Main activities

22 Evaluation of the financial centre in Switzerland
25 Progress on resolving the "too big to fail" issue
28 At a glance: the TLAC concept
30 Enforcement policy
32 Business conduct of financial institutions
34 Trends in asset management and supervisory practice

Evaluation of the financial centre in Switzerland

In May and September 2014, the results of the Financial Sector Assessment Program were published by the International Monetary Fund.

As an IMF member and home to a major financial centre, Switzerland is obliged to participate regularly in the Financial Sector Assessment Program (FSAP). This is also a requirement for membership in the Financial Stability Board (FSB).

The FSAP is designed to assess the stability of a financial centre and issue any recommendations needed to strengthen it. The IMF also evaluates and rates compliance with the principles on financial market regulation and supervision prescribed by international standard-setting bodies (BCBS, IAIS and IOSCO). These three sets of principles, which are regularly revised, comprise between 26 and 37 requirements, with countries being graded on their level of compliance.

The IMF published a report on financial stability, an overview report and three detailed reports on compliance with international regulatory and supervisory standards for banks, insurance companies and markets. They were accompanied by four thematically focused technical notes on stress testing in the banking system, systemic risk and contagion analysis, macroprudential supervision and financial market infrastructures.[20]

IMF assessment of financial stability

In general, the assessment of Switzerland was positive. The IMF considers the Swiss financial sector to be essentially robust and stable, even in severe stress scenarios. Dangers were identified as a result of the low interest rate environment and the associated interest rate risk, imbalances in the real estate market, the US tax issue and possible hindrances to cross-border market access. Despite measures taken by the large banking groups to reduce risk and increase their capital base, the IMF recommended a further reduction in their leverage ratios, which are high compared with other international big banks.

IMF assessment of the regulatory framework

Switzerland's regulation and supervision of banks and insurance companies complies to a high degree with the relevant international principles. The IMF praised Switzerland's pioneering role in many areas of financial market regulation. It welcomed the introduction of the countercyclical capital buffer and other measures to limit risks in the real estate market, the introduction and ongoing implementation of the "too big to fail" regime, and the Swiss Solvency Test (SST) for insurance companies.

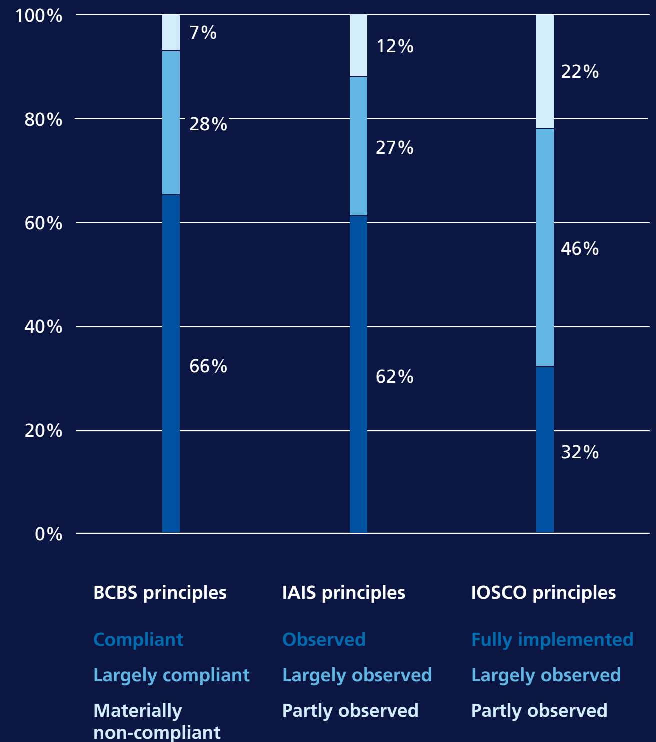
However, it identified room for improvements in client protection. It also recommended making independent asset managers and insurance intermediaries subject to supervision, stricter rules for issuers, and more stringent disclosure obligations for securities and structured products. The experts identified weaknesses in market regulation, but acknowledged that the legislative efforts to create a Financial Services Act and Financial Market Infrastructure Act contain many new rules that should improve compliance in these areas.

The IMF noted that Switzerland pursues a principles-based regulatory approach, which means that the density and level of detail in regulation are very low by international standards.

[20] See https://www.imf.org/external/np/fsap/fsap.aspx?CountryName=Switzerland.

IMF rating of compliance with international principles in Switzerland

IMF assessment of supervision
The IMF offered a positive assessment of the progress made by FINMA since its creation, as well as the level and quality of its supervision. According to the assessment, FINMA's staff have a high level of expertise and its off-site work is of high quality. The IMF acknowledges the advantages of the Swiss supervisory approach, under which key elements of supervision are outsourced to audit firms. It recommends greater use of on-site supervisory reviews, however, to reinforce the approach, as well as extra resources, especially for supervising medium-sized banks and insurance companies, and stronger leadership by FINMA of the audit firms involved in regulatory audits. FINMA greatly appreciated the professional exchange with the IMF specialists and is intensively addressing their proposed improvements.



BCBS assessment of Basel III implementation

Switzerland's implementation of Basel III was assessed in 2013 in the BCBS Regulatory Consistency Assessment Programme (RCAP). Further important jurisdictions, such as the EU and US, were assessed in 2014. The comparison below gives an overview of the assessment outcomes to date and shows that Switzerland is well placed in the midfield.

Country	RCAP report dated	Overall assessment	Assessment of components of the Basel III framework: Scope of application	Transitional arrangements	Definition of capital	Capital buffers	Credit risk: standardised approach	Credit risk: IRB approach	Credit risk securitisation framework	Credit risk: counterparty risk	Market risk: standardised measurement method	Market risk: internal models approach	Operational risk: standardised approaches	Operational risk: advanced measurement approaches	Pillar 2 requirements	Pillar 3 disclosure requirements	Number of completed or approved adjustments to national Basel III implementation
Japan	Oct. 12	C	C	C	LC	NYA	C	C	LC	C	LC	C	C	C	C	C	5
Singapore	Mar. 13	C	C	C	C	C	LC	LC	C	C	C	C	C	C	C	C	15
Switzerland	June 13	C	C	C	LC	C	C	LC	C	C	C	C	C	C	C	LC	23
China	Sept. 13	C	C	C	C	C	LC	C	C	C	C	C	C	C	C	LC	90
Brazil	Dec. 13	C	C	C	C	LC	LC	C	C	C	C	C	C	C	LC	C	42
Australia	Mar. 14	C	C	C	LC	C	LC	C	C	C	C	C	C	C	C	C	14
Canada	June 14	C	C	C	LC	C	C	C	C	C	C	C	C	C	C	C	54
EU	Dec. 14	MNC	C	C	LC	C	LC	MNC	LC	NC	LC	C	C	C	C	C	1
US	Dec. 14	LC	C	C	LC	C	LC	LC	MNC	LC	MNC	C	NA	C	C	C	3

C Compliant
LC Largely compliant
MNC Materially non-compliant
NC Non-compliant
NYA Not yet assessed
NA Not assessed

Progress on resolving the "too big to fail" issue

Further key measures to improve the resolvability of global systemically important banks were launched internationally in 2014. Credit Suisse Group and UBS are adjusting their group structures accordingly.

In addition to stricter prudential requirements, stronger supervision and an effective resolution mechanism for large and complex institutions, there have been calls from outside Switzerland for structural reforms. These led to regulatory initiatives in the US (Volcker Rule), the UK (Vickers Commission) and the EU (Liikanen group of experts). The proposals that emerged are currently at various stages of implementation. All of them aim to introduce legislation requiring banks to separate some of their activities. The European approach is primarily geared to improving resolvability by outsourcing deposit-taking to a subsidiary and thus keeping it apart from the more volatile and riskier forms of bank business.

The two Swiss big banks intend bundling their domestic business and systemically important functions within separate Swiss legal entities, as provided for in the Swiss emergency plan. This achieves the desired improvement in resolvability without structural measures mandated by the legislature, through the functional separation of commercial banking from riskier investment banking.

FINMA's preferred resolution strategy involves recapitalisation of the group by bailing in[21] existing liabilities. To support this strategy, the two Swiss big banks will begin issuing their medium- and long-term refinancing instruments through a non-operational holding company. This structure is the best way to ensure that the subsidiaries can maintain operations while the group is in resolution. UBS launched the transition to a holding structure in September 2014 with a share exchange offer. Credit Suisse Group already has a holding structure in place.

Total loss-absorbing capacity requirements for global systemically important banks

In November 2014, the Financial Stability Board (FSB) presented a proposal[22] to secure an appropriate level of loss-absorbing capacity for global systemically important banks in resolution, complementing the existing minimum requirements under Basel III Pillar 1.[23] A public consultation on the proposal was initiated.

Adequate loss-absorbing capacity is necessary in a going-concern scenario and in resolution for the following reasons:

- to secure a high probability that the home supervisory authority can resolve a global systemically important bank or, if this is impossible, wind it down in an orderly manner;
- to strengthen the confidence of the host supervisory authorities that a global systemically important bank can be successfully resolved or wound down in an orderly manner without adverse impact on the host countries; and
- to send a clear signal to all financial market players that a global systemically important institution is far more likely to be resolvable without taxpayer support if it meets the total loss-absorbing capacity requirements.

[21] See Glossary, p. 113.

[22] See "At a glance: the TLAC concept" chart, p. 28.

[23] For details on the three pillars of Basel III, see Glossary, p. 113.

The total loss-absorbing capacity (TLAC) concept is designed to allow for recapitalisation during resolution without government support. The TLAC requirement for global systemically important banks will apply in parallel to the existing Basel III capital requirements. The key elements of the FSB proposal are:

- the TLAC as a requirement that is to be met at all times and that corresponds conceptually to a Basel III Pillar 1 minimum requirement;
- the establishment of TLAC eligibility criteria for a financial institution's liabilities; and
- rules on the location of the TLAC within group structures.

The FSB proposals will be validated in 2015 as part of a comprehensive quantitative impact study. The TLAC standard is likely to be adopted at the end of 2015.

Recognition of cross-border resolution action

Resolution of a global systemically important bank can only be credible if resolution action in the home jurisdiction is recognised by the other jurisdictions in which the bank operates. Two elements are particularly important: cross-border recognition of legal "stays"[24] or other postponements of termination rights in financial contracts (such as derivatives); and the write-down or conversion of debt instruments issued under foreign law in accordance with the bail-in powers of the home resolution authority.

The FSB envisages the following measures in this area:

- an additional protocol[25] to the Master Agreement of the International Swaps and Derivatives Association (ISDA), under which global systemically important banks (G-SIBs) undertake to waive their termination and close-out rights in respect of cross-border transactions in a crisis and to recognise the counterparty's resolution regime;
- a commitment on the part of national authorities to make the additional protocol compulsory for market participants; and
- a requirement for national supervisory authorities to create the legal basis for cross-border recognition of resolution action.[26]

Both the TLAC concept and the removal of obstacles to successful resolution are key components of a solution to the "too big to fail" issue.

FSB Resolvability Assessment Process carried out for the first time

The Resolvability Assessment Process (RAP) for each G-SIB is carried out by senior policymakers from the authorities represented in the Crisis Management Group (CMG) concerned. The steps needed to improve resolvability are then agreed, and the results of the assessment formally communicated to the chair of the FSB. This gives the FSB an overview of the resolvability status of all 29 G-SIBs and enables it to monitor progress in resolving the "too big to fail" issue.

[24] Ordered by the authority, a stay is the postponement of an early termination right linked to the occurrence of a resolution event.

[25] In a bank initiative in October 2014, 18 G-SIBs agreed to sign the additional protocol; see ISDA media release dated 11 October 2014 (http://www2.isda.org/news/major-banks-agree-to-sign-isda-resolution-stay-protocol).

[26] See FSB press release dated 29 September 2014 (http://www.financialstability-board.org/press/pr_140929.htm) and the FSB consultation paper "Cross-border recognition of resolution action" (http://www.financial-stabilityboard.org/publications/c_140929.pdf).

FINMA completed the RAP for UBS and Credit Suisse Group on 30 September 2014. The senior policymakers, consisting of representatives from the Board of Governors of the Federal Reserve System (the Fed), the Federal Reserve Bank of New York (New York Fed), the Federal Deposit Insurance Corporation (FDIC), the Bank of England and the Prudential Regulation Authority (PRA), confirmed the bail-in strategy set out in the FINMA position paper on resolution of G-SIBs[27] of 7 August 2013 as the preferred resolution strategy for UBS and the Credit Suisse Group. They also gave a positive overall assessment of the efforts already made by Switzerland's two big banks to improve their resolvability. The RAP will be carried out annually from now on.

Cooperation agreements for crisis situations

The RAP demonstrated that successful resolution crucially depends on clearly regulated cooperation with the members of the CMG and other relevant host supervisory authorities. This is to be achieved by means of international cooperation agreements chiefly covering information exchange and organisational matters. Rapid progress was made on drafting these agreements, as a result of the preparatory work carried out in the CMG. Conclusion of the agreements for UBS and Credit Suisse Group is planned for 2015.

[27] See FINMA position paper "Resolution of global systemically important banks" of 7 August 2013 (http://www.finma.ch/e/finma/publikationen/Documents/pos-sanierung-abwicklung-20130807-e.pdf).

At a glance: the TLAC concept

The FSB has been instructed by the G-20 to develop the total loss-absorbing capacity concept for global systemically important banks. A public consultation was launched in November 2014.

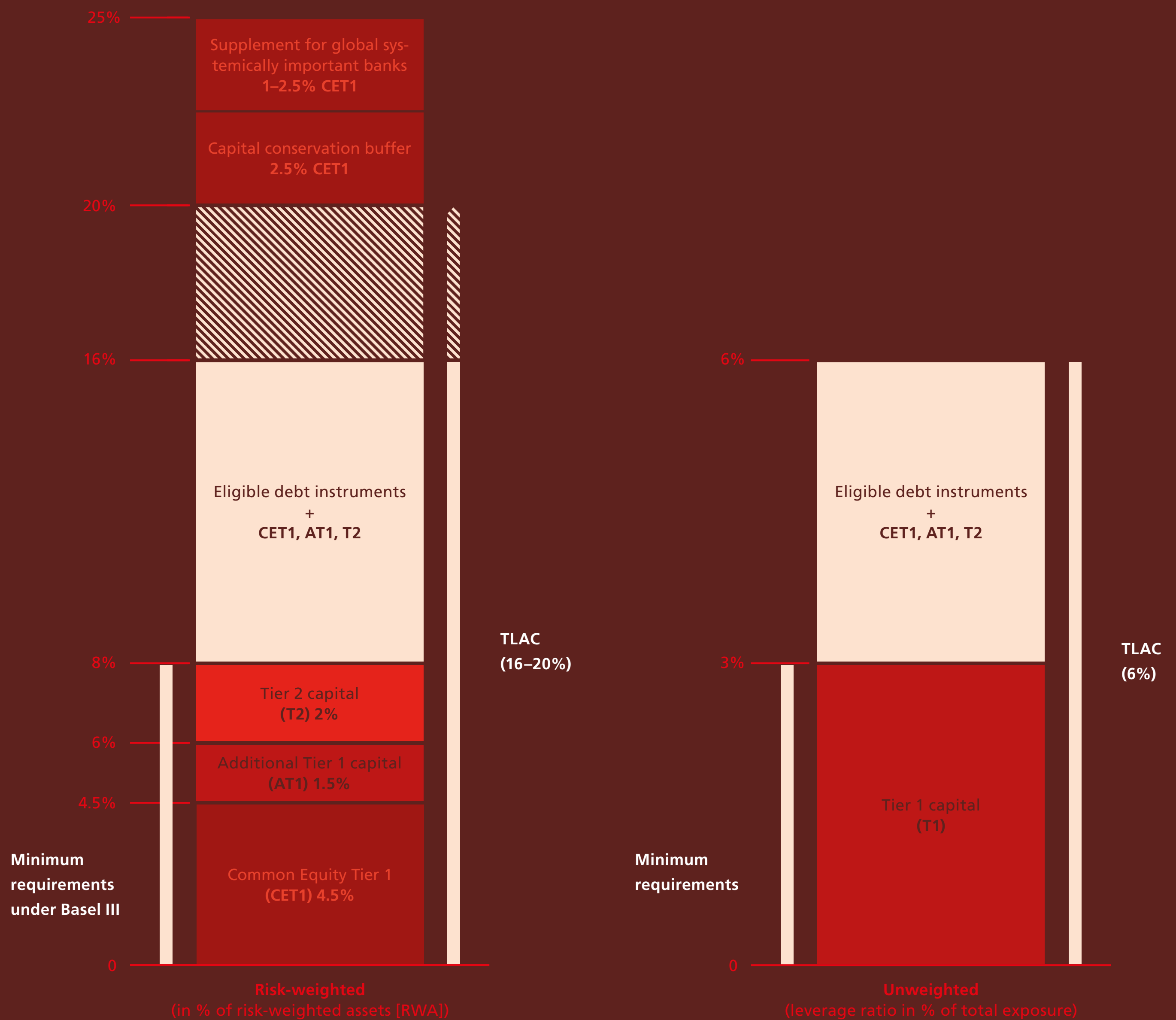
The total loss-absorbing capacity (TLAC) concept aims to facilitate the resolution of globally active banking groups without impairing financial stability or exposing taxpayers to loss. The FSB proposes that, in addition to the existing capital requirements for the going-concern scenario under the Basel III standard, G-SIBs be required to demonstrate sufficient loss-absorbing capacity at all times, corresponding to a Pillar 1 requirement. Subject to calibration once the impact assessment is complete, the TLAC is to be set at 16% to 20% of the capital requirement based on the risk-weighted assets and at 6% of the capital requirement based on the total exposure.

The chart shows the relationship between the TLAC and the capital requirements.

- The Basel III minimum of an 8% total capital ratio must be satisfied. Additional regulatory capital and debt instruments with a minimum remaining maturity of one year that are subordinated to all other creditor claims in insolvency (eligible debt instruments) can then be included in the TLAC.
- The various Basel III buffer requirements (capital preservation buffer, supplement for G-SIBs) must also be met.

The TLAC concept is scheduled for adoption by the FSB as a minimum standard at the end of 2015, with the new requirements coming into force no earlier than 2019.

Heightened requirements for the loss-bearing capacity of global systemically important banks



Enforcement policy

In 2014, FINMA published a strategic enforcement policy replacing the earlier version from 2009.

The term "enforcement" covers all the investigations, proceedings and measures undertaken by FINMA relating to violations of financial market law. It is mainly conducted in three areas: supporting supervision of authorised institutions; combating insider trading and manipulation in market supervision; and halting the activities of unauthorised financial intermediaries.

The 2009 enforcement policy

FINMA adopted its first enforcement policy in December 2009. It contained 13 principles governing FINMA's enforcement activity, including general statements on enforcement at FINMA and its internal organisation. It also contained principles for making information public and for deploying agents, as well as explanatory notes on proceedings against individuals and on cooperation with prosecutors, other administrative bodies and self-regulatory organisations.

The content of the policy was strongly influenced by the situation in 2009, when FINMA did not yet have a separate Enforcement division and enforcement functions were spread across various organisational units within the authority. Moreover, the Financial Market Supervision Act (FINMASA) had only just created new enforcement instruments such as industry bans and the power to order the disgorgement of profits. The primary aim of the policy was therefore to establish a uniform approach within FINMA and curb public expectations that the new instruments would be deployed across the board. It had little to say on the strategic orientation of enforcement.

The 2014 enforcement policy

The new enforcement policy[28] sets out how FINMA uses enforcement to achieve its supervisory objectives. To enhance the deterrent effect of enforcement, FINMA has stepped up its action against individuals for alleged serious violations of supervisory law. In particular, the policy highlights that FINMA gives high priority to combating market abuse and insider trading in the Swiss securities market, with particular emphasis on the market conduct of prudentially supervised institutions and their employees. It also stresses that FINMA takes resolute action against unlicensed financial intermediaries.

Unlike the earlier document, the enforcement policy is purely strategic in nature. Operational matters have been transferred to other vehicles. The principles governing communication are now set out in a communication policy.[29]

[28] Enforcement policy dated 25 September 2014, p. 31 (see also http://www.finma.ch/d/aktuell/Documents/ll-finanzmarktenforcement-20140925-d.pdf).

[29] See "FINMA and its national stakeholders", section on Communication policy, p. 15.

Enforcement policy

FINMA takes enforcement action as a visible means of achieving its supervisory objectives. Enforcement aims to remedy shortcomings, restore compliance with the law and exert a deterrent effect by imposing sanctions for violations of the law. Serious lapses are dealt with as a matter of priority.

- FINMA's enforcement activities support its supervision of licence holders. To promote compliance with regulatory requirements, FINMA takes targeted action to respond to serious violations of the law, specifically violations of business conduct rules.
- FINMA's enforcement activities are primarily directed against serious violations of market integrity and market manipulation performed by all participants in the Swiss securities market; where licensed market participants and their employees are concerned, FINMA also acts in response to serious market abuse in similar markets in and outside Switzerland.
- FINMA follows up indications of unauthorised business activities that do not comply with the requirements set out in financial market legislation.
- FINMA takes targeted action against individuals responsible for serious violations of supervisory law.
- FINMA initiates insolvency measures deemed necessary and appropriate in individual cases. Insolvency proceedings are mainly conducted by external liquidators appointed by FINMA.
- FINMA views the rapid provision of international cooperation as an important contribution to global efforts to ensure the proper functioning and integrity of the financial markets, particularly where market supervision and unauthorised activities are concerned.
- FINMA ensures that its dealings with prosecutors and other authorities are conducted in line with its supervisory objectives.

Business conduct of financial institutions

Proper business conduct by financial institutions is more important than ever. Corporate culture and risk management play a key role. FINMA takes action against specific instances of misconduct and holds individuals to account. Where necessary, it issues a warning as a preventive measure.

More than almost any other branch of the economy, the financial sector depends on trust. But that trust, so often taken for granted in the past, has been seriously eroded in recent years, and especially since the financial crisis of 2008. More recently, the repeatedly unacceptable business conduct of many financial institutions has contributed to the problem.

There have been numerous examples of misconduct, some directly involving Swiss banks. They include fraudulent speculation by a trader in London, interfering in the prices of securities, aiding and abetting tax offences abroad and manipulating key interest rate benchmarks and the foreign exchange market.

The causes of misconduct

The common element in all these cases is a corporate culture driven by misdirected incentives and excessively focused on profit generation and variable salary components, with client interests taking second place. Business conduct risks have been identified and managed inadequately or even ignored. Some arise through violations of codes of conduct; others may be unregulated but are still of importance to operational business.

Requirements for proper business conduct

A number of general measures are required to reduce the risk of misconduct. Senior management must lead by example. Companies must not put profits before the interests of their clients. Remuneration systems must not incentivise inappropriate conduct. Firms need to pinpoint where the dangers lie, and issue internal directives and regulations to limit them. Employees need to be trained in what is expected of them, and adherence to directives must be rigorously enforced. Compliance needs to be a strong and effective control function; misconduct must be strictly sanctioned internally.

Role of senior management

Senior management must set an example in all aspects of business conduct. Top executives have to make it absolutely clear that profiting from inappropriate or unethical conduct will not be tolerated, and especially not rewarded.

Remuneration systems must send a clear message

Incentive systems, including those for senior management, must be appropriate. They must recognise more than just performance indicators, net new money inflows or profits. Proper business conduct, identification and prudent management of risks, as well as professionally conducted internal controls must also be rewarded. Executive salaries must reflect the degree to which those who receive them have lived up to their responsibilities. They must send

a clear message, not merely recognising good practice through higher salaries and variable compensation, but also curbing remuneration that is not earned.

Improved identification and sanctioning of misconduct

Technology is making misconduct increasingly risky. The greater transparency that comes with the digital age is making it easier than ever to expose misconduct and sanction it accordingly.

FINMA takes corrective action whenever it identifies specific instances of misconduct. Increasingly, it uses the freedom granted to it by law to hold individuals to account and does not hesitate to ban them from practising when they are found responsible for serious misconduct.

If FINMA establishes that a problem is not an isolated incident but a more widespread phenomenon, it issues a preventive warning to supervised institutions. Going forward, FINMA will place increasing emphasis on monitoring compliance with codes of conduct.

Responsibility lies with institutions

Ultimately, the key to avoiding over-regulation and repressive measures lies with financial institutions themselves. They must recognise that they are part of a larger system that only works if the fundamental social consensus to support it is preserved.

Trends in asset management and supervisory practice

As expected, the number of licensed asset managers of collective investment schemes increased as the transitional periods under the revised Collective Investment Schemes Act neared their end. Changes to the licensing procedure and enhanced communication led to efficiency gains.

In 2014, the newly created Asset Management division focused primarily on improving the efficiency of the licensing procedure and stepping up communication with applicants.

Market trend: asset managers

The number of institutions supervised under the Collective Investment Schemes Act (CISA) rose again in 2014, as did the volume of assets under management.

With a few exceptions,[30] all Swiss-domiciled asset managers of collective investment schemes (CIS asset managers) are subject to FINMA supervision now that the partially revised CISA is fully in force. For the first time, asset managers of foreign collective investment schemes must also be licensed. Under the transitional periods set out in the revised CISA, they were required to report to FINMA by the end of August 2013 and then had until the end of February 2015 to apply for a licence. As a result, the number of licensed CIS asset managers had risen to 151 by the end of 2014 (2013: 119). Additional applications were received before the end of the transitional period and have since been approved by FINMA or are pending, so the number will increase further in 2015.

Assets managed by CIS asset managers also increased, to CHF 164 billion as of 31 December 2013 (previous year: CHF 147 billion). Adding in assets managed directly by fund management companies, supervised institutions managed assets totalling CHF 535 billion as of 31 December 2013.

These developments, coupled with the steady growth in asset management over recent years, have given rise to new challenges. FINMA has responded accordingly, and its newly created Asset Management division implemented a range of measures that have increased the efficiency of licensing and supervision.

Changes to the licensing procedure for CIS asset managers

In response to a number of frequently asked questions on the licensing procedure for CIS asset managers, FINMA briefed market participants on issues such as corporate governance, the expertise required of the board of directors and executive board, risk management, compliance, internal control systems and separation of functions. In addition, it communicated its expectations in those areas.

These briefings heightened understanding of the requirements, in particular compliance with the licensing conditions. Combined with the introduction of standardised application form templates, streamlined internal processes and greater communication with audit firms, lawyers and consultants, they improved the quality of applications and cut the average time taken to process new applications and amendments.

FINMA can also relax certain organisational requirements for “start-up” asset managers if it deems this appropriate given the scope and complexity of their business model. Since such asset managers need a licence before they can commence operations and thus rely on their applications being processed swiftly, they are normally dealt with within 90 days provided they meet the legal and other regulatory requirements.

Clarification of practice

One exception to the licensing requirement under CISA, adopted from the EU’s Alternative Investment Fund Managers Directive (AIFMD), applies to managers of assets that fall below the “de minimis” thresholds.[31] The wording of the relevant article in CISA has caused some uncertainty, in particular regarding whether Article 2 para. 2 let. h no. 2 CISA applies only if the collective investment schemes

[30] See Article 2 para. 2 let. h CISA.

[31] Asset managers of foreign CISs are not subject to CISA if the assets under management do not exceed the figures stated in Article 2 para. 2 let. h nos. 1 and 2 CISA and they are only open to qualified investors.

managed by the asset manager are invested solely in non-leveraged target funds or, alternatively, if the collective investment schemes managed do not in principle employ leverage. FINMA's interpretation of this provision is that it applies to all asset managers of non-leveraged collective investment schemes for qualified investors that are closed-ended for a minimum of five years where the assets under management amount to less than CHF 500 million, regardless of whether they are invested in target funds or other investments.

One of the most important licensing conditions for CISA asset managers is that they manage a collective investment scheme. When processing a number of applications, FINMA found that while the applicants managed a scheme authorised or registered under foreign law, only one investor or a group of investors that were not independent of each other had invested in it. In such cases, FINMA informed the applicants that this did not meet the definition of a collective investment scheme under CISA and instructed them either to comply with the conditions or withdraw their application.

Many of the newly licensed CIS asset managers manage foreign collective investment schemes established in offshore locations and not subject to equivalent supervision. To protect investors in such structures, FINMA ordered the applicant to provide up-to-date confirmations, verified by an audit firm, of the actual existence and scope of the assets managed in the collective investment schemes concerned.