FMA

Finanzmarktaufsicht
Liechtenstein

Trends, risks, and supervisory priorities 2022

Contents

As an integrated and independent supervisory authority, the Financial Market Authority (FMA) Liechtenstein supervises the financial market participants of the Liechtenstein financial centre. Through its supervisory activities, the FMA safeguards the stability of the financial institutions and the financial market as well as the protection of clients. In this way, the FMA strengthens the competitiveness and viability of the Liechtenstein financial centre for the future.

By exercising supervision, the FMA ensures that financial intermediaries adequately address potential risks. A key element in this regard is the assessment of the risk situation for the financial centre and the supervised financial intermediaries. The FMA's supervisory priorities are guided by the risk situation, strengthening resilience against the identified risks.

In this document, the FMA presents its supervisory priorities for 2022, updating certain priority areas defined for 2021. The FMA will monitor implementation of these priorities. The risks and supervisory priorities mentioned here are not exhaustive. Other risks not mentioned may also be important or – as in the case of the Covid-19 pandemic – may become important. Moreover, the FMA will always respond quickly and appropriately to unforeseeable events. It is important to note that these supervisory priorities do not cover the full range of work performed by the FMA, but rather serve as documentation of the issues on which supervision is focused.

These trends, risks, and supervisory priorities have been identified in a careful analysis of the market environment, regulatory developments, the Union Strategic Supervisory Priorities (USSP), the work programmes of the European supervisory authorities, the recommendations of the European Systemic Risk Board (ESRB), and the results of the supervisory activities of the FMA.

1. Risk-based supervision

In its supervision, the FMA pursues a risk-based approach that takes into account the potential macroprudential and microprudential risks as well as conduct risks associated with the supervised undertakings. In risk-based supervision, resources are deployed where they have the greatest impact and where the greatest threat to investors and financial market stability can be situated.

2. Current risk assessment

2.1 Market development

As a small and open national economy, Liechtenstein was strongly affected by the global economic downturn resulting from the Covid-19 pandemic, in light of the sharp decline in export activity at the beginning of the global recession.

Thanks to the gradual easing of restrictions, the economic outlook continued to improve in the first half of 2021, as reflected in the further improved GDP forecasts, even though uncertainly continues to be high about the ongoing economic impact of the pandemic. The Liechtenstein economy in general and the financial sector in particular have demonstrated remarkable resilience in this challenging environment.

The pandemic has intensified the challenges to the business models of banks, insurers, and pension schemes. While equity valuations of banks in Europe have returned to pre-pandemic levels, reflecting a recovery of the banks' profitability outlook, many structural issues remain. In general, profitability in the European banking sector continues to be subdued given the low interest rate environment, the high cost/income ratio, and the expected worsening of asset quality.

During the crisis, the Liechtenstein financial sector benefited from its high capital and liquidity buffers, which contributed to strong client confidence. Similarly to previous global downturns, the strength of the domestic labour market not only supported economic recovery, but also had a stabilising effect on the financial sector. This further supported Liechtenstein's reputation as a stable financial centre. Overall, the analysis of financial stability once again demonstrated the soundness and stability of Liechtenstein's financial sector, with systemic risks assessed as low.[1]

Financial markets are experiencing rising and in some cases record-high valuations across all asset classes, and the March 2020 setbacks from the Covid-19 pandemic have been compensated. Combined with massive price fluctuations in cryptocurrencies, increased risks in certain individual stocks (e.g. GameStop, Archegos, and Greensill), and high trading volumes, this raises questions about increased risk appetite among investors along with potential over-exuberance and overheating.

Fixed-income markets, like equity markets, are exhibiting persistently high valuations. While inflation fears and interest rate hikes could generate pressure on this asset class, high-yield corporate bonds continue to gain in value, manifesting the search for yield by many investors.

On balance, both the FMA and the European supervisory authorities have concerns about the sustainability of the current market valuations. Corrections cannot be ruled out, which makes increased vigilance in the risk management of financial intermediaries especially important.

2.2 Residential real estate and private debt

Compared with other countries, Liechtenstein has a strikingly high level of private household debt. With a debt ratio of 120% of GDP, private households are the most indebted of all EEA countries, and Liechtenstein also ranks among the top countries in terms of debt relative to disposable income. In contrast to many other countries, debt levels have continued to increase since the financial crisis. The main reason for the high household debt is mortgages. In absolute terms, Liechtenstein has the highest mortgage debt per capita in the world, with about 1,500 households owing more than CHF 1 million. The high level of private household debt harbours risks – both for the households themselves and for the banking sector.

While the vulnerability of the mortgaged asset and financing vulnerability are estimated to be low to moderate, the data suggest a high vulnerability in the household sector. Liechtenstein lacks reliable price indicators on the real estate market, in terms of both transaction and rental prices. However, the available data indicate a relatively high price level for real estate, with prices having continued to rise only moderately in recent years. Alternative indicators, such as construction activity and vacancy rate, also signal low to moderate risks to the vulnerability of the mortgaged asset, and imbalances are likely to be limited. Financing vulnerability is also limited in light of the decline in mortgage growth in recent years and high capital ratios in the banking sector. However, the vulnerability of households – i.e. of borrowers – is estimated to be high due to structurally high indebtedness. The high proportion of households with negative net financial assets, as well as numerous households with excessive debt-to-income ratios, point to substantial risks and vulnerabilities among households, which could materialise in the event of an economic downturn or rising interest rates.[2]

2.3 Money laundering

The Principality of Liechtenstein has a specialised, internationally networked and stable financial centre, which is of special importance for the national economy. Liechtenstein's domestic market is very small, which is why financial service providers are mainly active in cross-border business. The financial centre is accordingly heavily focused on providing services primarily for (wealthy) persons abroad. This international focus offers Liechtenstein financial market participants many opportunities, but also entails certain risks

[1] Financial Stability Report 2021, FMA, November 2021

[2] Liechtenstein Real Estate and Mortgage Market, FMA, October 2021

due to the persons and countries involved and the increasing complexity of business relationships. The financial centre has undergone changes in recent years, with the addition of new market participants (e.g. casinos) along with new digital technologies and novel business models (FinTech) in a wide range of areas. The FMA continues to assess the money laundering risk as high.

Violations of supervisory law can result in significant sanctions and reputational damage for financial institutions both abroad and in Liechtenstein. The FMA has recently identified several violations of money laundering regulations by various actors in the Liechtenstein financial centre. This shows that the risks for financial institutions in cross-border asset management business remain high. The use of domiciliary companies and complex structures increases the risk.

In addition to the known risks of cross-border asset management, however, new risks are also emerging with respect to blockchain-based business models. In light of the strategic emphasis of Liechtenstein's FinTech offensive and the trend towards new, digital business models, the risks of such companies must be analysed and monitored. Deficient money laundering prevention in the FinTech sector would have an especially negative impact on the reputation of the Liechtenstein financial centre.

Liechtenstein underwent a country assessment by Moneyval in 2021, the result of which was still pending at the time of publication of this report. Experience indicates that the assessment will result in a series of recommendations for further optimisation of the financial centre's defensive measures.

2.4 Environmental, social and governance risks (ESG)

Climate risks constitute a core risk for Liechtenstein and the financial centre. The Liechtenstein Parliament approved the Paris Agreement on climate change on 9 June 2017, committing Liechtenstein to reduce its emissions by 40% by 2030 compared to 1990 levels (instead of the previous 20%). The financial sector plays a key role in achieving the climate target.

ESG risks represent a significant challenge for the banks themselves. Investing ethically and sustainably and assessing asset and liability counterparties according to ESG criteria can greatly reduce risk exposure in private banking. Combined with a clear definition of ESG risk appetite, this is also a powerful tool in the reputational risk management of intermediaries.

The definition of risk appetite as well as the implementation thereof by means of ESG customer ratings is increasingly being demanded by global rating agencies as well as by investors.

Numerous intermediaries already have or are establishing a sustainability strategy (especially in producting) that largely incorporates sustainability risks and sustainability factors into the business strategy or good business management principles. A risk-increasing factor for the financial centre is the continuing lack of transparency and consistency, given that the regulatory requirements are still not sufficiently detailed. This increases the risk of "greenwashing".

Sustainable investments continue to be on the advance in Europe, as reflected in a 20% growth in ESG funds and the increase in sustainable bonds outstanding. Inflows into ESG funds have accelerated again, with impact and environmental funds being the fastest growing strategy. Given the popularity of sustainable investments – but also which clients a bank is associated with – three developments must be carefully observed. Firstly, due to demand, there is a risk of a "green bubble", i.e. an overvaluation of companies with sustainable business models. Secondly, research by the European Securities and Markets Authority (ESMA) has shown that sustainable investments have a lower expected return.[3] This could accentuate the search for returns and drive investors into even riskier asset classes.

Starting in 2022, the European Banking Authority (EBA) will increasingly focus on the holistic inclusion of ESG risks in the risk appetite framework of financial intermediaries. The focus will be not only on the intermediaries' products, but

[3] ESMA Report on Trends, Risks and Vulnerabilities, No. 2, 2021, S. 61.

in particular on the risk-oriented assessment of counterparties and their ESG characteristics.

2.5 ICT and cyber risks

The use of information and communications technology (ICT) by financial institutions and their clients has increased sharply in recent years. The Covid-19 pandemic has accelerated this trend. Digital client interaction and decentralised forms of work have become the norm within a very short time. But the widespread reliance on ICT has also highlighted vulnerabilities. The trend of attacks is clearly upwards. The number of attacks in the wake of the Covid-19 pandemic has increased significantly. Liechtenstein and its financial centre have not been spared from cyber attacks either. Specific incidents show that not only large institutions are affected, but also smaller companies have become the target of cybercriminals. Cyber incidents constitute a systemic risk for the financial system, with the potential to severely impact critical financial services and operations. It should also be noted that dependencies exist outside the regulated area as well. A failure of data providers (e.g. Bloomberg or Telekurs) due to cyberattacks would also have significant damage potential and must be taken into account by the risk management of financial intermediaries.

Decentralised forms of work and digital business models have increased the dependence on a smoothly functioning infrastructure. IT breakdowns or cyberattacks not only disrupt operations, but also impact the availability, confidentiality, and integrity of systems and data. They often lead to significant financial losses and reputational damage.

The FMA has taken into account the growing importance and increase in cybercrime and issued cross-sectoral rules for ICT security.[4] These rules apply effective 1 January 2022.

As part of ongoing supervision of banks, the FMA conducted a thematic examination of resilience against cyberattacks. The institutions must close the identified gaps.

2.6 Structural dependency

Liechtenstein financial intermediaries use the Swiss financial market infrastructure to a high extent. The most important components are combined under the umbrella of SIX Group – primarily the use of clearing and settlement services, custody of and the use of the settlement systems for securities (SECOM), and CHF payment transactions (SIC). Challenges arise from Liechtenstein's membership in both the Swiss franc currency area and the European Economic Area (EEA). Access to service providers or infrastructures in third countries is subject to increasingly extensive restrictions, generally requiring an equivalence decision by the European Commission. The suspended negotiations between Switzerland and the EU on an institutional framework agreement are also having a blocking effect on pending equivalence decisions. The exchange equivalence of Swiss stock exchanges was no longer extended, and the decisions regarding central counterparties and central securities depositories are pending.

The use of Swiss infrastructure without an equivalence decision on the part of the European Commission is limited to regulatory definitions of transitional periods. As time passes, the risk of losing access at some point increases. Liechtenstein financial intermediaries would be forced to use central securities depository services for the issuance of Liechtenstein financial instruments – such as funds – from another provider. Such a change would require considerable time and high costs. The FMA is raising awareness among the affected financial intermediaries so that they have exit strategies in place.

3. Supervisory priorities

Based on the risk analysis, the FMA defines its supervisory priorities for the coming two to three years. In addition to the cross-sectoral supervisory priorities, the FMA also sets targeted, sector-specific priorities each year, which are generally aligned with the supervisory programmes and strategic guidelines of the European supervisory

[4] FMA Guideline 2021/3 on ICT security.

authorities. This publication contains the cross-sectoral supervisory priorities.

Market developments and the interest rate environment continue to be the subject of the supervisory dialogue between the FMA and the supervised banks, insurance undertakings, and pension schemes. In particular, the strongly accentuating inflationary trends in the United States, including their potential impact on the global economy, must be closely observed. The FMA will also continue to focus on asset quality in the balance sheets of banks and on sustainable lending standards. The FMA will continue its intensive exchange with the supervised financial intermediaries on how to handle interest rate risks, and it will also discuss risk-oriented dynamic collateralisation. In the context of the low interest rate environment, generating sufficient returns is a crucial challenge, especially for pension schemes. Particular attention will be paid to ensuring that the conversion rate and the return on pension capital are adjusted to the market situation.

The implications of real estate market developments and private household debt for financial stability are continuously monitored by the FMA. The measures proposed in the Liechtenstein Real Estate and Mortgage Market report to address the medium-term risks to financial stability are to be elaborated in detail and implemented step by step in close cooperation with financial intermediaries and policymakers. The measures are structured into three major topic areas, namely (1) expansion of data availability and improvement of data quality, (2) promotion of risk awareness on both the borrower and lender side, and (3) a discussion on strengthening borrower-based measures, in particular with respect to income-based macroprudential instruments.

Money laundering prevention will continue to be a key supervisory focus of the FMA in 2022. The FMA will continue its consistent risk-based supervision as well as its proven supervisory strategy with both mandated and its own due diligence inspections. The audit programme specified by the FMA is oriented towards the risks and vulnerabilities identified in National Risk Assessment II. The inspections focus primarily on the following topics: (1) risk assessment, (2) appropriateness of business profiles (in particular, source of funds and source of wealth as well as documentation on effective contributors of assets), and (3) identification and verification of beneficial owners.

ESG risks will be a key supervisory priority in 2022. The prevailing lack of clarity and transparency will be further remedied with the help of regulatory requirements, and financial intermediaries will be required to implement the European requirements regarding sustainable investments and disclosure obligations. The further specification of the requirements for the disclosure of climate-related financial risks will increase awareness of the need to capture these risks. At the same time, financial intermediaries are provided with a concrete and legally secure framework for disclosure. This strengthens transparency and confidence in sustainable investments. The FMA will continue to closely accompany market participants, both through analyses of climate-related risks among Liechtenstein financial intermediaries and through guidelines and implementation aids. In the transition phase to a sustainable financial system, the FMA will focus its supervisory attention primarily on preventing "greenwashing", which is both counterproductive for achieving the ambitious climate goals and harmful to investors. In coordination with the Union Strategic Supervisory Priorities (USSP), the FMA will also pay attention to fee increases in order to prevent investors from incurring unjustifiably high additional costs when switching to sustainable investments. In addition, the FMA will increasingly focus on the integration of ESG factors and ESG risks into business and risk management processes (e.g. in lending, in ALM financial investments, and in relation to ICAAP/ILAAP in Pillar 2 risk quantification).

Entry into force of ICT Guideline 2021/3 is the starting point for various supervisory activities relating to ICT and cyber risks over the next two years. The FMA is paying particular attention to cyber risks. The FMA is focusing on improvements to the defensive measures as well as the ability to detect and manage IT breakdowns and cyberattacks. The FMA is also improving the information flow and data on cyber incidents in order to derive and communicate conclusions of general relevance for the entire financial centre.

A second focus is on the increasing outsourcing of IT services, including the use of cloud services. In 2022, the FMA will systematically ask the outsourcing undertakings what measures they have taken to limit or reduce IT and cyber risks.

With regard to Liechtenstein's structural dependencies on the Swiss financial market infrastructure, the FMA will continue to closely monitor risks. In coordination with the competent offices of the National Administration and policymakers, the FMA will make an effective contribution to securing the use of the Swiss infrastructure and/or reducing this dependency through alternative infrastructures.

Since the reform of the European supervisory authorities in 2019, they have been empowered to set Union Strategic Supervisory Priorities. These must be taken into account by national supervisors and help to achieve supervisory convergence among EEA Member States.

The 2022 supervisory priorities of the EBA include

- *Impact of the Covid-19 pandemic on asset quality*
- *ICT security risks and ICT outsourcing risks*
- *Aggregation of risk data*
- *ESG risk*
- *AML/CFT*

as well as digital transformation strategies and the impact of FinTech companies on financial systems.

ESMA is continuing its Union Strategic Supervisory Priorities already set for 2021:

- *Costs and fees of services and products*
- *Quality of the reported data*

EIOPA is also continuing its Union Strategic Supervisory Priorities already set for 2021:

- *Sustainability of business models*
- *Adequate product design, including monitoring of Product Oversight and Governance (POG)*

4. Abbreviations

ALM	Asset and Liability Management
AML	Anti-Money Laundering
CFT	Combating the Financing of Terrorism
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pensions Authority
ESMA	European Securities and Markets Authority
ESG	Environmental Social Governance
ESRB	European Systemic Risk Board
FMA	Financial Market Authority
GDP	Gross Domestic Product
ICAAP	Internal Capital Adequacy Assessment Process
ICT	Information and Communications Technology
ILAAP	Internal Liquidity Adequacy Assessment Process
IT	Information Technology
POG	Product Oversight and Governance
SECOM	Settlement Communication System
SIC	Swiss Interbank Clearing System
SIX	SIX Group; operator of financial centre infrastructure in Switzerland
USSP	Union Strategic Supervisory Priorities

Legal notice

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