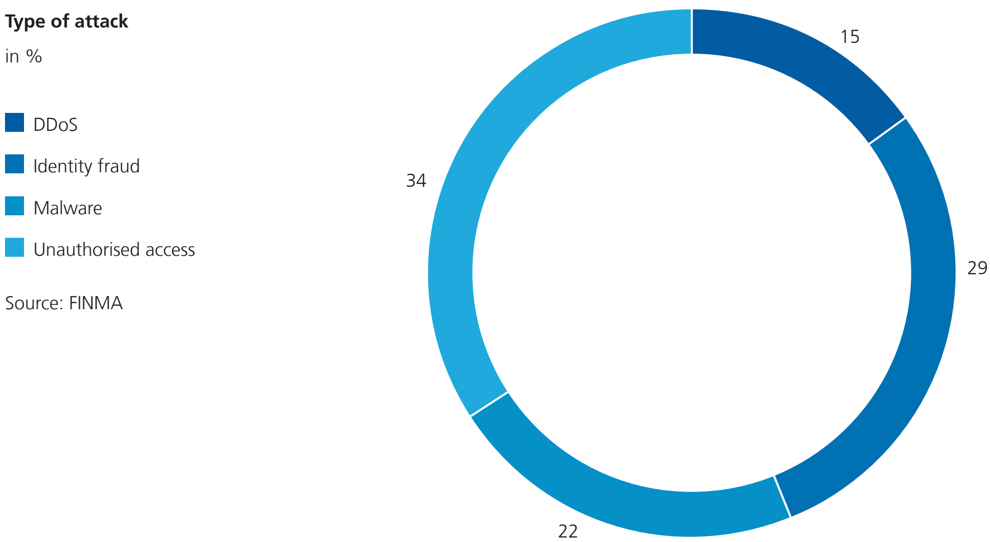
In many cases, the institutions did not notice the cyberattacks for a prolonged period. The attacks were carried out on outdated technological infrastructure that was no longer maintained and updated, or external service providers did not inform the institutions promptly. This indicates firstly that there are some serious deficiencies in the life cycle management of IT infrastructure. Secondly, it highlights weaknesses in cybersecurity policies in connection with service providers. The identification and reaction capabilities of the institutions remain key factors in handling cyberattacks successfully. This is underlined by the fact that a quarter of the incidents reported relate to infections with malicious software.

In the past year there have again been multiple waves of distributed denial of service (DDoS) attacks,[6] which led to services being restricted for Swiss financial market participants and their customers for limited periods. The attacks were mostly financially motivated and accompanied by blackmail letters. Critical infrastructures in Switzerland were also hit by ideologically motivated DDoS attacks.

Supply chain attacks and cyberincidents in connection with outsourced services and functions remain relevant and continue to account for nearly a third of all reported cyberincidents. It is safe to assume that cyberattacks on IT and communications technology supply chains will continue to increase. Supervised institutions therefore need to take technical and organisational steps to protect their main business processes and critical data.

Distribution based on cyber reports received by FINMA over the last twelve months

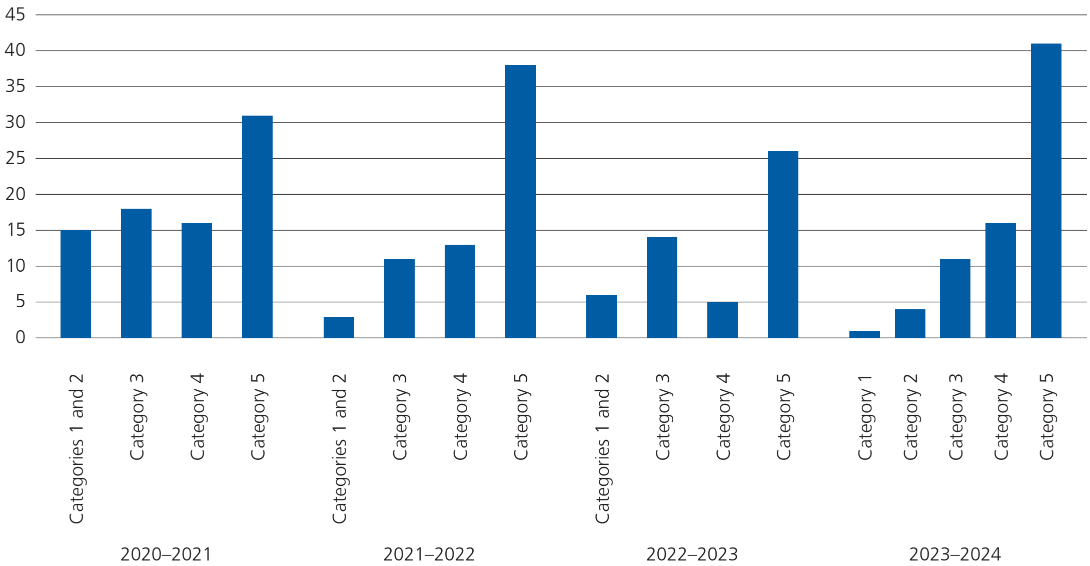
Type of attack
in %



Source: FINMA

[6] Attacks on the availability of technology infrastructure, see also Attack on availability (admin.ch).

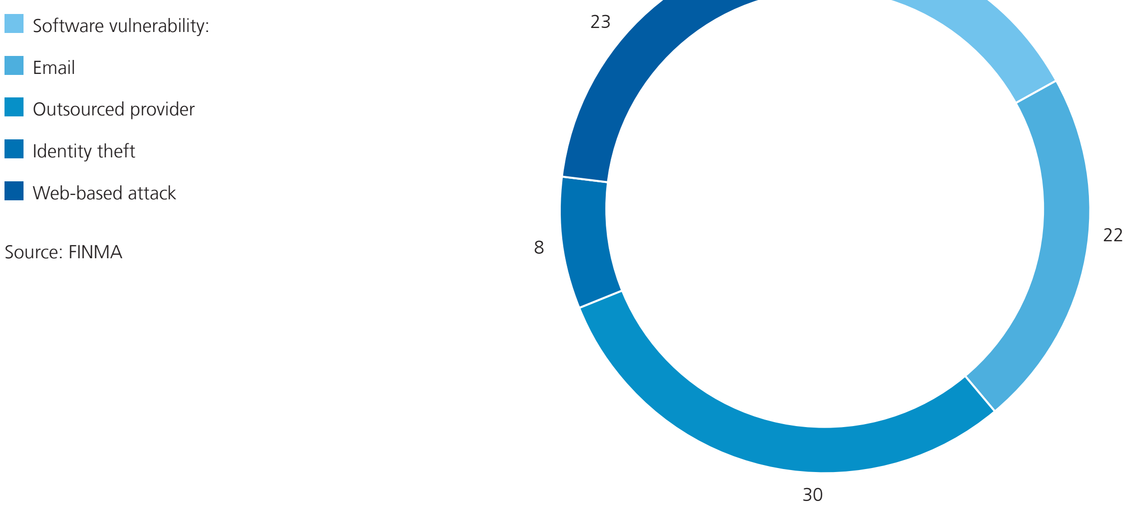
Reports of cyberattacks by supervisory category



Source: FINMA

Attack vectors

in %



Source: FINMA

FINMA's supervisory focus

FINMA aligns its supervisory focus with the risks discussed in this Risk Monitor. Important tools in supervision include regular supervisory discussions, on-site reviews, data surveys, stress tests, and, in the case of insurance companies, the SST scenarios. FINMA also makes targeted use of specific supervisory instruments. If it identifies weaknesses at a financial institution, it will instruct it to take appropriate action, for instance by requiring a bank to hold more capital or change its organisation or governance. FINMA also draws on the support of third parties in its supervisory work.

Credit risk on mortgages is a key focus of FINMA's supervisory activity. Due to the structural changes and initial market reactions **in the commercial investment property segment,** FINMA carefully monitors institutions that are heavily involved in this segment. In the course of its supervisory activity it gains an overview of supervised institutions' lending criteria, credit risk management, and strategic management in line with their risk tolerance. It deploys its supervisory tools (such as on-site reviews, stress tests, data analysis, etc.) to do so. **Depending on how the risks evolve, regulatory changes may be considered (e.g. rules-based regulation of affordability). At banks with major risks that do not have sufficient loss-absorbing capital, capital surcharges or other measures can be applied.**

In this context, FINMA **regularly evaluates data surveys.** In the insurance sector, for instance, it obtains detailed information on the real estate and mortgage portfolios annually. **At the same time FINMA carries out stress tests for portfolios of existing mortgages at selected banks using its own methodology.** FINMA examines what significant price falls or rate increases along with an economically unfavourable backdrop would mean for the banks concerned. It also conducts stress tests and scenario analyses in the insurance sector. In addition, if insurers have a geographical concentration of real estate exposure, they are required to aggregate a scenario in the SST and hold additional capital against it.

Credit risks are usually the main risk on the asset side of Swiss banks' balance sheets. This risk exists for all types of loans. Alongside the mortgage segment discussed above, **FINMA continues to monitor the leveraged finance positions at UBS intensively after the takeover of CS.** FINMA conducts supervisory discussions and on-site reviews on the corporate lending business in Switzerland and **monitors the Lombard loan business with a particular focus on risks that could emerge from concentrated or more illiquid collateral.**

The **risk of higher credit spreads** is another key topic in FINMA's supervisory dialogue. FINMA monitors this risk through its **regular loss potential analysis at larger institutions.** In addition, it will carry out a data survey on exposure to sovereign borrowers at the larger banks.

FINMA monitors banks' **liquidity and funding risks** on an ongoing basis and **carries out both regular and situation-dependent analyses.** This ensures that the supervised institutions are meeting both the quantitative and qualitative regulatory requirements. **In addition, FINMA regularly analyses compliance with the special provisions for systemically important banks.** If necessary, it defines institution-specific measures, which may mean imposing stricter requirements in certain circumstances.

FINMA pays attention to **market, legal, and reputational risks associated with access to foreign markets in its supervision.** It also assists the relevant political bodies in Switzerland in their efforts to ensure equivalence at a technical level and in the planned implementation of the mutual recognition agreement with the United Kingdom in the financial sector. Furthermore, like its partner authorities elsewhere in Europe, FINMA recommends prompt implementation of the Basel III standards as comprehensively as possible. This will not only strengthen the resilience of the banking sector but is also conducive to market access. In the insurance sector, FINMA also advocates that Solvency II equivalence is maintained.

FINMA monitors compliance with due diligence obligations in relation to **money laundering** through numerous on-site reviews across all supervisory categories. **The focus is on the definition and implementation of risk tolerance and risk management at financial institutions and other entities that have politically exposed customers or customers with links to state or quasi-state companies in high-risk business areas.** FINMA has completely overhauled the audit programme for supervisory audits by audit firms to bring the audits into line with changing risk profiles and make them more effective. In relation to digital assets, FINMA takes institution-specific measures to mitigate the money laundering risk. **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 high exposures.** FINMA coordinates closely with SECO on this issue.

FINMA monitors **outsourcing risk** by means of specific **on-site reviews – both at supervised institutions and service providers – and by evaluating supervisory and audit data.** The data quality and data points obtained in the surveys are reviewed continuously and may, where necessary, be changed to meet supervisors' needs. FINMA also actively monitors international developments in this area and participates in the discussions on developing potential risk reduction measures. One of the main areas of focus is the development of the Principles for the sound management of third-party risk (bis.org) as published by the Basel Committee (BCBS) and the broadening of narrowly defined outsourcing risk towards a comprehensive approach to third parties.

FINMA has also observed a trend towards a large number of institutions delegating certain services to small number of service providers, with this concentration itself giving rise to new risks. FINMA is seeking to raise awareness of the problem both in the financial institutions themselves and the service providers. **To identify concentration, FINMA obtains and analyses data on significant outsourcing by banks, insurers, financial market infrastructures, and other financial market participants** and defines supervisory actions based on this information. FINMA focuses first and foremost on outsourcing of critical functions in connection with the management of operational risks and ensuring operational resilience as defined in FINMA Circular 2023/1.

The FINMA Guidance 03/2024, published in June 2024, outlines the findings that have emerged from FINMA's supervision of **cyber risks** and clarifies the reporting requirements for cyberattacks set out in the prior FINMA Guidance 05/2020 along with the requirements in FINMA Circular 01/2023 "Operational risks and resilience – banks" on scenario-based cyberexercises (margin no. 70). Fund management companies and managers of collective investments were reminded of the general requirements for risk management set out in FINMA Circular 01/2023. Based on the findings in the two guidance documents, FINMA will put an emphasis on **data-based supervision and enhance its assessment of the maturity of supervised institutions' cyberprotection policies by deploying suitable tools, such as scenario-based cyberexercises**.

Abbreviations

BCBS Basel Committee on Banking Supervision
BEC Business email compromise
CCP Central counterparty
CEO Chief executive officer
CS Credit Suisse Group
DDoS Distributed denial of service
EMIR European Market Infrastructure Regulation
ETP Exception to policy
EU European Union
FSO Swiss Federal Statistical Office
IT Information technology
Margin no. Margin number
NBFI Non-bank financial institution
OFAC Office of Foreign Asset Control
SECO State Secretariat for Economic Affairs
SIM Subscriber Identity Module
SME Small and medium-sized enterprise
SST Swiss Solvency Test

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