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# Supervision and regulation – or on the smithing of iron

On the smithing of iron… these words evoke powerful images, that do not a priori bring us back to thinking about supervision... indeed so as the smithing of iron triggers recollections of blaze and embers, handicraft, as well as artful ironworks. And the dance of the sparks bursting between hammer and anvil. The question rises: who takes on which part? Who guides the hammer? Who is the anvil? Who is entitled to the collecting of the hot iron? And here we get closer to supervision. It makes thus sense to clarify this distribution of parts between the supervisory authority, the supervised bodies, the professional associations and last but not least the self-regulation. True the supervised bodies tend to see themselves as belabored ironwork or else feel like the anvil, albeit fancying themselves as the smith. No less does the supervisory authority claim its belonging to the guild of blacksmiths. Whereas the self-regulators fear their fading away in the welding of these fronts.

## The smithy

The way I see things is the following: the piece work, the tool steel, is the Law, and the accompanying cortege of ordinances, circulars and guidelines, all – I hope – are the proceeds of a creative process. Now both the legislature and the supervisory authority forge and sculpt these into the appropriate shape by being the hand behind the hammer. Their task is to pound and hammer and they know that nothing of use is to come out in the absence of a counter-force, the anvil. In the part of the anvil, I picture the professional associations. Indeed so as they no less contribute both as self-regulators and partners to the final design. And what about the regulated bodies? In this picture of mine, they are the final recipients, who in turn will pound and carve the proceeds into their own organisations. They collect and take the ironwork over, being careful not to bend it for only unbent does it warrant security and shelter.

**Irons in the fire**

There are currently a number of irons in the fire. They are at different temperatures and are being worked purposefully. Let us start with the Collective Investment Act, a legislation piece genuinely promoting our financial marketplace – Vice-Chairman Jean-Baptiste Zufferey will say more on this later. Then the implementation of Basel II in Switzerland, a case example of customised legislation – more on this from Director Daniel Zuberbühler. Now then there is the market conduct issue, still to be clarified. As a result of an in-depth analysis of the outcome of the consultation on its draft circular on market conduct rules as well as after extensive discussions with representatives from the Swiss Bankers Association and the SWX Swiss Exchange, the Banking Commission set up a working group in January of this year including representatives from both partners under its lead.

The working group's task is to establish a viable basis for the circular. It will thus extend its sight beyond national boundaries. The aim is to investigate the developments in terms of fight-against-market-abuse that have taken place within those financial marketplaces directly competing with Switzerland. It will analyse both the implementation and the application of the measures taken in those markets. The working group is also assessing the options for the prompt deletion of paragraph 3 of Article 161 relative to insider-dealing in the Swiss Penal Code. Indeed the goal is to remove, as swiftly as possible, the excessively restrictive provision that limits the current application of criminal sanctions with respect to insider dealing in the context of abuse of information in mergers issues or in any similar cases. In particular, this legislative move would extend the application of criminal sanctions to cover the abuse of information related to profit warnings.

You may well be asking yourselves why I have chosen to mention this particular iron piece today. The answer is simple: this is just because I have this issue at heart. Market abuse contradicts our understanding of an ethical conduct of affairs and as such we deem it wholly unacceptable. Anyone seeking involvement in our financial marketplace must abide by ethical principles and, in my opinion, satisfy very high standards. This also includes practising credible governance. The Banking Commission submitted a draft circular on internal monitoring and controlling to this end for consultation a year ago. This draft triggered varied and at times fierce reactions. A constructive dialogue with the Bankers Association was thus established in which views were exchanged and eventually differences ended up in being reconciled. A revised circular is now due to come into force on 1 January 2007. It differs from the original draft in a number of areas, and in particular in the following:

It contains no rules on whistle blowing for the Parliament will be taking up this issue and its remit will go far beyond what is relevant for the financial sector. In addition, there are changes with respect to the definition of what is understood by an "independent representative". The circular now stipulates the following: an individual, proposed for a position on the Board of Directors of some institute, should not have been active within that institute during the last two years. This should be contrasted with the formulation in the draft circular, where the Banking Commission had called for a three-year qualifying period. The new provision is in line with the rules on independence in the planned law on

audit supervision. Furthermore, only a third – and not, as originally proposed, a half – of the members of an institution's Board of Directors now have to be deemed independent. The "size" criterion with regard to the establishment of an audit committee has also been removed. It is now no longer mandatory, in order to establish such a committee, that the Board of Directors have more than eight members. Moreover should an audit committee be established, then only a majority of its members must be independent. Finally the internal audit function does not necessarily have to report to the audit committee. Private bankers are wholly exempt from these regulations. Greater flexibility has also been created for a number of other provisions through the use of a "comply or explain" clause. In view of the impending entry into force of the revised circular, the Bankers Association has decided to dispense with its own internal control guidelines.

The publication of this circular as well as others by the Banking Commission does not however mean that the task is now complete. Market participants should both constantly and critically review the solutions implemented and ponder upon their practical application. Electing to avoid making the proper adjustments on the mere grounds of incurred potential costs will not be acceptable; there are broader expectations to be met. In this respect, the Banking Commission defends itself of just prescribing that supervised institutions only mark checklists in order to comply to regulation. On the contrary it requires that responsible management teams constantly re-evaluate the appropriateness of the solutions implemented in terms of their chosen business model and moreover expects them to adapt to changing circumstances. Indeed the Banking Commission, in its function of supervisory body, expects all institutions to think and act in a highly responsible fashion.

**A blacksmith with muscles**

A blacksmith needs muscles, and not just because of the weight of his hammer. He needs plenty of strength for only so is he assured to apply the appropriate hammering and pounding that shall bring the iron into the desired shape. And similarly only a strong supervisory authority may provide a handling of affairs that is forward-looking, oriented towards the needs, economically sensible and understandable and thus, capable of warranting the good reputation and competitiveness of the financial marketplace under its jurisdiction.

A forward-looking handling of affairs means identifying market trends and developments at an early stage and being able to understand them. I am thinking, for instance, of developments in the area of credit derivatives and hedge funds. A forward-looking handling of affairs also means correctly assessing the need for action in response to international developments. It is crucial to act neither too early nor too late and the regulator definitely must master the art of timely intervention.

An oriented-toward-needs handling of affairs means stepping in where there are genuine risks. But then since the nature of risks changes over time, the supervisory authority must by all means keep pace with these changes. An oriented-toward-needs handling of affairs means market proximity as well. Indeed so, as regulations have to be developed in close cooperation with those they affect, that is with those that will ultimately

implement them. Last but not least, an oriented-toward-needs handling of affairs also means regarding the tasks to be carried out as a service. Clearly the Banking Commission must be service-oriented, reliable and efficient.

An economically sensible handling of affairs means not only creating new regulations, but also revising outdated ones as market conditions evolve. It means accounting both for costs and benefits (80/20 rule), evaluating alternatives and issuing rules with the appropriate level of complexity. For, after all, what we aim for by the way of regulation as well as through the pursuing of dialogue with those we supervise, is only to create value. Ultimately we may fulfill this aim only if we are perceived as a genuine sparring partner.

Finally, an understandable handling of affairs means that we act in a logical, transparent and simple manner, putting forward convincing arguments and ensuring active, objective and direct communication.

**The happily diligent blacksmith**

Every man is responsible for forging his own destiny. This holds true for the financial marketplace as a whole, as well as for individual market participants; but it is no less true of the supervisory bodies. And indeed the Banking Commission is happy when it achieves the goals it sets for itself. Our ambition is to carry out the mandate we have been given to the best of our ability. And to be sure our action will be deemed fruitful as long as our work is respected internationally, as long as the international competitiveness of our financial marketplace can be further strengthened, and as long as our influence can help to prevent any serious "mishaps" that could damage those very players, namely investors and creditors, in need of our protection. Our "customers", that is the institutions we supervise, should view the Banking Commission as a competent authority, should take note of what it says and should ultimately value their cooperation with it. And therefore the Banking Commission will aim at reviewing the appropriateness of its practices at regular intervals; for a good reputation can only be sustained if everyone delivers its part accordingly.