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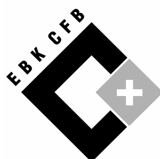

Eidgenössische Bankenkommission
Commission fédérale des banques
Commissione federale delle banche
Swiss Federal Banking Commission

Media Conference, 27 March 2007

Speech: Daniel Zuberbühler
Director of the Swiss Federal Banking Commission

Risk based supervision – implications for our stakeholders

One concept that features prominently in current trends and discussions on the regulation and supervision of financial markets is risk-based supervision. The draft of the Federal Act on Financial Market Supervision actually grants it a law-like status[1] according to the regulatory principles to be observed by FINMA, the future integrated financial market supervisory authority. FINMA recognises in particular "the divergent business activities and risks of the supervised institutions" (Art. 7 para. 2 (c)). In practice, however, the principle of risk-based supervision is already enforced in the "Guidelines for Financial Market Regulation", as issued by the Federal Department of Finance in September 2005[2]. And to be sure, the SFBC's own regulatory duties (ordinances and circulars) and primarily its ongoing supervisory activities have been guided by this principle for even longer. We are constantly refining the risk-based approach and applying it ever more systematically and consistently. The most recent step involves the risk-based supervision of small and medium-sized banks and securities dealers, implemented since 1 January, on the basis of the SFBC's own early warning and rating system. We provide comprehensive information on our website regarding the functionality of the system and the six derived supervisory classes.[3] This detailed information is primarily aimed at the financial intermediaries subject to our supervision, and their audit firms, as the institutions directly affected. However, we also intend to inform the public and the political establishment (the beneficiaries and contacts) about the meaning and consequences of risk-based supervision. The traditional media conference for presentation of the SFBC Annual Report provides a suitable platform.

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[1] see. http://www.efd.admin.ch/dokumentation/gesetzgebung/00570/00859/index.html?lang=de

[2] see http://www.efd.admin.ch/dokumentation/grundlagenpapiere/00818/index.html?lang=en

[3] see http://www.ebk.admin.ch/e/dossiers/risikoorientierung.html

What do we mean by risk-based regulation and supervision? The aim of financial market supervision is to protect both the financial system and the consumers of financial services (who in terms of the SFBC's remit are chiefly creditors and investors) against financial and reputational risks that are undesirable for both the economy and society. It cannot – nor is it designed to – enforce a zero-tolerance policy that excludes all risks, because this would hamper business activity and prevent the appropriate levels of income and innovation. The resources available to financial intermediaries and supervisory authorities for the purposes of risk control will always be limited, which is the desired objective. Thus these limited resources should always be allocated so as to optimise the relationship between cost and benefit, which means targeting them at areas where the risks are highest – in terms of the potential damage and the likelihood of it occurring – and where there is an increased need for protection for the financial system, creditors and investors. The decision to forego uniform, blanket monitoring presupposes boldness with respect to loopholes and acceptance of minor incidents.

In theory, nobody would disagree with the idea of a risk-based approach. However, following specific cases of money launderers slipping through bank security procedures, or market abuses remaining undetected or even financial intermediaries becoming insolvent, observers have been all too quick to conclude a failure on the part of the supervisory system (regulatory norms, audit companies, financial supervisory authorities) and demanding more regulation and more intensive controls. In such instances, little consideration is given to the potential overregulation and pedantic supervisory perfectionism that all this could cause. We therefore consider it essential that the media – the brokers of information to the public – should understand that we cannot supervise or pursue all cases to the same degree, and we will not always set our priorities to match those of the daily media. Even our own supervisory personnel are having to rethink their procedures; abandoning proven routines in favour of a differentiated supervisory intensity – e.g. by foregoing detailed analyses of audit reports for small institutions with low risk ratings.

Risk-based approaches have already been implemented in many areas of supervision

The authorised **audit firms** are obligated to provide an unambiguous statement to a long list of checkpoints as part of annual audit reports. However, given the volume and increasing complexity of business activities and the abundance of rules and regulations, it is unrealistic to expect all required audits to be performed to the same degree of intensity. Audit companies are therefore obligated, as of financial year 2006[4] , to begin annual audit planning for all banks (or securities dealers) by performing a systematic risk analysis and deriving a subsequent audit strategy. Audits are performed with varying intensity and security requirements, in line with risk content: audit (for maximum risk), review (for medium risk), plausibility check (for moderate risk). No audit is performed for minimal risks. For a number of central audit areas (licensing requirements, equity, large exposure, liquidity, etc.), mandatory audits are still prescribed on an annual basis or can be imposed additionally by the SFBC, but even in this case the audit intensity is determined by risk content.

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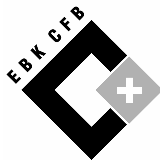
[4] see SFBC-Circ. 05/01 Audit



The new **Collective Investment Schemes Act** (CISA) does stick firmly to the lengthy common international product controls for providers and supervisory authorities. Every publicly distributed fund – 'collective capital investment' according to new terminology – continues to require a supervisory authority license, as does every amendment to fund regulations. However, the controls will be more consistently graded in line with the need for investor protection and the risks associated with investments. The Act and associated Ordinance provide for a simplified licensing procedure and fixed deadlines.[5] In the case of open collective capital investments for 'qualified investors' (institutional investors, clients with power of attorney for asset management and high-net-value private clients with at least CHF 2 million financial assets), licenses are issued on receipt of application for traditional investments and within four weeks of receipt for alternative investments. While there is no automatic license for mutual funds, the license does have to be issued by the supervisory authority within the prescribed deadlines, graded according to risk content.

The SFBC **Money Laundering Ordinance** of 18 December 2002 does not require financial institutions to provide blanket control of all business relationships and transactions according to a uniform standard of diligence. Increased due diligence obligations and investigations are only required for business relationships and transactions with increased legal and reputational risks. It is the individual responsibility of every institution to develop criteria, tailored to their business activities, for identifying increased risks.

The SFBC Circular 06/06 **Supervision and Internal Control** is designed to strengthen **Corporate Governance** among banks, securities dealers, financial groups and conglomerates by providing regulation on Supervisory Board independence, the establishment of an Audit Committee, internal auditing and the responsibilities of compliance and risk control. This may appear to be a Swiss version of the Sarbanes-Oxley Act at first glance, but it is structured as a regulatory framework that can be implemented by individual financial intermediaries, as differentiated by measure of their size and the complexity of their activities. By adhering to the "comply or explain" principle, institutions are also able to apply the provisions extremely flexibly – e.g. foregoing the establishment of an Audit Committee, even though one or more criteria may apply.

Intensive and bespoke supervision of large Swiss banks

In 1998 – the year when the former Union Bank of Switzerland and Swiss Bank Corporation merged to form UBS – we at the SFBC **split up the organisation of banking supervision**. Supervision of Switzerland's two large banking groups, UBS and Credit Suisse (which remained a bank-dominated financial conglomerate until selling the Winterthur Group to AXA Group in 2006) was taken away from the Banks / Securities Firms department and transferred to a new **Large Banking Groups department**. The supervision of both major banks was systematically expanded under the stewardship of Vice-Director Dr Andreas Bühlmann, who leaves us at the end of March and hands over an extremely effective team to his successor Mr Daniel Sigrist. In terms of **intensity and**

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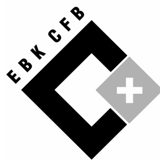
[5] see Art. 17 CISA and Art. 16 ff. CISO



methodology, supervision in this instance is significantly different from that applied to the other 340 banks and 70 securities dealers subject to SFBC supervision, even though the same regulations apply in principle to all institutions in Switzerland.[6] The Large Banking Groups department employs 25 staff in total, but also performs tasks for other departments – especially the Risk Management group, which makes its specialist expertise available to other departments in order to support institution-specific approaches (internal models) for calculating capital requirements and, in particular, the implementation of Basel II. Calculated as full-time positions, at least 10 people are involved in the ongoing supervision of these two large banking groups. This does not take into account the additional resources allotted to the large banks from other departments – for collective capital investments (Investment Funds), market supervision (Exchanges / Markets) and enforcement (administrative proceedings of the Legal Department). The contrast with the SFBC resource allocation in mid-1990s illustrates the development over the ten years. One person used to manage the then four major Swiss banks on the basis of external audit reports, and would also acquire statistical analyses for the entire banking system. There is also a noticeable contrast to the supervision of the other banks by the Banks / Securities Firms department, where today each line supervisor is responsible for an average of 20 institutions.

The **focus of SFBC large banking supervision**, which enjoys high recognition at the two banking groups in question, as well as among our key partner supervisory authorities abroad, is based on economic facts and **risk considerations**:

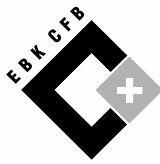
- UBS and CSG are active globally and are among the world's biggest players in investment banking, private banking and asset management. They are ten times (or more) the size of the largest other banks subject to SFBC supervision, listed below.

- The Swiss banking system is extremely concentrated by international standards. The two large banks have market shares of 50 percent in most business lines, and account for similar proportions of headcount, equity capital and net profit for the Swiss banking system as a whole.

- Their business is predominantly conducted abroad. Through their investment banking operations, they are closely tied to the global financial system, the key financial markets and the other major market participants. The complex investment banking business conducted primarily from the US or from London, would be impossible to monitor without the close collaboration with the Federal Reserve Bank of New York and the UK Financial Services Authority.

- Major groups operating on a global level are not more vulnerable to risk per se, and can even prove more resistant thanks to better diversification. Large multinationals also tend to be among the front-runners in developing sophisticated risk methods and control systems. The same applies for these two large Swiss banks, of which our country can be proud.

[6] see SFBC-Circ. 05/01 Large Bank Supervision



- The insolvency of one of these large banks would indisputably have such devastating implications for both the Swiss financial system and the economy, that the traumatic grounding of the Swissair fleet would appear trivial by comparison. It is the vast damage that would be caused rather than the probability of it occurring (which appears slight from a present-day perspective) that justifies the close supervision of the large banks. Our task is to work with the Swiss National Bank, which is responsible for safeguarding the stability of the system, to ensure that such a worst-case scenario never transpires.

Risk-based supervision of small and medium-sized banks / securities dealers with the new early warning and rating system

While the two large banks are in a category of their own and as such subject to specifically tailored supervision, there exists below them a whole variety of institutions of very different sizes, with widely differing business activities, ownership structures, organisational complexities and products, and with both international and local orientations. The wealth management banks span from the listed Bär Group, with client assets of CHF 360 billion and branches across a multitude of continents, past other globally operative private bankers (liable to unlimited extent) such as Pictet and Lombard Odier Darier Hentsch, down to institutions with barely CHF 100 million in client assets. Zürcher Kantonalbank, which has total assets of CHF 95 billion, extensive commercial activities, net profit in excess of CHF 900 million and employs 4,300 staff, operates in a different league to Banque Cantonale du Jura, which has total assets of CHF 1.8 billion, net profit of CHF 7 million and around 100 employees. The Raiffeisen Group, which has total assets of CHF 113 billion, net profit of around CHF 650 million and 6,700 employees, operates at a different level to the regional banks. Of the foreign banks, HSBC stands out somewhat with just over CHF 300 billion in client assets. The activities of foreign banks in Switzerland are mostly focused on private banking, entrusted with coordinating this business line at European or global level as part of the group.

The SFBC had already pursued a nuanced approach to supervision that reflects the heterogeneous nature of these institutions, according the highest priority to and conducting the closest supervision of major organisations (chiefly measured in terms of size and international relationships) or those where there are indications of increased risks. However, the work of our supervisory teams was largely based on audit reports produced by external audit firms plus certain supplementary information. Even in the case of lower-priority, smaller, well organised and financially sound institutions, the audit reports tended nonetheless to be subjected to full review on a yearly basis.

Since the 2006 financial year, the SFBC's new early warning and rating system now enables the Banks / Securities Firms department to focus its supervisory activities more systematically and even more consistently on the risks attached to the licensed institutions. A detailed description of the early warning and rating system as well as the procedure itself can be found on the SFBC's website.[7] The approach adopted is similar to

[7] see http://www.ebk.admin.ch/e/dossiers/risikoorientierung.html, a summary can be found in Annual Report 2006, p. 36 f.

the internal rating systems used by banks to assess their credit risk on the basis of the creditworthiness of individual debtors: we assign each bank to a supervisory class on the basis of quantitative data and qualitative factors, which also contain a subjective assessment by the line supervisor responsible, and this allocation then determines the intensity of supervision. For this reason, I would like to emphasise the consequences of risk-based supervision of small and medium-sized institutions – for them and for our activities.

The SFBC supervisory system assigns every institution one of 6 **supervisory classes** with differing **supervisory intensity**.

In a first step, the institutions are divided into **two groups**:

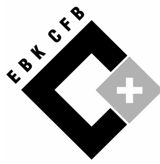
- Institutions with **increased supervisory risk** are primarily those whose size or associational function (providing services for a number of institutions) are key to the **stability** of the Swiss banking system. These include all cantonal banks, which – due to the public status of their ownership structure and with the canton as formal or virtual guarantor – require taxpayer protection as well as creditor protection, and therefore entail increased reputational risks for the supervisory authority. Ultimately, the **international integration** of institutions via a network of branches abroad leads to increased supervisory risk, particularly since cross-border activities demand the exchange of information between the SFBC, as domestic supervisory authority, and the foreign supervisory authority in the host country. At the present time, around 70 institutions of this group are assigned increased supervisory risk. They are devoted increased attention and more resources a priori, even if the specific institution is able to demonstrate a low risk profile.

- Institutions with **normal supervisory risk**. At the present time, this group contains around 340 institutions.

In a second step, both groups (increased / normal supervisory risk) based on the SFBC's own 9-stage rating system (1 = best; 9 = worst) are each separated into one of three **supervisory classes**:

- Rating 1-3 → Low risk → **Basic** supervisory intensity → Class 1 (normal supervisory risk) and Class 4 (increased supervisory risk). External auditors for class 1 institutions are only contacted by SFBC line supervisors once a year, and representatives of the institutions only at their request. Audit reports for class 1 institutions are checked on a random basis and do not have to undergo full annual review. The institutions affected should tend to be released from enquiries and interventions by the SFBC.

- Rating 4-6 → Medium risk → **Medium** supervisory intensity → Class 2 (normal supervisory risk) and Class 5 (increased supervisory risk). These medium classes represent the standard.



- Rating 7-9 → High risk → **High** supervisory intensity → Class 3 (normal supervisory risk) and Class 6 (increased supervisory risk). This involves a fundamental intensification in activity: multiple contacts with key individuals at institutions over the course of a year, plus demands for and discussion of additional information beyond that obtained from ordinary reporting.

The six supervisory classes exhibit a certain spectrum of their own, within which the supervisory intensity can vary and therefore overlap to a certain extent.

Limited communication of supervisory ratings and classes

Each individual supervised institution and its auditors are notified of both the class to which it has been assigned and also the institution-specific rating. This enables both parties to see how they have been rated by an independent body, and compare that view with their own assessment. It also enables the institution to see why it is subjected to a particular level of supervision. However, this information is for internal supervisory purposes only, and is based on information that is in some cases confidential and subject to official secrecy. Accordingly therefore, and fully in line with the practice of foreign supervisory authorities, this information is not published by the SFBC, nor may the institutions concerned publish it or use it in dealings with third parties, such as for marketing purposes. In this respect, the process is analogous to the internal credit ratings of banks, which serve primarily the risk management and pricing activities in the individual institution's lending business and are communicated to debtors, but not the public, to allow them to better utilise opportunities for improvement. This is the key difference between them and external rating agencies, whose credit ratings are designed explicitly as information for market participants and investors and therefore tend to be made public.

The new early warning and rating system for small and medium-sized banks and securities dealers is not a panacea that will prevent every single loss or accident; rather it is an aid to allocating limited supervisory resources as objectively and efficiently as possible to the most significant risks, in terms of the potential damage and the likelihood of it occurring. It employs historical data that cannot be used to predict the future, judgments by human beings who can make mistakes, and the simplifications that are an inevitable part of the modelling process. These limitations are inherent to all supervisory activity. We are fully aware of them and are therefore attentive to them, as one would expect a watchdog to be.