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Foreword

In tandem with the financial industry's expanding areas of activity, the scope of supervisory duties continued to widen in 2004. The density of regulation and supervision is increasing at both national and international levels. The buzzword occupying the attention of banks and regulators in equal measure last year, albeit from different angles, was overregulation. The banks fear rising costs and diminishing competitiveness. The regulators recommend taking a more relaxed and differentiated view of developments. The Banking Commission is aware of the prevailing concerns and endeavours to make a reasoned judgement as to whether and when new regulations are needed.

Compatibility with international standards

Not all regulation is really new, however. It often serves simply to record established practices or to modernize and harmonize an existing framework of rules. For the most part, regulation entails the implementation of international minimum standards. It should be remembered that the equality of regulation and compliance with international standards are prerequisites for access to foreign markets. At the same time, regulation can sometimes arise from market developments. For instance, closer cross-border ties between stock exchanges and financial market infrastructures can lead to an increase in the degree of intertwining of supervisory systems.

No uniform rules

The Banking Commission attaches particular importance to differentiated regulation and supervision. It takes account of variations in the size, complexity and risk profile of financial intermediaries and thus their differing needs.[1]

Differentiated regulation under Basel II

This insistence on avoiding uniform rules is especially apparent in the new Capital Accord (Basel II). In its implementation for Switzerland, the Banking Commission has even worked out two alternative forms of the standard procedure in order to cater to the needs of institutions with a national focus as well as those that are internationally oriented. Small and medium-sized banks do not face an unreasonable workload in connection with the changeover, while SMEs need not fear a credit crunch. The quantitative target of keeping Swiss capital adequacy requirements higher under Basel II, on the other hand, is paramount. Like Basel I, Basel II represents only a bare minimum, the lowest common denominator that could be agreed on by the supervisory authorities and central banks making up the Basel Committee. When it comes to protecting creditors and the system as a whole, a world-leading financial center cannot assume that this minimum will suffice.[2]

[1] see I/5
[2] see I/1

FINMA, the supervisory authority for Swiss financial markets to be created by the merger of the Banking Commission with the Federal Office of Private Insurance and the Money Laundering Control Agency, is a further example of how regulation does not have to mean overregulation and high costs for supervised entities. This reorganization of the supervisory apparatus would not heap additional financial burdens on the institutions that fall under FINMA's authority. FINMA is in fact an essential step towards a regime of financial market supervision geared to the needs of the 21st century. It unlocks synergies and allows a more balanced approach to overseeing identical or similar risks in banking and insurance. FINMA also makes it possible to ensure that the supervisory function enjoys greater independence in terms of administration and resources, which is an urgent necessity.[1]

Independent FINMA essential

A new body of regulation for investment funds is certainly desirable. The planned Collective Investment Act will enhance Switzerland's appeal as a financial center. It will incorporate the latest developments in the fund industry as well as the diverse protection needs of different investor groups.[2] Efforts to rectify the lack of serious competition with regard to fund pricing and introduce transparent rules governing the practice of granting rebates are motivated by the same goals.[3]

New Investment Act needed

The two-tier supervisory system is also set to be optimized. Four new circulars are aimed at reforming and harmonizing the audit process with a view to improved transparency and more effective treatment of risks. By stepping up quality checks of audit companies and carrying out its own audits of the two big banks, the Banking Commission hopes to strengthen the framework of indirect supervision.[4]

Optimization of indirect supervision

As far as the supervision of markets is concerned, Switzerland has no choice but to give its authorities more power and expand the legal definitions of financial market crimes. Current deficiencies are evident relative not only to the EU directive on market abuse, but also to international standards in the area of administrative assistance.[5]

More effective market supervision

The expectations placed on supervision, which are already high, will continue to rise, so the challenging task of balancing restraint in the degree of regulation imposed against calls for state intervention in real or supposed

Rising expectations placed on supervision

[1] see I/3
[2] see III/1.1
[3] see III/2.3
[4] see I/2 and II/3.1
[5] see I/4 and IV/1.1

problems can only get harder. Against this backdrop, the Banking Commission is working to develop its risk-oriented approach further and provide a clear picture of the scope for and limits on successful supervision.

These aims are at the heart of this year's Annual Report.

Dr Kurt Hauri Chairman	Daniel Zuberbühler Director

April 2005

1 Implementation of Basel II in Switzerland

The Basel Committee on Banking Supervision signed off the revised Capital Accord (Basel II) at the end of June 2004.[1] The Banking Commission, which has the task of organizing the technical details of how Basel II is to be implemented in Switzerland, intends to follow the lead of key foreign supervisory authorities as regards the entry into force of the new Swiss regulations. It is very much in favour of a pragmatic and differentiated implementation of Basel II that takes account of each institution's individual circumstances and needs as far as possible.[2]

Adaptation of Swiss legislation

Basel II can be implemented in Switzerland without amending the current Banking Act. As is already the case, the Federal Council will make the fundamental decisions and set the standardized risk weightings and capital adequacy rates via its ordinances. More technical details will be covered by SFBC circulars. The Banking Ordinance, however, is already bursting at the seams with comprehensive guidelines on capital adequacy and risk distribution. There is therefore no more room to include the full menu of Basel II procedures as well. As a result, these will have to be the subject of a separate Federal Council ordinance on capital adequacy and risk distribution into which the existing regulations not altered by Basel II will simply be incorporated unchanged.

Timetable

The national working group on the implementation of Basel II, which includes representatives of all interest groups concerned by the Accord, has met five times. A round of discussions on the new regulations, combined with a study of the quantitative impact on individual institutions, will take place in autumn 2005. Following this, the risk weightings will be fine-tuned. Since the majority of Swiss banks will opt for a simple procedure to calculate their capital adequacy requirements, the national working group's focus is on the implementation of the simple approaches outlined in Basel II. The new regulations will come into force simultaneously in Switzerland and the EU. This will happen on 1 January 2007 for the simple, standardized procedures and the basic internal ratings based approach ("Foundation Internal Ratings Based Approach, F-IRB"). The rules governing the Advanced Internal Ratings Based Approach (A-IRB) for credit risks and the institution-specific Advanced Measurement Approaches (AMAs) for operational risks will then come into force on 1 January 2008.

[1] see VI/2.1.2
[2] see Annual Report 2003, p21ff

Proven Swiss regulatory system

The Swiss regulatory system already permits more differentiated risk weightings as compared to the Basel Committee's first Capital Accord (Basel I). In fact, the risk weightings for mortgage and corporate loans – both of which constitute important areas of business for Switzerland's two internationally active universal banks – have been taken over directly from Basel I. The current Swiss regulations are actually a Swiss peculiarity and are in fact more lenient relative to Basel I for certain commercial mortgages with conservative loan-to-value ratios and for collateral (Lombard) loans. They are much more strict and differentiated, however, when it comes to interbank transactions and assets where no counterparty is involved (e.g. certain equity holdings, real estate and tangible fixed assets) due to the importance of such items in the Swiss financial system. The rules in these two areas have not changed at all under Basel II.

New, straightforward standard procedure

The Banking Commission does not believe there is any need to amend the existing Swiss regulations in areas that are not directly affected by Basel II. The regulations already in force are in many cases more stringent and more differentiated than the international minimum requirements. That said, changes to international minimum requirements brought about by Basel II will be incorporated into Swiss legislation. These include the easing of capital adequacy requirements for loans to SMEs, homeowner mortgages and the new "retail" category. The new Swiss standard procedure for credit risks is thus very closely based on the existing regulations, so it should be easy to implement and involve only a minimal workload for the banks when the changeover comes. This convenience is amplified by two factors: firstly, the risk distribution rules, which relate to the risk weightings used for capital adequacy, and the upper limits will be the same under the Swiss standard procedure; secondly, the new capital reporting standards will not be significantly different.

Capital buffer maintained

The Swiss banking system's capital buffer should be maintained at the current level under the new regulations. It should continue to be well above the Basel Committee's minimum requirement. The new Swiss capital adequacy benchmarks will be calibrated separately for the two big banks on the one hand and all the remaining banks on the other. If there is a reduction in capital adequacy requirements for the big two due to the use of procedures based on internal ratings, this must not be offset by higher requirements for the others. The average capital adequacy requirements for small and medium-sized universal banks, which operate primarily in the domestic retail business and whose books mainly contain loans to SMEs and homeowner mortgages, are not likely to undergo any substantial changes on account of the minimal changes in the new standard procedure for credit risks and the calibration of the simple procedure for operational risks.

Comparison pressure on internationally oriented banks

In addition to the big two, Switzerland has some internationally oriented banks and subsidiaries of foreign banks that will increasingly be publishing their financial statements in accordance with international financial reporting standards. These banks – or their foreign parent groups – are usually listed on the stock exchange and often have an external rating. They are thus monitored closely by financial analysts and rating agencies and judged against international standards. Most of these institutions have surplus capital, which means that saving on regulatory capital is not one of their foremost concerns. There is no obligation on the Banking Commission's part to calculate a BIS ratio in accordance with the Basel rules. However, the internationally active banks not only calculate their own capital adequacy requirements under Swiss law, they also calculate a BIS ratio in the interests of transparent communication vis-à-vis third parties, i.e. for better international comparability of their capital underpinning or for the purposes of consolidated reporting by a foreign parent.

Basel II pure

These banks have expressed a preference for waiving these double calculations under the new regulations and instead adopting the Basel II rules for calculating capital adequacy requirements without any changes. We refer to this as "Basel II pure". In order to accommodate this preference, the Banking Commission intends to give banks a choice under the new regulations between the current regulations, adapted in line with the Basel II standard procedure (Swiss standard procedure), and Basel II pure, provided they meet certain criteria with regard to the international focus of their business activities. In order to prevent capital arbitrage and distortions of competition within Switzerland and in particular to ensure that the risks attached to assets where no counterparty is involved (Art. 12b of the Banking Ordinance) and interbank transactions are provided for to a reasonable degree as they have been to date, the capital adequacy requirements under Basel II pure (known as the international standard procedure) must be weighted with a multiplier to ensure that they are at least as high as under the Swiss standard procedure. The desire for Basel II pure concerns only the standard procedure for credit risks. The implementation of IRB procedures envisaged in Basel II and all procedures for calculating capital adequacy requirements in respect of operational risks (basic indicator approach, standard approach and AMA) will be based on the Basel II guidelines.

Risk distribution guidelines

For banks adopting the Swiss standard procedure, the risk distribution guidelines will continue to be tied to the risk weighting rates for capital adequacy in respect of credit risks. For those adopting Basel II pure or an IRB procedure, the risk distribution guidelines will – as in the EU – in future be tied to gross positions that are not risk-weighted (with some exceptions).

Preliminary checks of the large banking groups

The Banking Commission has been holding regular talks with the two large banking groups with a view to testing the strict approval criteria for the complex, internal procedures. Intensive preliminary checks have already been carried out at both banks, focusing on the management of credit and operational risks. These preliminary checks have shown that there are no obvious problems at the big two as regards their internal implementation of the IRB procedures and the AMAs and that they are well on the way to receiving Banking Commission approval for their internal capital adequacy calculation systems by the end of 2007.

International coordination and cooperation between supervisory authorities

For internationally active banks, the implementation of Basel II across national borders may result in a very large workload due to differences in legal requirements from country to country (cross-border issues).[1] The Banking Commission plans to meet with the big two and the foreign supervisory authorities that are most important for them in 2005. The aim of the meeting will be to coordinate the checks undertaken by the various national authorities and thus minimize the workload for the banks.

Foreign banks in Switzerland

The Banking Commission in no way expects (let alone forces) foreign banks to apply an IRB procedure or AMAs. However, it also has no intention of preventing any foreign bank from adopting an IRB procedure if the supervisory authority in the parent group's country of domicile requires it to. In such cases, the Banking Commission would choose a pragmatic and risk-oriented approach in order to avoid potential problems with cross-border issues. Wherever possible, it will base its decisions on the findings from examinations made by the supervisory authority in the country of domicile and follow that authority's rulings. This simplified approach will be compensated for – not least in the interests of fair competition – by requiring foreign banks with IRB or AMA approval to still comply with capital adequacy requirements comparable to those that apply under the corresponding standard procedure (or the basic indicator approach for operational risks). This will iron out any discrepancies between the technical requirements placed on the group's internal procedure and those imposed by the Swiss regulations.

[1] see VI/2.1.2

2 Audit reform

New circulars welcomed

As part of its concerted effort to reform the audit process, the Banking Commission released its four new circulars for consultation: Audit, Audit Report, Audit Companies and Supervision of large banks.[1] Their general thrust met with a predominantly positive response. In particular, the risk-oriented audit approach, improved transparency, the separation of accounting audit from supervisory audit and the coherence of the circular package were welcomed. Criticism, meanwhile, was levelled at the circulars as representing a further addition to the flood of regulation. This is understandable given the sheer size of the package. However, the critics overlook the fact that it is for the most part simply formalizing established practices that have until now not been suitably documented – only part of the content is truly new. In the discussion of the circulars, the costs that would result proved a controversial point. Some persuasive arguments were put forward regarding potentially higher costs as well as some regarding cost reductions. It is proving difficult to arrive at a definitive assessment of the overall impact in terms of costs, which depends on how individual factors are weighted.[2]

Entry into force of circulars

While the "Supervision of large banks" circular already came into force on 1 June 2004 after the consultation process was completed, the other three are currently in a pilot phase with 23 banks and securities dealers.[3] This pilot is intended to optimize the quality and suitability of the circulars, to promote acceptance of the changes and to give a clearer picture of the cost impact, which is difficult to estimate. The three circulars should come into force in mid-2005, once any amendments deemed necessary have been made.

Working group's concluding report

The working group that prepared the circulars also submitted its concluding report to the Banking Commission in 2004, containing drafts of new articles of law and ordinances together with circulars based on these. The report provides an overview of the entire project. It additionally contains suggestions for updating and fine-tuning the current regulations on auditing banks and securities dealers and on the independence of audit companies as well as recommendations for auditing financial services groups and conglomerates (for which there has to date only been piecemeal regulation) and for monitoring audit companies. The reform proposals do not represent a complete upheaval of auditing practice. They are aimed at modernizing and expanding the regulations and giving them a more concrete form, although they do go beyond a mere update.

[1] see Annual Report 2003, p17ff
[2] see 5
[3] see http://www.ebk.admin.ch/e/archiv/2004/aktuelles2004.html

Difficulty in coordination

As the audit project progressed, it became clear that it was very difficult – and in some cases even impossible – to align it with other regulatory projects with a partially similar content. At the time the concluding report was submitted, the projects in question, namely those on the reform of financial market supervision[1] and audit supervision, had not yet been completed. Consequently, there was a lack of coherence and clarity of content in certain key areas, especially the prerequisites and procedures for licensing and monitoring audit companies. The project on the reform of financial market supervision has also created further overlaps concerning audits commissioned by the Banking Commission in addition to the statutory audit and situations that result in an immediate obligation on the audit company's part to report to the Banking Commission. Discrepancies could not be ruled out. With this in mind, publishing and implementing the reform package in its entirety while being forced to leave the various interfaces to the aforementioned, overlapping projects open seemed unwise. Such a move would be difficult to comprehend for those concerned and with an interest in the issue.

Step-by-step procedure

The Banking Commission therefore decided on a step-by-step implementation of the reform incorporating as much alignment as possible with the said regulatory projects. Proceeding one step at a time also represents a concession to the (over)regulation debate and makes the reform easier to digest. Temporary contradictions due to lengthy transition periods, however, may turn out to be a disadvantage.

Implementation at circular level

During the first phase, the circulars that do not contradict the existing regulations will be subjected to the usual consultation process and then implemented. This applies first and foremost to the "Audit", "Audit Report", "Audit Companies" and "Internal Monitoring" circulars. The discussion stage has already been completed for the first three, which have now entered a pilot phase. The consultation process is scheduled to begin for the "Internal Monitoring" circular in 2005. This circular will contain rules aimed at strengthening internal monitoring and control mechanisms at banks, securities dealers and financial services groups and conglomerates. In particular, it will set out requirements for the supreme management, supervision and control body or its audit committee, for the internal audit, executive management, compliance and risk controlling. It will also replace the current "Internal Audit" circular. Following the sign-off of the Insurance Supervision Act, the "Consolidated Supervision" circular is also to be implemented. It will summarize, explain and supplement where necessary the key provisions on

[1] see 3

consolidated supervision in order to create the requisite degree of transparency.

Implementation of the reform proposals in the Banking Act and the Stock Exchange Act, as well as at ordinance level as necessary, will not begin until clarity is achieved with regard to the content of the reform of financial market supervision and audit supervision projects.

3 Reform of financial market supervision

Back in December 2001, the Federal Council tasked a commission of experts headed by Professor Ulrich Zimmerli with drawing up proposals for a reform of financial market supervision.[1] The commission published two interim reports. A third and final report on the extension of prudential supervision is expected in early 2005.

Organization and instruments

The commission presented a draft Financial Market Supervision Act in 2003.[2] It envisages an independent supervisory authority, the Federal Financial Market Authority, FINMA, constituted as a legal entity in its own right. FINMA would assume the tasks of both the Banking Commission and the Federal Office of Private Insurance (FOPI). The legislative framework will not undergo any major material changes – the separate acts currently in force will merely be merged into the Financial Market Supervision Act.

Approval of FINMA organization

The Federal Department of Finance published the outcome of the debate on the draft in 2004. The basic concept of an integrated supervisory authority for financial markets was supported by almost all cantons, all political parties apart from the Swiss People's Party (SVP), the leading industry associations and other organizations. However, there were a lot of objections to individual aspects. For example, calls were made for a proper set of checks and balances between FINMA's governing bodies.

Fundamental agreement

The Banking Commission supported this idea and presented a number of proposals for improvement.[3] It fundamentally welcomes the advent of FINMA. Having a single authority will unlock synergies, for example by making better use of staff members' specialist skills and allowing coherent monitoring of identical or similar investment risks in banking and insur-

[1] see Annual Report 2002, p15ff
[2] see Annual Report 2003, p32ff
[3] see Annual Report 2003, p34ff

ance. FINMA will also enhance the independence of the supervisory apparatus in terms of administration and resources as demanded by international standards. The commission of experts has rightly not proposed harmonizing the legislative framework for supervision beyond organizational issues and the instruments used.

Green light from Federal Council

The Federal Council requested in November that the Department of Finance draw up a Memorandum for parliament outlining those elements of the Financial Market Supervision Act that deal with organization and sanctions by the end of 2005. In addition to the Banking Commission and FOPI, the Money Laundering Control Agency is also to be integrated into FINMA. As the Banking Commission had hoped, the Supervisory Board will play a more important role in strategic and fundamental questions. However, it will not be given the authority to determine, which the Banking Commission regrets. The draft limits the liability of both FINMA and the federal government. FINMA is to report in the first instance to the Federal Council rather than parliament. The Banking Commission will take part in the further preparatory work and endeavour to promote solutions that ensure strengths and synergies for FINMA, especially as far as resources are concerned. It will also attempt to promote its own positions within the scope of the Federal Council's parameters. This includes in particular the form of the secondary audits.

FINMA sanctions

The Department of Finance published the Zimmerli commission's second interim report, dealing with sanctions, in August. The report follows on from the Banking Commission's report on sanctions of April 2003.[1] The commission commented that the Banking Commission's proposals provided an "innovative basis for discussion", but did not adopt them. Although various European countries are taking a similar approach, the commission viewed the imposition of fines of a certain size in the context of administrative proceedings as problematic. It also rejected the procedural guarantees proposed in the Banking Commission's report on sanctions (e.g. contradictory proceedings before an independent sanction committee). It suggested instead that the administrative procedure, which the Banking Commission regards as insufficient, should basically be kept, but with increased fines and central powers of judgement assigned to the federal criminal courts.

[1] see http://www.ebk.admin.ch/e/archiv/2003/pdf/m030502–02e.pdf

Professor Zimmerli's expert commission also called for FINMA to wield new administrative instruments in respect of two particular points. On the one hand, it says that FINMA should be able to seize profits or the equivalent value of avoided losses from supervised institutions found to have committed major breaches of supervisory provisions. On the other, it wants FINMA to have the power to ban those responsible for such major breaches from holding a management role at a supervised institution for up to five years. In contrast to the Banking Commission's proposals, decisions of this nature would be made not by an independent sanction committee, but by FINMA's Supervisory Board or Management Board. Finally, FINMA should, according to the Zimmerli commission, be able to make final rulings public once they become effective in cases where major breaches of supervisory provisions have been identified. Under the commission's proposal, there would be a judicial right of appeal against such publication.

Seizure of profits, ban on professional activity, publicity

The Federal Council opened a discussion round on these proposals in November without communicating a position of its own. The Banking Commission was basically in favour. It acknowledged that the ideas it put forward in its report on sanctions had so far not received a positive response. Although they are largely in line with international standards, they are impossible to implement from a political viewpoint. In its position statement, however, the Banking Commission refuted the claim that the sanctions process contravened the European Convention on Human Rights. Nevertheless, it does support in particular the expert commission's proposals regarding seizure of profits. Likewise, it is in favour of the ban on professional activity, although it believes that those concerned should also be banned from holding a significant stake in a supervised institution. It therefore prefers the term "functional ban". The Banking Commission also thinks that sanctions should apply for more than five years in serious cases such as investment fraud. It welcomes the prospect of FINMA being able to publish rulings in cases where major breaches have occurred, but it regards suitable arrangements for providing information on FINMA investigations as more important than the use of such publication as a form of sanction.

SFBC's position

4 Market supervision

The Banking Commission's market supervision activities are essentially based on Art. 6 of the Stock Exchange Act: "The stock exchange monitors the pricing, execution and settlement of transactions undertaken in such a way that it is possible to identify when confidential information has been misused, prices have been manipulated or other legal provisions have been infringed. In the event that infringements or other irregularities are suspected, the stock exchange informs the supervisory authority, which arranges the necessary investigations."

Prudential supervisory approach

This point of law does not make it clear whether or to what extent market supervision is possible beyond the overriding principle of prudence. Art. 6 of the Stock Exchange Act provides no answer (positive or negative) to the question of which market participants – those not subject to prudent regulation included – fall under the Banking Commission's market supervision authority. In view of this situation, the Banking Commission has developed its market supervision since the Stock Exchange Act came into force in 1997 such that suspected abuses are comprehensively investigated, but administrative proceedings are only started when suspicions mount in respect of companies and persons under its supervision. In all other cases where there are sufficient grounds to suspect insider trading or price manipulation (Art. 161 and 161bis of the Swiss Penal Code), it forwards the relevant documents to the appropriate criminal investigation authority at cantonal level together with a criminal charge[1], as is its duty by law. This collaborative approach has established itself well. The criminal authorities appreciate the fact that they can base their investigations on documents and justified suspicions passed on by the Banking Commission.

Measures only taken in cases where banking supervision applies

The Banking Commission's market supervision remit, insofar as it includes the power to sanction those who contravene its regulations, must thus remain restricted to companies under its supervision. These include securities dealers, banks, stock exchanges, custodian banks, fund management companies, distribution agents and auditors as well as their corporate bodies. Any measures taken against an institution or its bodies are based on the requirement for proper conduct of business activities. They are limited to restoring compliance with the law. Added to this is the authority to impose sanctions on individuals who work in securities trading.[2]

Inequitable treatment of market participants

A substantial deficiency exists in the current market supervision regime in that the Banking Commission cannot fully investigate and take action against market participants not covered by its supervision. This limits the Banking Commission's effectiveness and credibility as the authority overseeing the market. Moreover, there is no equality in the treatment of regulated financial intermediaries on the one hand and the remainder of market participants on the other – not least because the provisions of supervisory

[1] see Art. 35 para. 6 of the Stock Exchange Act
[2] see Art. 35 para. 3b of the Stock Exchange Act

law that require an undertaking to ensure proper conduct of business activities go beyond the excessively narrow definitions of the two forms of financial market crime specified in the Stock Exchange Act.

Extension of market supervision

An extension of market supervision to all market participants thus seems justified. The Stock Exchange Act's purpose, namely to ensure the transparency and functioning of the securities markets, can ultimately only be achieved if sufficient, effective means are also included in the instruments of market supervision.

Expansion of sanctioning authority

On top of this, the opportunities for imposing sanctions within the scope of the supervision of institutions are insufficient.[1] Specifically, the Banking Commission lacks the authority to impose administrative sanctions such as fines or seize illegal profits. The revision of the definitions of financial market crimes and the centralization of criminal prosecution are not the subject of discussions on the legal foundation for the new regime of financial market supervision.[2] These issues are being dealt with by other committees, which are proceeding with the ongoing reform effort on the basis of the preliminary work of the working group on financial market crimes headed by Zug Cantonal Councillor Hanspeter Uster[3]. Their work on the revision of Art. 161 and 161bis of the Swiss Penal Code will use the 40 revised recommendations of the Financial Action Task Force on Money Laundering (FATF) as a reference point.[4]

Initiative to pursue further

It is not currently possible to foresee what will happen following the concluding report of the working group on financial market crimes. The Banking Commission's position is that the working group's findings on the material revision of Art. 161 and 161bis of the Swiss Penal Code and on the questions of procedure and authority should be taken forward rigorously. It has therefore made a request to the Federal Department of Justice and Police for an appropriate remit to be issued for a committee of financial market and criminal law specialists.

Lagging behind internationally

On an international comparison, too, Switzerland cannot escape the need to give the Banking Commission greater market supervisory powers and expand the legal definitions of financial market crimes. In material terms, Switzerland lags well behind the regulatory systems of other key markets,

[1] see SBFC report on sanctions and Annual Report 2002, p24ff
[2] see 3
[3] see Annual Report 2003, p98ff
[4] see IV/1.3

especially the new EU directive on market abuse.[1] Restricting the norm on insider trading to merger-like situations as price-relevant events is untenable and the circle of potential wrongdoers is too narrowly defined. The same is true for price manipulation, the legal definition of which is limited to fictitious transactions. Prices can of course also be manipulated via genuine transactions.

Hindrance of administrative assistance

These narrow definitions also serve to hinder administrative assistance, since Art. 38 para. 2 lit. c of the Stock Exchange Act specifies that double criminal liability must apply for information to be forwarded by foreign supervisory authorities to criminal authorities over and above the Banking Commission's consent (by agreement with the Federal Office for Justice).[2]

Furthermore, Switzerland has some catching up to do in terms of investigative methods and procedural law. The US Securities and Exchange Commission (SEC) is no longer the only financial market regulator with wide-reaching investigative and sanctioning powers. The EU's market abuse directive (directive on insider dealing and market manipulation) also requires that, irrespective of the judicial authorities' responsibilities, a single authority be in charge of monitoring compliance with the relevant rules and have all the necessary supervisory and investigative powers. In addition, it requires appropriate administrative measures to be taken in cases of market abuse or sanctions to be imposed in administrative proceedings. Under the EU directive, such sanctions must be "effective, proportionate and dissuasive"[3].

Swiss solution

The approach suggested by the Banking Commission's report on sanctions would meet these requirements. The Banking Commission therefore believes that it should be integrated into the reform efforts for financial market supervision and Art. 161 and 161bis of the Swiss Penal Code. It is certainly not suggesting that the EU rules should be copied word for word. However, if the current reform efforts, prompted by the FATF requirements, were limited to this, there is a risk that the much more urgent issue of improving the two criminal norms would be blocked for a long time. Parliament can hardly be expected to deal with the two articles twice in quick succession. Nevertheless, it would be problematic for the Banking Commission in its market supervisory function if its concerns were to be sidelined.

[1] see http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_096/l_09620030412en00160025.pdf
[2] see IV/1.1
[3] see http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_096/l_09620030412en00160025.pdf, Art. 14

5 Overregulation?

Public debate

The scope of regulation and supervision of the financial sector is increasingly a topic of discussion among the general public and in the media. That regulation is justified and beneficial to Switzerland as a financial and economic centre is not contested. At the same time, though, opinions differ as to what the right degree and timing of regulation should be.

Financial market regulation is necessary

As a leading financial center in cross-border private clients business, Switzerland needs a credible system of financial market regulation. Monitoring in accordance with internationally recognized supervisory standards is essential from the global perspective. The key rules here are those of the Basel Committee[1] and the International Organization of Securities Commissions (IOSCO)[2]. Equivalent regulation and compliance with international standards are prerequisites for access to foreign markets. The Swiss supervisory regime must therefore show itself to be as effective as those of other financial centres. The Swiss financial sector is particularly exposed on account of its law on bank-client confidentiality and its position in private banking. The extent to which international standards are complied with is checked and published these days by supranational organizations, as in the International Monetary Fund's Financial Sector Assessment Program (FSAP) and the FATF's Mutual Evaluations. Failure to comply damages the national industry's reputation and thus its competitiveness.

Not overregulated on an international comparison

On an international comparison, the Swiss financial sector is not overregulated. Certain other international financial markets have significantly more extensive and detailed regulatory frameworks than Switzerland. In addition, Switzerland eschews market intervention, unlike other countries. Rapid developments in the financial sector go hand in hand with the constant need to adapt regulation to new economic circumstances. On top of this, international standards are continually evolving, and Switzerland cannot ignore them if it wants to retain its status as a globally networked center of finance. Regulation for the most part involves implementing international minimum requirements. However, this cannot always be done without thinking. Instead, the material, temporal and political scope for preserving the financial industry's competitiveness must be assessed and exploited in each case. The Banking Commission only wants to go beyond international minimum standards in specific, strategically important areas. These include capital adequacy[3] and the fight against money laundering[4].

[1] see VI/2.1
[2] see VI/2.2
[3] see 1
[4] see II/1.3

Dialogue with banks

The need for regulation arising from developments at both national and international levels is essentially not disputed by the regulated parties. However, the number of regulatory projects currently in progress[1] is causing some to fear that banks will be called on to fund the cost of regulation by paying higher fees. The Banking Commission thinks it is reasonable and necessary to maintain dialogue with those concerned on the priorities and strategic aims of its regulatory plans. It therefore decided to hold regular meetings with bank representatives in order to set a course for new regulations at the earliest possible stage.

Promoting Switzerland via regulation

It must be remembered, though, that not all regulatory initiatives lead to extra regulation or additional costs for the banks and securities dealers supervised by the Banking Commission. Modernizing or harmonizing existing regulations, for example, can certainly not be seen as a case of overregulation. The Financial Market Supervision Act[2] would in fact create new supervisory structures at no extra cost to the regulated institutions. The absolute number of regulatory projects on its own tells us very little and is not an ideal criterion for judging the burden of regulation on the financial system. The (legitimate) need of those supervised for greater legal security and differentiated regulation that takes account of the specific features, size, complexity and risks of individual business activities and sectors leads more or less automatically to a more detailed regulatory framework, but this can have a positive impact on our financial sector's appeal. The implementation of Basel II is a good example of differentiated regulation.[3] The Book-entry Securities Act and the Investment Act, for instance, serve to modernize and promote the Swiss financial industry.[4]

Cost/benefit considerations

The cost of implementing financial market regulation has risen in recent years not only in Switzerland, but throughout the world as well. It basically makes sense to carry out a cost/benefit analysis before embarking on any regulatory project. This enhances people's awareness of the cost aspect, provides a basis for making decisions on the necessity and suitability of planned regulations and helps with working out alternatives. Reasoned consideration of the costs and benefits presupposes detailed knowledge of the project, including its corpus of data, economic scope and evaluation methodology, and is only really possible if everyone concerned is involved as much as possible, which is a major challenge. Even with a lot of effort put in, a cost/benefit analysis can only provide estimates, not exact figures. We

[1] see www.finweb.admin.ch
[2] see 3
[3] see 1
[4] see III/1.1

can hardly make an accurate guess in advance as to how much it will cost to implement a new regulation. Costs that would be incurred anyway even without the new regulation have to be removed from the equation. This makes it difficult to specify or even estimate the inherent costs due to such factors as loss of income, loss of competitive edge and innovations. Collective benefits can barely be quantified reliably in advance, if at all. Consequently, the Banking Commission does not believe that systematic cost/benefit analyses prescribed by law are a good idea, especially in view of their laborious and complex nature. They would undoubtedly delay the already slow regulation process further. Cost/benefit analyses should, however, generally be included in the regulation process within reasonable limits.

Improving the regulation process

The Federal Department of Finance's FinWeb site[1] shows how a range of financial market regulation projects are underway under the aegis of different authorities and commissioned by different parties. Several of these projects overlap with each other, increasing the need for coordination. The Banking Commission endeavours, within the scope of the opportunities open to it, to achieve better coordination of the regulation process and to define the phases and timetables of the individual projects as clearly as possible.

Relief through self-regulation

Self-regulation is steadily gaining in importance from the Banking Commission's perspective. It has essentially become established practice in Switzerland. It lightens the state regulator's workload, ensures proximity to the market and thus creates a solid foundation for maintaining the competitiveness of the regulated institutions. Recent examples of successful self-regulation are the Swiss Bankers Association (SBA) guidelines on the independence of financial analysis and the Swiss Funds Association (SFA) code of conduct. In order to be a viable alternative to state regulation, self-regulation must be properly aligned with it. This is done via a legal mandate for self-regulation in the area of stock markets and by the Banking Commission recognizing self-regulation as a minimum supervisory requirement.

New circular

In order to emphasize the importance of self-regulation, the Banking Commission has released the "Self-regulation" circular as a minimum standard. The circular names the SBA and SFA rules and regulations developed for the purpose of self-regulation and recognized as the minimum standard by the Banking Commission. The SFBC Circular 04/02 replaces Appendix I of the Circular 96/3 "Audit Report". Audit companies must check on a risk-oriented basis whether the self-regulation prescribed as the minimum standard is complied with and must publish their findings in the audit report.

[1] see www.finweb.admin.ch