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Eidgenössische Bankenkommission
Commission fédérale des banques
Commissione federale delle banche
Swiss Federal Banking Commission

Risk based supervision of small and medium-sized banks / securities dealers[1]

1 General information

In line with the two-tier supervisory system in Switzerland, the supervisory activities of the Swiss Federal Banking Commission (SFBC) are largely based on the work of external auditors governed by the Banking Act and the Stock Exchange Act. As an extended arm of the supervisory authority, they regularly audit the banks and securities dealers (institutions)[2] subject to supervision, thus fulfilling their role as direct supervisors. They submit a report with the results of their audits to the SFBC at least once a year.

Presented below is the flexible and differentiated procedure used by the SFBC in its supervision of the institutions licensed by it, aided by an early warning / rating system.

2 Strategy

The increasing complexity of banking transactions as well as national and international influences, often triggered by unwelcome events[3], have led to more stringent requirements for banks, auditors and even the supervisory authorities. Partly as a result of public pressure, this has led to tighter regulation in the financial sector worldwide.

Due to the two-tier supervisory system, the SFBC has limited staff resources in relation to the number of institutions it supervises. These resources have to be primarily focussed on institutions that require extra attention due to their risk profile. In order to implement this risk based approach in a consistent manner, the SFBC has developed an early warning / rating system similar to that employed by various foreign supervisory authorities, which it uses in its risk based approach to its supervisory activities.

Standardisation and IT support of routine processes now make it possible to deploy those limited human resources to more demanding activities and analyses (see figure 1).

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[1] Both major banking groups, UBS and Credit Suisse, are subject to a separate, specially tailored supervisory regime, which is not dealt with in this report.

[2] The auditing and reporting conducted by the audit firms and the supervision carried out by the SFBC takes place on two levels: licensed individual institutions and groups (banking and securities dealer groups). Where institutions are mentioned below, then the statements also generally apply to groups.

[3] Real-estate crisis of the 1990s, Enron, Worldcom etc.

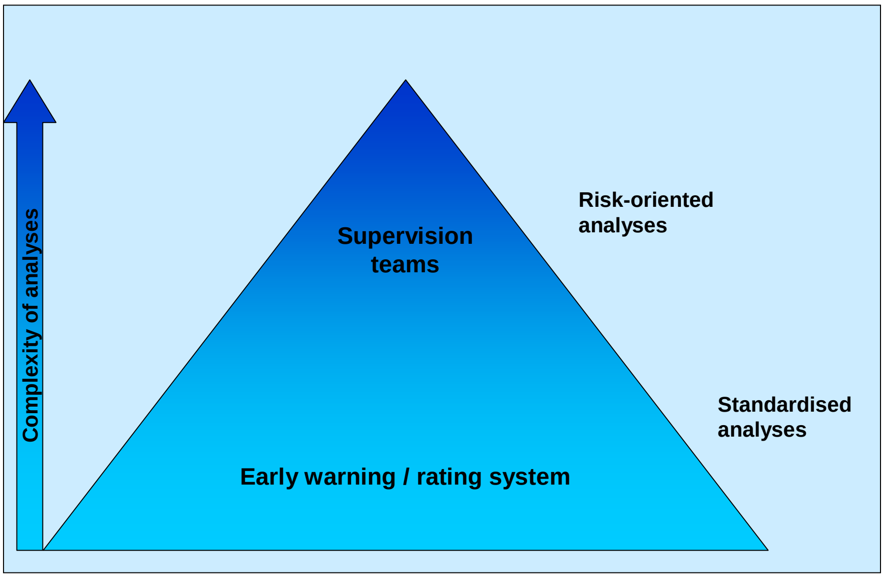

Figure 1 - Complexity

The institutions supervised are allocated to different supervisory classes. A different supervisory intensity is applied depending on the class involved.

In the first step, the institutions are divided into two groups. Institutions which, due to their size or public position for example, are important for the stability of the banking system in Switzerland, perform a service function for several institutions, in other words are of a cooperative nature, or which have strong international connections, are allocated to the group with increased supervisory risks. The other institutions are subject to normal supervisory risks. Each group is then further subdivided into three supervisory classes. Allocation to these classes is initially carried out by the early warning / rating system in a standardised process, and is verified by the supervision team in the next step. The relevant supervisory class then determines the intensity with which the individual institution is supervised. This process is depicted in figure 2.

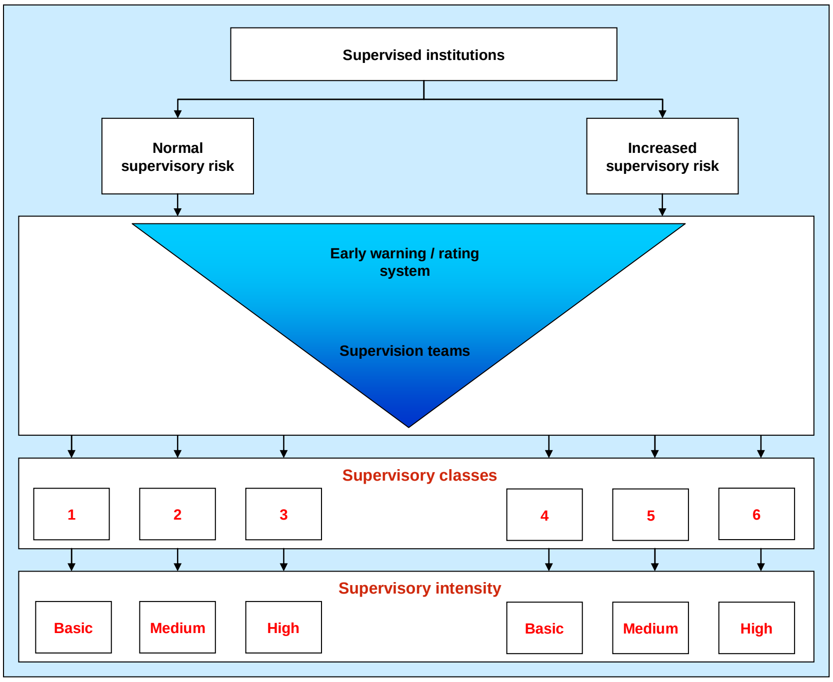

Figure 2 – Strategy for risk based supervision

3 Risk based supervision supported by the early warning / rating system

The early warning / rating system covers the largest part of the standardisation and IT support. The system is based on the internationally-recognised CAMELS approach. CAMELS stands for the following categories: **C**apital adequacy, **A**sset quality, **M**anagement factors, **E**arnings, **L**iquidity and **S**ensitivity to market risks. In each of these six categories both quantitative and qualitative information is processed. The quantitative data consist of key figures, which are largely drawn from the annual and semi-annual regulatory reporting[4]. These reports are supplemented by data from the capital adequacy report, interest risk report and liquidity statement. The SFBC obtains all of this quantitative data via the Swiss National Bank. The qualitative information, on the other hand, is obtained from the audit firms and derives from audit reports as well as various other findings from annual audits.

As the types and business activities of the supervised institutions in Switzerland are extremely heterogeneous, the institutions are separated into six peer groups[5]. This en-

[4] SFBC Circular 05/4 "Regulatory reporting" (information on the balance sheet, P&L and capital adequacy analysis, value adjustments and provisions, derivative financial instruments, client assets, privileged investments and minimal investments)

[5] Balance-sheet business; primarily balance-sheet business; advisory business; primarily advisory business; primarily trading business; universal bank

ables the SFBC to analyse individual institutions and also to make comparisons within the various peer groups.

The quantitative and qualitative information is differently weighted depending on its importance for the relevant peer group. This interaction is depicted in figure 3.

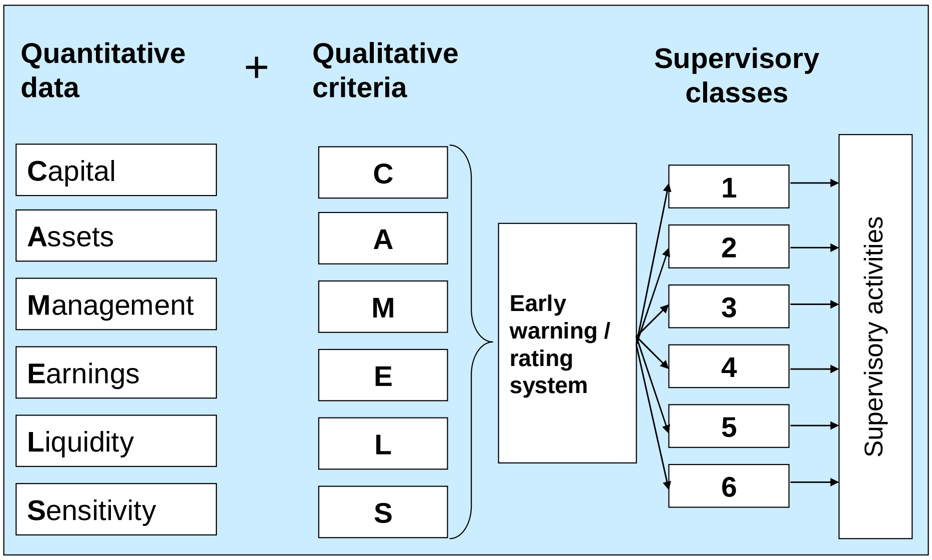

Figure 3 – Interaction

Based on the standardised early warning / rating system process, institutions are allocated to a supervisory class and also assigned a standardised rating suggestion. The various relationships in the peer groups mentioned above are very important for the rating calibration. As it is never possible to correctly reflect all the applicable factors using a standardised process, however, the supervision teams are responsible not only for the allocation to the valid supervisory class (see section 2), but also for reviewing and making any necessary adjustments to the standardised rating suggestion. The definitive applicable rating thus represents a snapshot assessment based on both objective and subjective measures.

The system displays all ratios and information for each CAMELS category and also provides standard evaluations. For their analyses, for instance, the supervision teams can see whether the supervised institution is in the best (green), second-best (yellow), second-worst (orange) or in the worst (red) quartile[6] of the relevant peer group for each CAMELS category (see figure 3). See the examples on "Earnings" and "Capital" in figure 4.

[6] A quartile is one fourth of a whole.

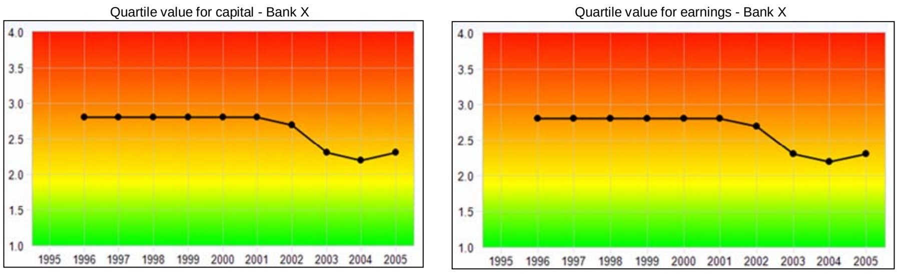

Figure 4 – Quartile values for capital and earnings for Bank X within its peer group

The early warning / rating system is thus a tool which fulfils several purposes at once and links them all together:

- Support for the allocation of institutions to supervisory classes according to which the risk based supervisory intensity of the SFBC is geared, in line with the strategy.
- Standardised analysis, for peer groups and temporal trends, of quantitative and qualitative criteria with a view to the early detection of potentially critical developments.
- Systematic positioning of individual institutions through the assignment of ratings.

As the early warning / rating system is primarily based on annual data, these functions are generally conducted, i.e. updated, annually. Naturally individual ratings and the allocation to supervisory classes can be altered at any time in response to new developments.

4 Risk based supervision by supervision teams

4.1 Existing practice

The work of the supervision teams is based largely on the audit report, which is one of the key information tools[7]. In line with SFBC guidelines[8], the external auditor compiles a risk analysis based on its knowledge of the activities of the institution and the environment within which it operates, uses this information to draw up an audit strategy, and carries out the necessary audits, broken down into regulatory audit and financial audit. It then presents its results in an audit report[9], which is compiled once per year. The re-

[7] The SFBC also has other sources of information at its disposal (circumstances requiring approval and reporting, annual reports, contacts with supervisory bodies abroad, information supplied by auditors and clients, articles from the press etc.)

[8] SFBC Circular 05/1 "Audit" (object of and procedure for annual audits)

[9] SFBC Circular 05/2 "Audit Reports" (form and content of the annual audit reporting process on the audit results)

port does not deal only with the annual financial statements, but also contains information on factors such as organisation and internal control, proper conduct of business by executive bodies, compliance with various regulations, the situation with regard to risk, assets, finances and earnings, and budgeting and planning. The summary also specifies whether a notice of reservation needs to be made with respect to certain circumstances and the deadline by which the institution must rectify any irregularities observed.

A close, three-way relationship essentially exists between the supervisory authority, auditors and institutions, although the type and frequency of contact may differ depending on the issues relevant for supervision. A range of risks may be uncovered within an institution by the analysis of the audit reports and the assessment of other information by the supervision teams. The consequences for the institution (based on the courses of action open to the SFBC) differ depending on the severity and may involve the exchange of letters, scheduling of meetings, additional audits, the appointment of investigators or even licence revocation proceedings.

The SFBC has thus always taken a differentiated approach to its supervisory activities, even before the introduction of the early warning / rating system and the implementation of the new strategy. In the case of major institutions (size, international connections etc.) or in the case of institutions deemed susceptible to risks, the supervision teams make it their top priority to analyse the information available and take the appropriate measures according to the situation at hand. By contrast, work in relation to smaller, well-organised and financially healthy institutions is given second priority, although audit reports are nonetheless subjected a complete annual analysis for the majority of institutions.

4.2 Future practice

The new method takes a more risk based approach. The supervision teams gear their activities to the supervisory class that they have determined on the basis of the results from the early warning / rating system. The individual steps involved have been defined and are set out in a handbook. The risk based approach provides for differing levels of supervisory intensity depending on the supervisory class.

Thus in the case of institutions belonging to supervisory classes 3 and 6 (normal/increased supervisory risk and "high" supervisory intensity, as per fig. 2), a close relationship is maintained with the institution's representatives and the auditors. The audit reports as well as any other additional reports and opinions that may be requested are analysed in depth and adequate measures are instigated for each case.

In the case of institutions belonging to supervisory classes 2 and 5 with supervisory intensity "medium" (standard), the supervisory activity (type and frequency of contacts with the institution's representatives and auditors, report analyses etc.) may vary within a certain bandwidth depending on the size, line of business and prevailing situation at the institution.

In the case of institutions belonging to supervisory classes 1 and 4 (normal/increased supervisory risk and "basic" supervisory intensity, as per fig. 2), however, contact with the auditors is normally only made once or twice per year, and with the institution's representatives sometimes only at their request. Moreover, in line with the risk based approach audit reports do not necessarily have to be completely analysed once per year. However, regular spot checks ensure that all institutions' reports are subjected to a complete analysis at set intervals and that the institutions' responsible bodies are contacted.

If information should emerge in the course of supervisory activities or from other sources that indicates the need for a reclassification, the supervision teams can transfer an institution to another supervisory category at any time and adjust the supervisory intensity accordingly.

4.3 Consequences for the institutions being supervised

For the institutions being supervised, nothing changes in terms of the audits carried out by external auditors or audit reporting. The important tool that is the audit report will continue to be supplied to the Board of Directors once per year. As mentioned above, however, the supervisory intensity on the part of the SFBC will increase considerably for various institutions. This may result in more regular contact with key individuals[10] throughout the year, or in the requesting and discussion of additional information beyond the scope of ordinary reporting (business performance, risk situation, strategic changes etc.). In the case of institutions with a lower supervisory intensity, however, contacts with the SFBC will occur once every year, every two years, every three years etc. (circumstances requiring approval and reporting will be unaffected by this). This takes account of the risk based approach required by today's business environment.

4.4 Communication of supervisory classes and ratings

In order to perform its supervisory activities, the SFBC relies on confidential information such as audit reports. The output of the early warning/rating system used to assess the institutions is also based in part on raw data not available to the public. For this reason it is not possible to make available ratings or supervisory classes to a wider audience.

During the contacts with institution representatives and auditors mentioned above, both the allocation to the supervisory class and the institution-specific rating may be communicated[11]. This enables those responsible not only to make a broader assessment of the situation, but also to measure it against their own evaluation. Moreover, it allows more targeted measures to be taken where necessary to make improvements in individual areas.

[10] Board of Directors, Executive Management, Internal Audit, Compliance etc.

[11] The rating communicated by the SFBC is intended as a tool and should be used for internal purposes only. It may not be published or used externally.