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Annual Report
Key themes

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

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Regulation and supervision

2003 was a year of consolidation for the Swiss Federal Banking Commission during which we focused firmly on the future. Whereas depositor protection was at the top of the SFBC's agenda just a few years ago, other challenges have since come to the fore. A key theme that will prove decisive for the SFBC's future is the draft of a law merging the Banking Commission with the Federal Office of Private Insurance to form an integrated financial market regulator (FINMA). Alongside the work of preparing the ground for this major undertaking, the SFBC is required to deal with numerous regulatory initiatives arising from its day-to-day activities and the implementation of international standards, while at the same time performing the ongoing core task of supervising and enforcing existing rules and regulations. One of its biggest challenges is thus to strike the right balance between regulation and supervision.

Efficient procedures

The SFBC was not lax in its supervisory duties in 2003, as evidenced by the numerous corporate governance proceedings it initiated and the special and summary audits it commissioned. In its supervision of financial markets, the SFBC is now also making use of "power enforcement", an accelerated and focused procedure carried out in conjunction with the stock market supervisory bodies and aimed at investigating and resolving cases as quickly as possible. Two cases of insider trading were dealt with efficiently using this method. In the first case a major firm of auditors parted company from its CEO, and in the second several people were indicted in criminal proceedings before the cantonal courts.

Praise for credit risk management

The SFBC conducted a summary audit of lending operations at more than 130 Swiss banks, investigating the quality of credit risk management with a view to determining whether a detailed regulatory framework is needed in this area. It instructed the banks' statutory auditors to provide in-depth commentaries on all aspects of credit risk management and to examine how banks with major credit operations deal with the risks inherent in this area of business. The results of the study painted an overwhelmingly positive picture and confirmed the SFBC's assumption that the banks have learned their lesson from the crises of the 1990s and made substantial improvements to their credit risk management instruments. There is no need for additional regulatory measures at present, since the SFBC's new Accounting Regulations, the Swiss Bankers Association's revised guidelines on valuing mortgage loans and the new guidelines from the Swiss Chamber of Certified Accountants and Tax Consultants on auditing mortgage loan business all take account of this key issue. Nevertheless, it would be desirable to see (and perhaps at some later stage prescribe) the further development of the internal rating systems used by lending banks. For the purpose of risk man-

agement, this could be based on the principles of the Basel II accord, but need not necessarily meet all the complex regulations for calculating capital under the Basel II Internal Rating Based (IRB) procedure.

No overregulation

The SFBC always gives careful consideration to the question of whether and at what point new regulations should be introduced or existing ones revised. This is its way of attempting to ensure that the Swiss financial industry does not become overregulated. While the wave of new regulation we currently face is indeed daunting, the phenomenon is by no means peculiar to Switzerland. Instead of criticising individual rules, we would do better to stay focused on the big picture and try to understand why it has come to this. For one, the national regulatory framework is shaped to a considerable extent by international standards that Switzerland cannot afford to ignore if it is to maintain its status as a globally networked financial centre, although there is a certain amount of leeway for these standards to be implemented in a way that accommodates differences between individual countries. For another, it is worth remembering that the harmonization of sector rules will lead to greater regulatory standardization over the longer term. However, the SFBC has every intention of going beyond the international minimum regulatory standard in strategically important areas. For example, it will ensure that banks in Switzerland maintain a capital ratio well above the international minimum, even under Basel II, in order to protect the Swiss financial industry's standing. It will also take extensive action against money laundering and the financing of terrorism in future so as to prevent misuse of the law on bank-client confidentiality.

Direct, in-depth testing

Wherever there is a need for it, the SFBC will not hesitate to take decisive action. Thus, while it remains fundamentally committed to the dual supervision system (delegation of on-site audits to approved private audit firms on the one hand, overall supervision and enforcement measures by the state supervisory authority on the other), it will add to this system in a number of areas. For example, it conducts its own examinations of the large banking groups due to their significance for the banking system as a whole and has, following the scandals at the cantonal banks of Geneva and Vaud and as part of a comprehensive audit reform, set up a new organizational unit to oversee the work done by the audit companies through direct testing on random basis. Following the "trust and verify" principle, this unit carries out quality control checks, casts a critical eye on auditors' methodologies and sometimes even monitors them on-site as they do their job. Aspects it pays special attention to include their impartiality vis-à-vis the companies they audit and their compliance with the regulations set out by the supervisory authorities. The unit's findings show that the SFBC's decision to monitor the

work of the auditors was indeed a wise one. It has not been operational for long, but has already shed light on a number of serious inadequacies.

Self-regulation

Despite the fact that self-regulation – like the dual supervision system – is always being called into question, the SFBC continues to believe in its value and even sees scope for expanding it. Its credo in this respect is one of liberal governance, starting out with the subsidiary "bottom-up" approach and delegating everything to the subsidiary levels that does not absolutely need to be dealt with at the top level. Transferring tasks from a public body to the private sector – in this case from the SFBC to the financial sector – guarantees that processes will be in touch with the real world, prevents overregulation and thus meets a crucial prerequisite for the supervised institutions to remain competitive. The SFBC acknowledges the framework of rules on which self-regulation is based as a set of minimum standards and has auditors check compliance with these standards every year. This has proven a successful arrangement over the years. The International Monetary Fund said as much in its Financial Sector Stability Assessment for Switzerland.

Room for improvement as regards administrative assistance

The Swiss financial sector's competitiveness is in fact under threat for a very different reason: the Swiss provisions on administrative assistance with regard to securities trading are incompatible with the applicable international standards. The current rules mean that the SFBC is unable to provide administrative assistance to such key countries as the United States and Italy. The SFBC is concerned about this situation and called for a revision of the Stock Exchange and Securities Dealers Act (SESTA, Art. 38) as far back as 2001. This shortcoming on Switzerland's part may block entry to foreign markets for Swiss financial intermediaries and may also hinder any cooperation between Swiss exchanges and foreign ones, since other countries specify administrative assistance with a company's country of origin as a condition for granting its access to their exchanges, as indeed does Switzerland. The indirect effects of insufficient administrative assistance should not be underestimated, either. It practically encourages indiscriminate attacks on bank-client confidentiality and thus the Swiss financial sector as a whole. It is very much in Switzerland's interest – and more specifically in the interest of the Swiss banks – to align the national administrative assistance regime with international standards and avoid anything that could pose a major threat to the central tenets of bank-client confidentiality. A revised draft of the new SESTA Art. 38, drawn up by the SFBC in conjunction with the Swiss Bankers Association, was put out for comment by the Federal Council at the end of January 2004.

Avoiding a concentration of power

In addition to regulatory projects that relate directly to its remit, the SFBC is also involved in initiatives that extend beyond the reach of its current activities and gives its opinion in consultations with the relevant bodies on plans which might affect its work. It was critical, for instance, of the proposed new federal law on audit supervision, under which a new registration and supervisory authority for independent auditors and audit companies would be created. The SFBC is not fundamentally opposed to such a body, but believes not enough consideration has been given to the effects it would have, especially in terms of staffing and costs, the financial impact on the auditors themselves and its compatibility with other regulatory frameworks in Switzerland as well as comparable systems in other countries. The SFBC also rejects the idea of integrating additional functions into the new authority. Not only does this pose the risk of too much power being concentrated in one body, it is also important to ensure that FINMA's effectiveness is not hampered by an accumulation of duties.

Dr. Kurt Hauri
Chairman

Daniel Zuberbühler
Director

Berne, April 2004

1 Audit reform

New circulars

As part of its comprehensive audit reform effort, the SFBC commissioned a working group to reformulate the laws, ordinances and circulars governing the auditing and supervision of banks and securities dealers[1], based on the recommendations put forward by the commission of experts under Prof. Peter Nobel[2]. Priority was given to implementing the recommendations relating to the tasks, function and independence of audit companies, to consolidated audits and the supervision of complex banking and financial services organizations with the aim of establishing appropriate regulations as soon as possible. Following this remit, the working group formulated four new circulars based on current legislation and ordinances dealing with the Audit, the Audit Report, Audit Companies and Supervision of Big Banks. The feedback given by those concerned during the consultative phase was almost entirely positive as regards the general thrust of the reform. The stronger focus on risk and efforts to increase transparency were particularly well received. It was stressed that this project must be coordinated with the work of the commission of experts headed by Prof. Ulrich Zimmerli[3]. The costs that would be incurred due to the reform were a controversial issue, and the results of a pilot scheme are expected to provide some clarification on this subject.

The working group will present its concluding report, complete with new drafts of the laws and ordinances as well as related circulars, in spring 2004.

"Audit" circular

The "Audit" circular explains the object of and procedure for annual audits of banks and securities dealers at both solo and consolidated levels. The circular aims to improve the structure of both the object of the audit and the way it is conducted, based on the division into an accounting audit and a supervisory audit as recommended by the Nobel commission. It also seeks to fill the gap in the provisions on auditing consolidated banking organizations. The audit concept on which the draft circular is based follows the risk-oriented approach that is already recognized and applied within the auditing profession.

"Audit Report" circular

The "Audit Report" circular deals with the form and content of audit reports and is intended to replace the current SFBC circular 96/3 "Audit Report: Form and Content". The new circular specifies that the report on the annual audit should, in line with the division of the audit's object, consist of two separate parts: a report on the accounting audit and one on the supervisory audit.

[1] see Annual Report / Key themes 2002, p22ff
[2] see http://www.ebk.admin.ch/d/archiv/2001/neu6-01.pdf
[3] see 5

"Audit Companies" circular

The "Audit Companies" circular contains the individual provisions on recognizing audit companies and lead auditors as well as on their independence, supervision and appointment and on changes of appointed audit companies. The current procedure for recognizing audit companies and lead auditors as well as for appointing and changing audit companies has proven effective, but has never been published in a suitable form. This is therefore the purpose of this circular. In addition, a significant need for further provisions has become apparent as a result of the SFBC's recently established supervision of audit companies and also in connection with the current, heated debate over their professional independence. The latter factor, far from being specific to Switzerland, is a major international issue.

"Supervision of Big Banks" circular

The "Supervision of Big Banks" circular explains the big banks' reporting obligations, the regular contact between these banks and the SFBC and the direct and in-depth audits they are subjected to. In order to implement the Nobel commission's recommendations, the dual control system will be developed and supplemented in certain areas by new supervisory models with a view to ensuring quality and international acceptance. The direct audits are intended to enable the SFBC to form an opinion of its own about particular divisions or functions of the big banks and, by examining the same parts of the two big Swiss banks, to gain an overview of how the banking system is developing in certain key areas. In-depth audits will enable the SFBC to commission a detailed investigation of a specific area of a big bank's business by the audit company.

Quality checks

New organizational unit

In the year under review the SFBC decided to create a new organizational unit to strengthen and expand its supervisory activities. This new unit is tasked with supervising the recognized audit companies that undertake the audits of banks, securities dealers and investment funds[1]. It has so far carried out ten quality checks on working papers drawn up by audit companies. It has also used interim audits as an opportunity to accompany the audit companies on-site at the audited institutions on two occasions. These quality checks allow the SFBC to gain a clearer picture of whether the audit companies consistently meet the criteria for being recognized and comply with the supervisory provisions and with the standards of their profession. They also make it possible to determine whether the auditing methods stipulated

[1] see Annual Report / Key themes 2002, p22ff

in the relevant manuals and codes of conduct are in fact followed. The new unit's remit has been successively enlarged. By monitoring the audit companies on-site as they audit banks and securities dealers – a measure which is currently performed on an irregular basis – the SFBC has been able to add further to the broad range of efficient instruments available for the conduct of its supervisory activities. The quality checks and on-site monitoring of auditing firms have additionally had a preventive effect, given that the auditors must reckon on direct intervention by the supervisory authority while they are working.

Opposition to on-site monitoring of auditors

The audit companies have basically reacted positively to the quality checks, since they see the necessity of cooperating with the SFBC. They have been rather less enthusiastic, however, as regards monitoring of auditors on-site, to the point that they have even actively opposed this measure. Their initial argument was that the SFBC had no legal basis to take such action. The SFBC, on the other hand, does not share this opinion. The law in fact empowers it to collect all the information and documentation from the auditors – and from the banks themselves – that is needed to fulfil its remit. The audit companies then argued that the aims, conditions, scope and practical aspects of this on-site monitoring must first be fixed. The SFBC is not in principle opposed to the idea of drafting a basic concept in this regard, but thinks it is better to gather some experience – perhaps incorporating other objections from the auditing profession in the process – before formulating a new procedural draft.

Inadequacies

The quality checks and on-site audit monitoring have yielded valuable results in the form of important information. For example, it was discovered that one audit company's methodology was neither formally documented nor uniformly adhered to by all its staff. The measures also shed light on major discrepancies between the risk analysis of the company being audited as defined in the audit plan and that actually carried out during the audit. In some cases, the auditors' documentation was found to be insufficient. Comparing the information contained in the audit report with the comments made during the audit and recorded in the working papers showed that one audit company had failed to mention all the irregularities it discovered in its report, even though some of them were quite serious. As a result, the report did not provide a true and fair view of the audited institution's financial position.

Corrective action

These problems were communicated to the audit companies concerned, which took immediate corrective action. In the most serious case, a special audit by a different audit company was commissioned. This second opinion

confirmed the results of the quality check. Administrative proceedings were thus initiated against the audit company and the lead auditor.

Unlocking synergies

The quality checks on audit companies helped to unlock substantial synergies between the groups responsible for supervising banks and securities dealers and the unit tasked with supervising audit companies. Using multi-skilled teams, the SFBC can gain an insight into both the audit company's activities and the financial position of the company being audited. This approach has proven worthwhile, especially in one particular case where it served to confirm the doubts arising after the check and call into question not only the appropriateness of the required impairment charges and provisions, but also the way the bank's lending business was organized. In this case, the SFBC ordered a special audit by a different company to the bank's statutory auditor.

Conclusion

The results achieved thanks to these quality checks are undoubtedly encouraging. They support the SFBC in its efforts to strengthen its supervision of recognized audit companies. Furthermore, the practical experience gained on-site at the audited companies confirms that the audit companies' objections to being monitored on-site by the SFBC were unfounded in that no evidence to support their original doubts was found. On the contrary, the openness and cooperation of those involved made for smooth handling of the audit process, improved relationships between the SFBC and the auditors and above all provided valuable information.

Autonomy and conflicts of interest

The burning question in connection with quality checks concerns the independence of the audit companies in financial, staffing and functional terms and the potential for conflicts of interest with their clients in performing their audit function. Professional independence has increasingly become a key issue recently. This is why the SFBC expressed the wish to obtain detailed information on the services audit companies provide for the companies they audit. If a recognized audit company intends to accept a mandate to audit a bank, securities dealer or investment fund, be it at the time an institution or investment fund is founded or when a bank, securities dealer or fund decides to change audit companies, the audit company is required to provide the SFBC with the details necessary for assessing its independence vis-à-vis the audited institution. A questionnaire has been drawn up and introduced for this purpose.

2 Implementation of Basel II in Switzerland

Pragmatic and flexible implementation

The Basel Committee is expected to sign off the revised Capital Accord (Basel II) in mid-2004. The accord will then come into force at the end of 2006. The SFBC is responsible for implementing Basel II in Switzerland. It will adopt a flexible regulation approach in its implementation of Basel II, i.e. one tailored to the circumstances of each individual institution, as it already has for the regulation of market risks. The entire Basel II menu selection will thus be made available, as in the European Union, but unlike in the United States, for instance. The majority of banks in Switzerland will nevertheless apply the simple Basel II options, whereas the complex internal procedures are primarily suited to the internationally active big banks. The more complex Basel II methods, on the other hand, serve as a model for all institutions to improve their risk management. The tried-and-tested "Swiss finish", involving the setting of capital adequacy requirements well in excess of the international minimum standard, will be maintained under Basel II. Capital adequacy requirements are on the whole to be kept in line with current legislation, although the requirements for credit risks will be reduced due to the additional funds required for operational risks, which will in future be treated separately. There are no grounds to fear either discrimination in lending to small and medium-sized enterprises (SMEs) or a general credit crunch.

Background

Reasons for revising Basel I

The first Basel Capital Accord (Basel I), which dates back to 1998, represents the international minimum standard for capital adequacy in relation to the risks associated with the banking industry. The regulatory provisions of Basel I are relatively simple and do not go far enough in accounting for the risks involved. The internationally active big banks have made huge progress over the past few years as far as risk management is concerned, decoupling themselves ever more from the schematic approach of the supervisory authorities. They have also increasingly turned to asset securitization as a means of circumventing the Basel I requirements, a tactic referred to as regulatory arbitrage. The current regulations are thus no longer in line with the common practices of the banking industry. The Basel Committee therefore decided in mid-1998 to undertake a fundamental revision of the Capital Accord. After three international discussion rounds, the revised version (Basel II) is to be signed off in mid-2004 and implemented in the national laws of the member countries and the EU by the end of 2006[1].

[1] see Annual Report 2002, p94ff and VI/1.1.2

Procedure in Switzerland

Implementation without changing the law

Implementing Basel II in Switzerland does not require a change in the law, it only necessitates an adjustment in the implementing ordinance. Art. 4 of the Banking Act – in its current wording following the amendment of the National Bank Act – only stipulates in general terms that the banks must have sufficient capital both individually and at consolidated level. The Federal Council determines the elements of capital and fixes the minimum requirements in line with the banks' business and risks. The SFBC can issue guidelines on execution. The provisions of Basel II can thus be implemented via an ordinance issued by the Federal Council together with technical ordinances and circulars from the SFBC.

National working group headed by the SFBC

The SFBC heads a diverse, national working group comprising representatives of all interest groups within the Swiss financial industry that are affected by the new regulations. The group aims to define supervisory standards for implementing the minimum requirements of Basel II in Switzerland. It will circulate draft standards to all those concerned for comment in 2005 in order to ensure that the Federal Council and the SFBC can issue the relevant regulatory guidelines (including new capital reporting standards) in plenty of time before Basel II comes into force. Also planned for 2005 is a Quantitative Impact Study (QIS) of the Swiss banks, which will serve to compare their capital adequacy requirements under the current regulations and under the new draft regulations. This study will make it possible to assess whether the quantitative aims have been achieved and to finalize the risk weightings. If Basel II is postponed yet again, the SFBC will adjust its deadlines accordingly.

Basel II menu approach

Selecting the method for risk categories

Basel II aims to record the many risks involved in banking in a more complete and accurate manner. Operational risks will additionally be taken into account. A "menu" of different methods will be available for calculating capital adequacy requirements in relation to credit, market and operational risks. Each bank will thus be able to choose between simple, standardized methods on the one hand and complex, bank-specific ones on the other.

Credit risks

The methods available for calculating capital adequacy requirements in relation to credit risks include a relatively simple standard procedure and complex credit rating procedures that are specific to the bank in question

and thus require approval. The new standard procedure is very similar to the current one. It has merely been expanded with additional risk weighting classes and thus remains relatively simple to use. The more sophisticated, internal procedures, known as the FIRB (Foundation Internal Ratings Based) and A-IRB (Advanced Internal Ratings Based) approaches, entail the bank estimating risk factors itself by means of internal credit ratings. Allowing internal credit ratings to be used to determine regulatory capital adequacy requirements is a way of accounting for the fact that only a small minority of debtors – primarily large companies rather than SMEs – have an external rating and that, at the same time, even the new standard procedure for allocating debtors to a small number of risk weighting classes is still a relatively schematic one. Thus, for the complex, internal procedures, Basel II is only proposing methods for rating and monitoring credit, risk-adjusted pricing, controlling credit portfolios and determining impairments that have been employed successfully for years by well run banks. Furthermore, the recognition of internal procedures by a supervisory authority is intended to serve as a regulatory incentive to improve risk management.

Operational risks

As regards operational risks, the basic indicator and standard approaches are the simple options. In the basic indicator approach, the capital adequacy requirement corresponds to a predefined percentage of gross income. In the standard approach, it is the sum of various percentages of gross income in eight divisions. The AMA (Advanced Measurement Approach), meanwhile, provides a complex, internal alternative for quantifying operational risks. Approval is mandatory for this method and the conditions imposed are strict.

Capital underpinning for market risks

As far back as 1996, the Basel Committee revised the Capital Accord to include guidelines on capital adequacy for market risks. Here, too, banks can select from a variety of procedures tailored to their individual needs. These regulations on market risk have so far proven effective and will therefore remain unchanged under Basel II.

Differentiating methods of calculating capital adequacy requirements

The simple methods are less laborious in terms of application and calculation, but they normally result in higher capital adequacy requirements as a way of making up for their inaccuracy. The complex ones have to be validated and approved by the supervisory authorities under strict conditions. They are more closely related to a bank’s internally developed risk management mechanisms and result in lower capital adequacy requirements provided the bank’s risk profile is good. Instead of a rigid, uniform concept for all banks, they offer a flexible approach to accommodate the wide variety of activities, sizes and risk exposures that exists among the banks. All of the

Basel II menu options will be implemented in Switzerland and will in principle be available to every institution.

Complex procedures as a model for good risk management

Implementing the complex, internal procedures is subject to very demanding regulatory requirements. These procedures not only involve a great deal of work and expense in aligning risk management mechanisms with Basel II and meeting the conditions for approval, they also require a huge commitment to ongoing risk management efforts. For most banks, the cost of meeting the minimum regulatory criteria for the complex procedures outweighs the potential savings on capital adequacy requirements considerably. Incurring these additional costs with the sole purpose of optimizing their regulatory capital requirement is likely to be worthwhile for a very small group of institutes that have plenty of capital. The SFBC thus expects most Swiss banks to opt for the relatively simple standard procedures for calculating capital adequacy requirements under the new regulations. However, they must look to the complex procedures as an inspiration to improve their risk management systems. The analysis of the responses to the survey in SFBC Newsletter No. 22 showed that many banks already use an internal rating system for granting and managing credit[1]. These rating systems are being continually developed, the focus being on improving risk management rather than the intention of choosing one of the complex options for calculating capital adequacy requirements under the new regime. The SFBC welcomes this trend.

Survey of banks and first preliminary tests

Not many banks interested in using internal procedures

A survey in the SFBC Newsletter No. 30 found that, at the end of October 2003, only around 20 foreign banks, the two big banks and one other bank had requested approval to use internal procedures. The strong interest among foreign banks is due to the fact that their parent groups outside Switzerland use the complex procedures in their countries of domicile and are thus required by the relevant authorities to apply them at most of their subsidiary banks as well. The SFBC has been holding regular talks with the two big banks with a view to testing the strict approval criteria for the complex, internal procedures. The first preliminary tests in the management of credit and operational risks are planned for early 2004. The SFBC has put together testing teams for this purpose.

[1] see II/3.4.1

It would of course be unfair to suggest that Basel II can be reduced to a set of sophisticated internal procedures for calculating capital adequacy requirements. This would fail to account for the fact that the overwhelming majority of institutions, while basing their efforts to improve risk management on the high qualitative standards of the internal procedures, will in fact use the standard procedure to calculate their capital adequacy requirements.

Basel II is more than just a sophisticated set of procedures

No across-the-board increase in capital adequacy requirements

Swiss banks already have to meet much higher capital adequacy requirements than are stipulated as the minimum under Basel I. The Swiss rules set a compulsory minimum which is 20 percent to 50 percent higher than the Basel I standard, depending on the institution's risk structure. Furthermore, the SFBC expects every bank to exceed the compulsory Swiss minimum by at least 20 percent. Comparable targets have been agreed with the two big banks. They are allowed to fall short of these targets, but only temporarily. As soon as a bank falls short of the target figure, it is subjected to a more intensive check by the SFBC, must submit a plan for rebuilding its capital buffer – for example by reducing its risks or increasing its equity – and is only allowed to pay out dividends within certain limitations.

Capital underpinning already much higher

This supervisory practice, which proved effective during the three-year bear market, for instance, will be continued with the national implementation of Basel II. The Swiss minimum capital adequacy requirements will remain well above the international minimum. Likewise, the SFBC will maintain its practice of setting additional targets as a part of the specific supervisory process tailored to each individual institution, which will be known as the "second pillar" of Basel II.

Continuation of tried-and-tested methods

On an international comparison, Swiss banks have relatively substantial capital buffers. Their eligible capital is on average 159 percent of the current Swiss requirement[1]. Since the changeover to Basel II will not lead to a significant increase in the overall capital adequacy demands placed on the Swiss banking system, the banks will still have sufficient reserves to mitigate the risk of a deterioration in their credit portfolios while meeting their capital adequacy requirements. With this capital buffer, it seems unlikely that any credit crunch for SMEs or other companies will occur as a direct result of Basel II.

Adequate capital buffers

[1] see http://www.ebk.admin.ch/d/aktuell/m030502-05d.pdf

Preserving existing level of capital

All in all, the current level of capital present in the Swiss banking system will be maintained, which is in fact what Basel II is aiming for internationally. However, there is no intention to raise overall capital adequacy requirements in the tailwind of Basel II. Depending on their risk profile, individual institutions may be faced with higher requirements than at present or lower ones. The two big banks will have similar capital adequacy requirements under the new regulations to those they must currently meet, provided their risk profiles remain unchanged, on account of their special importance to the Swiss banking system.

No discrimination against SMEs

Credit risk management continues to develop independently of Basel II

The internationally active big banks went ahead on their own with the development of their credit risk management systems, regardless of regulatory capital adequacy requirements, long before the revision of the Basel Capital Accord became an issue. Domestic credit business within the Swiss banking system suffered huge losses in the first half of the 1990s, and some of the cantonal banks are still feeling the after-effects. This negative experience prompted the big banks to adopt internal rating systems with differentiated credit extension practices and risk-adjusted pricing in the mid-1990s. A lengthy public debate ensued over the possibility that this new credit regime would make it harder for SMEs to obtain financing and thus jeopardize the economy as a whole. The big banks responded with a less schematic approach to the issue and improved communication of their criteria to the SME debtors concerned. The other Swiss lending banks also learned their lesson from the 1990s and have since been steadily pursuing improvements in risk management. Even if Basel II were not implemented in its entirety in Switzerland as far as setting regulatory capital adequacy requirements is concerned, the recording, measurement and controlling of credit risks in line with a borrower's specific level of creditworthiness would still be a fait accompli. This is to be welcomed as a means of creditor protection and safeguarding the banking system as well as from the macroeconomic viewpoint. Subsidizing loans to undercapitalized and badly managed SMEs is in the interests of neither the multitude of well run SMEs nor the sustainable development of the economy as a whole. Bank failures create enormous economic losses, and a banking system paralysed by non-performing loans is no longer in a position to keep capital flowing to companies that need it to finance their business. This is proven all too clearly by the crisis in the Japanese banking system, which has lasted for more than a decade in spite of massive state intervention.

The capital adequacy requirements for loans to SMEs will on average be lower under Basel II than under the current regulations. In general terms, it should be noted that Basel II will on the whole lead to a reduction in capital adequacy requirements for credit risks. The Basel Committee's intention was neither to increase nor to reduce such requirements for the average bank. However, the introduction of new requirements for operational risks (which are not specific to SMEs) inevitably has the effect of reducing the requirements for credit risks. The concerns over alleged discrimination against SMEs and loans becoming generally more expensive due to Basel II have died down of late in the international arena. In Switzerland, where the trend towards borrower-specific credit risk management is already at an advanced stage on account of the large market share held by the big banks and the painful experiences of the entire banking system in the recent past, such concerns would be completely out of place.

Capital underpinning for operational risks reduces requirements in respect of credit risks

The problem of adverse selection, i.e. the risk of good credit risks becoming concentrated with the banks that use the complex methods because of their risk-adjusted and therefore comparatively favourable credit terms while bad risks accumulate with banks that use the simpler approaches, will be addressed by the SFBC in its institution-specific supervisory process (the "second pillar")[1]. Every bank active in this field must therefore be able to gain a clear picture of its credit risks in order to compare its regulatory capital adequacy requirements with the actual risks it takes on. An internal rating system for credit risks tailored to match the institution's circumstances can provide such a picture and allow the SFBC, where necessary, to take remedial action (for example by imposing a capital adequacy premium).

Adverse selection

In addition to the second pillar, the revised Capital Accord will also include a third pillar. This third pillar concerns expanded disclosure obligations and is the Basel Committee's attempt to encourage the banks to improve transparency and thereby increase the discipline exercised by the markets. The plans for implementation in Switzerland go no further than the disclosure obligations stipulated in Basel II.

Market discipline

The SFBC intends to make two further changes to the Banking Ordinance at the same time as the adjustment required for Basel II. The first of these is the removal of the capital discount for the cantonal banks, i.e. the reduction in their capital adequacy requirements due to the state guarantee in their favour (Art. 13 let. b of the Banking Ordinance). The second is that the obligation of cooperative members to provide additional capital to the cooper-

Cantonal bank discount and additional capital requirement for cooperatives

[1] see Annual Report 2002 p95ff

ative will no longer be recognized as supplementary capital (Art. 11b para. 2c of the Banking Ordinance).

3 The Money Laundering Ordinance and its implementation

Object

The SFBC's Money Laundering Ordinance came into force on 1 July 2003 with a transition period of one year for certain provisions. Some existing rules have been carried over into the new Ordinance, albeit in a more refined form. These include increased due diligence obligations in the case of business relationships with politically exposed persons (PEPs) and the duty to clarify the background of business relationships. The risk-oriented approach, on the other hand, is a new addition. The Ordinance requires banks to ensure that their due diligence is aligned with their specific risks. Business relationships that involve higher risks in abstract terms require additional verification – for example regarding the origin of the assets concerned. Risk criteria thus need to be defined that can provide a basis for determining and internally classifying all new and existing high-risk business relationships. For normal relationships, meanwhile, the client must be identified as before in accordance with the Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence (CDB) without any additional verification being necessary. Other changes concern the introduction of computer-aided transaction monitoring systems and the extension of the rules to combating the financing of terrorism.

Scope

The scope of the Money Laundering Ordinance has been formally widened to include companies belonging to a bank or securities dealer that do not themselves have the status of a bank or securities dealer. These companies can submit a formal application to be placed under the SFBC's money laundering supervision. Companies already subject to money laundering supervision in accordance with SFBC Circular 98/1 were required to submit a new application by 30 September 2003.

Consolidated supervision

The change to Art. 13 of the Money Laundering Act, which is pending in parliament in connection with the revision of the Insurance Supervision Act, creates a clear legal basis for uniformly monitoring a group of companies with regard to money laundering. Thus, for example, subsidiaries of a bank or securities dealer that are not subject to any special, legally prescribed supervision, but are covered by the Money Laundering Act, can request supervision by the SFBC as far as money laundering is concerned. This ruling is intended to avoid overlaps between supervision based on special laws (i.e. that performed by the SFBC) and the supervisory regime of the Money

Laundering Control Agency. It should also allow uniform money laundering supervision within a consolidated banking organization even when the group owns subsidiaries that are not subject to any special supervision prescribed by law.

Implementation

In order to ensure that the Ordinance is implemented correctly and on time, all institutions supervised by the SFBC had until the end of September to present their implementation concept, timetable and comments regarding the resources needed. Standardized questionnaires were used to make the reports submitted as homogeneous as possible. Financial intermediaries were required to have their questionnaire countersigned by their external auditors before returning it to the SFBC.

Results

The analysis showed that implementation will involve considerable outlay. The most resource-intensive aspects are the investigation of high-risk business relationships on the basis of criteria defined by the financial intermediaries themselves, any additional clarification required in this connection and the introduction of transaction monitoring systems. Most banks nevertheless stated that they would be implementing the Ordinance in full by the July 2004 deadline.

4 International administrative assistance

Unsatisfactory legislation

The SFBC continues to view the current legislation on international administrative assistance as unsatisfactory. It therefore submitted a proposal, drafted in conjunction with the Swiss Bankers Association, to the Federal Department of Finance in March 2003 to amend Art. 38 of the Stock Exchange and Securities Dealers Act[1]. The Federal Council then decided in December to put a revised draft of the proposal out for comment.

Blocking mutual administrative assistance

The current legislation blocks the provision of administrative assistance to certain key countries. For example, the SFBC is at present unable to provide administrative assistance to the US Securities and Exchange Commission (SEC). There are similar problems with Italy's Commissione Nazionale per le Società e la Borsa (CONSOB).

International incompatibility

The article on administrative assistance is simply not compatible with international standards. The International Organisation of Securities Commissions (IOSCO) has created a minimum standard with its multilateral Memo-

[1] see Annual Reports / Key themes 2001 p21ff and 2002 p13ff and SFBC Bulletin 45/2003 p15ff

randum of Understanding (MOU), which governs cooperation and the exchange of information between stock exchange supervisory authorities[1]. The compatibility and cooperativeness of individual countries is measured by their ratification of and adherence to this minimum standard. Switzerland's current legislation on administrative assistance, especially its insistence on double criminal liability as a prerequisite for passing information to penal authorities, prevents it from ratifying the MOU.

Encouraging financial crime

The Swiss legislation on administrative assistance hinders foreign supervisory authorities in the enforcement of their national laws. Foreign perpetrators take refuge in the Swiss financial system to avoid prosecution in their own or other countries. In doing so, they are abusing Switzerland's financial intermediaries to aid their crimes.

Alignment with international standards needed

It is very much in Switzerland's interests – and thus in those of the Swiss banks, too – to bring this rather feeble legislation on administrative assistance up to international standards so as to avoid jeopardizing the strong international position of the country's financial services industry and reduce the scope for abuses. International pressure on Switzerland, which has a reputation for encouraging abuses and failing to assist the effective prosecution of financial crimes, must be reduced if the Swiss banks are to retain their international competitiveness.

No access to markets

Swiss financial intermediaries could even find that they are denied access to foreign markets as a result of Switzerland's shortcomings with regard to administrative assistance, since some countries stipulate a functioning assistance arrangement with the country of origin as a condition for granting foreign companies access to their stock markets. The same will apply to Swiss exchanges seeking to enter into cross-border joint ventures. Furthermore, administrative assistance is not a one-way street. There is a risk that the SFBC will no longer receive information for its own investigations from certain countries to which it can provide only limited assistance or none at all, if those countries insist on the principle of reciprocity.

Retaining the speciality principle

The draft revision of the article on administrative assistance has the following key features: The speciality principle – the principle that information may only be used to enforce regulations concerning stock markets, securities trading and securities dealers – is upheld in full. Information passed to foreign financial market supervisory authorities via the administrative assistance process may therefore not be used for any other purpose, e.g. taxation.

[1] see VI/1.2.2

The SFBC's experience shows that foreign authorities respect the speciality principle.

The confidentiality principle will be defined more precisely, although the rules on publicizing proceedings and providing information on them to the public will generally be preserved.

Specifying the confidentiality principle

The forwarding of information to bodies involved in the regulation of stock exchanges, securities trading and securities dealers – i.e. within the scope of the speciality principle – will in future be allowed without the SFBC's specific approval. This also applies to forwarding information to penal authorities. The process is thus no longer split in two. However, the client may still appeal against the initial transfer of information to the Federal Supreme Court. Forwarding information to penal authorities for purposes that do not fall within the scope of the speciality principle, on the other hand, will be subject to the same conditions as before, in particular the double criminal liability requirement.

No approval needed to forward information within the scope of the speciality principle

Proceedings by clients, i.e. their right to appeal before the Federal Supreme Court, will be retained, but will be tightened and accelerated by means of deadlines and guidelines.

5 Reform of financial market regulation

The commission of experts headed by Prof. Ulrich Zimmerli, which was appointed by the Federal Council at the end of 2001, presented its first report in July on the creation of an integrated financial market supervisory authority[1].

Zimmerli commission's initial draft

In this first draft, the commission proposes establishing a new supervisory authority, the Federal Financial Market Authority (FINMA) via a federal law on financial market supervision. FINMA, to be created by merging the SFBC with the Federal Office of Private Insurance (FOPI), would take the form of a public-law institution with the status of an independent legal entity. It would have a Supervisory Board – elected by the Federal Council – that would be responsible for determining its strategy, deciding on regulations and appointing a Management Board, which it would also advise on general matters. Like the SFBC, the new authority would be financed entirely by fees

FINMA

[1] see http://www.efd.admin.ch/d/dok/gesetzgebung/vernehmlassungen/2003/10/finmarkt.htm and Annual Report / Key themes 2002 p8ff

and supervision charges and would not be constrained by any directives from the Federal Council. It would be entitled to manage its own budget and issue its own staff regulations. The authority itself would be supervised by the Federal Assembly.

Uniform regulatory instruments

At the SFBC's request, the commission of experts did not restrict itself to drafting a simple law of organization, but instead took into account a proposal by the SFBC for standardizing supervisory instruments and mechanisms in all areas of supervision. For example, the draft deals with the use of audit companies at supervised institutions. In principle, all supervised institutions should commission an audit company to audit their accounts (accounting audit) and their compliance with supervisory provisions (supervisory audit). FINMA would have the power to exempt individual institutions or groups of institutions from the audit obligation if it examines them itself or commissions an audit. All audit companies, however, would also have to be approved by FINMA. FINMA would determine the content of these audits above and beyond the best practices of the audit industry and would monitor their quality. It would be able to order in-depth and follow-up audits and could in certain cases carry out parallel audits. The SFBC's current efforts are already heading in this direction.

Uniform, direct regulatory instruments

According to the draft, FINMA's direct supervisory instruments should also be uniform for all areas of supervision. All supervised institutions would be obliged to disclose the information required by FINMA to fulfil its remit. In cases where supervisory provisions have been breached, FINMA would be responsible for restoring compliance. "Special Commissioners" could be employed, for instance, to investigate matters of supervisory relevance or to carry out any measures decided upon. If a supervised institute fails to meet the applicable licensing requirements or is guilty of a gross breach of its legal obligations, FINMA could revoke its licence to do business.

The SFBC's position

SFBC in favour of new law on financial market supervision and FINMA

The SFBC issued a position statement regarding the Zimmerli commission's draft in which we stated that we are fundamentally in favour of the proposed law on financial market supervision and the creation of FINMA. The SFBC thinks that the principal arguments put forward by the commission (better use of supervisory staff's skills and common ground shared by the banking and insurance sectors in the area of investment) are convincing. The fact that the financial markets appear to be turning their backs on the

"bancassurance" concept does not alter this view. It remains to be seen whether the trend will continue. In addition, given the aforementioned circumstances, creating a fully integrated supervisory authority is the only way to strengthen the administrative independence of the supervisory function. It must be remembered that the SFBC already supervises not only banks and securities dealers, but also investment funds, exchanges and to some extent securities markets as well.

Expectations and prerequisites

Although the SFBC welcomes the creation of FINMA, it warns against the illusion that simply integrating banking and insurance supervision into a new authority will in itself solve any problems of regulatory surveillance. If the basic requirements for effective supervision are in place, such as administrative independence, control of resources, freedom from political pressures, neutrality in dealing with those supervised and clear institutional governance, supervisory authorities can still do their job even when they operate separately in their respective sectors. If they are not in place, even an integrated authority will fail. The political debate should therefore not focus on FINMA as a solution to the material problems of supervision. FINMA represents nothing more than an important and appropriate reorganization of supervisory duties.

Tasks beyond the regulatory remit

In addition, the future FINMA should not be encumbered by unrealistic tasks that lie outside the regulatory remit. FINMA would of course bring together those areas of the two merged authorities (SFBC and FOPI) that are vulnerable to attack. Difficulties in one area of supervision would inevitably reflect upon the other and could have a negative impact on FINMA's image and its effectiveness. This is why a coherent supervisory policy for FINMA as a whole is indispensable, which means that the activities of the specialist "departments" must be clearly embedded in an overall strategy.

No overloading

FINMA must also not be paralysed by an overload of new projects. The Zimmerli commission's draft does not address the question of whether the new authority will be assigned additional tasks. It is thought that the new authority would oversee between 2,000 and 4,000 asset managers, close to 2,000 other financial intermediaries that fall under the Money Laundering Act, the audit companies of the 400 firms listed on SWX, the 4,000 auditors employed in the audit companies and over 11,000 independent pension funds and foundations covered by the Occupational Pensions Act. Whatever form FINMA takes, the areas of supervision the draft already envisages for it mean that its work will be quite complex enough. The organization and execution of the merger between the SFBC and the FOPI will also tie up considerable management resources to begin with. The SFBC is therefore

concerned to highlight the risk of paralysing FINMA by massively extending the scope of its regulatory remit.

In the Banking Commission's view, the most important aspect of the FINMA project must be to strengthen the independence of the new authority.

Powers of decision

Both the Supervisory Board and the Management Board should be allowed to delegate powers of decision not only to the specialist departments, but also to various committees. FINMA's organizational freedom should not be restricted by any stipulation that, apart from the Chairperson, every member of the Management Board must head up a specialist department. Rather, FINMA must be free to form a committee of the Management Board, if necessary, that can decide on key issues within the individual organizational units.

Increased independence

Its independence from the federal administration should be increased by the power to issue staff guidelines, as is provided for in the National Bank Act (both old and new versions) and in line with a recommendation made by the international group of experts in the Financial Sector Assessment Program (FSAP) of June 2002 initiated by the International Monetary Fund.

Independence from the supervised institutions must be clearly regulated by a provision that stipulates which private-sector jobs are incompatible with the function of a FINMA Supervisory Board member.

Strengthened institutional governance

The SFBC also believes the new supervisory authority's institutional governance has to be reinforced. One of the strengths of the current banking supervisory authority, the SFBC, is that it not only acts in an advisory capacity, but also has decision-making and enforcement powers in individual cases. The Executive Board's position is rightly a strong one, but this is balanced by the need to present its ideas and proposals to a panel that can judge matters with sufficient detachment. This reduces the risk of one-sided or hasty decision-making. In the SFBC's view, this principle should be retained in FINMA for fundamentally important decisions.

Limited liability

The law on financial market supervision should provide a clear standard for delimiting the responsibilities of FINMA and the (subsidiary) responsibilities of the federal government. Such a standard should – in line with international standards and the regulations in place in numerous other countries – limit liability for failure to properly fulfil its surveillance tasks to a moderate but reasonable degree. FINMA and (to a lesser extent) the federal government should only be liable towards the users of financial services whom

regulatory legislation is intended to protect. Liability for any failure to perform its duties properly should be limited to cases in which established supervisory practice clearly demands action that was not taken.

Informing the public

FINMA's efforts to inform the public, meanwhile, need to be defined in a more appropriate way. While the SFBC agrees with the idea of addressing these efforts in the law, it would like to see the rather vague provisions put forward in this respect substantially simplified. For instance, it should be possible to publish information on administrative proceedings (both closed and ongoing) if there is a particular need to do so from the regulatory point of view. This may include publishing information on proceedings that are already known to the general public, for the protection of market participants or to correct false or misleading statements.

Second audit as a standard regulatory instrument

The control instruments available to audit companies and the supervisory authorities should also be strengthened. The SFBC does not believe that the (fully justified) introduction of a second audit should be based on the existence of significant concerns about the conduct of the statutory auditor. Recourse to a second audit should not give the impression that the institution concerned is in trouble. In addition, the SFBC's experience shows that it must also be able to order a second or in-depth audit itself when needed without having to resort to the more incisive supervisory instrument of the "Special Commissioner". In order to allay fears of a routine second audit policy, the SFBC proposes carrying out second audits only for institutions with special risks and those that are of particular importance.

Cooperation with Swiss authorities

Further clarification is needed as regards how FINMA will cooperate with other Swiss authorities. The draft law assumes that it will only exchange information with penal authorities and financial market supervisory authorities, e.g. the Money Laundering Reporting Office, within Switzerland. The SFBC knows from experience that it is important to regulate the flow of information from FINMA to other Swiss authorities and in particular to set out the definitive procedure in the law on financial market supervision.

Sanctions and autonomy of the financial market supervisory authority

The experts' proposal does not deal with the question of what sanctions the future financial market supervisory authority should be empowered to impose. However, the commission has said that it intends to address the proposals the SFBC made in its "sanction report"[1] in 2004. This is an important issue in financial market regulation, regardless of the project for a law gov-

[1] see http://www.ebk.admin.ch/e/aktuell/m030502-02e.pdf

erning supervision of the markets. The same is true of the absolutely essential need to strengthen the administrative autonomy of the supervisory function and clarify the question of liability.