CENTRAL BANKING PUBLICATIONS LTD

THE Financial Regulator

Interview: Daniel Zuberbühler

A reprint from

The Financial Regulator

Volume 10 Number 2 - September 2005

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Switzerland's Federal Banking Commission supervises two of the world's largest banks with a staff of less than 200. Neil Courtis asks the director how they cope.

Financial centres, like London or New York, are home to thousands of financial regulators. Yet the EBK (Eidgenössische Bankenkommission, the Swiss Federal Banking Commission) manages with a staff of 160. How is this possible?

What allows us to be so lean is that we outsource onsite inspections to licensed audit firms, which report to us and which we in turn supervise and licence. We might need another 400 or 500 staff without this arrangement.

The United States and Europe are moving away from reliance on external auditors (in the light of problems at Parmalat, WorldCom etc). Are you tempted to follow them?

Switzerland is following this move to public oversight of external auditors of all companies which are listed on a securities exchange. The new Audit Supervision Act is in the final stage of the parliamentary process and will establish a new supervisory body under the auspices of the Federal Justice and Police Department.

You have to distinguish this latest move, which also covers auditors of non-financial firms, from the so-called "dualistic approach" in prudential supervision of banks, securities firms and investment funds, where the EBK delegates examination work to external audit firms and supervises them. The auditors we use are not merely self-regulated and left to themselves. We can withdraw the license and sanction auditors who do not behave as we want, and we can order a special audit by a second firm if we are not satisfied with the results of an audit. We have had a system of auditor oversight in the prudentially regulated financial sector since 1934, and we have been tightening and improving the system since then. These auditors act on our behalf in a public capacity, and we "watch the watchmen" through systematic quality controls and enforcement procedures.

Daniel Zuberbühler was elected director of the Swiss Federal Banking Commission in 1996. He joined the commission as a legal officer in 1976 and from 1977 onwards was in charge of the legal department II before becoming head of the legal department in 1981. In 1986 he became vice-director and in 1988 he was appointed deputy director. Since 1996, he has been a member of the Basel Committee on Banking Supervision.

The job that the Public Company Accounting Oversight Board is doing in the US is something we have done for decades, but with a different scope. Clearly there are potential conflicts of interest where an auditor is earning fees from a bank and also reporting to us on the bank's compliance with regulations, but we manage these.

Having said that, as far as the big banks are concerned, we have moved to a mixed system of more direct supervision, including our own onsite reviews and less reliance on the external audit firms. Since 1998 we have built up a large banks division of 25 people including a risk management group, which reviews and approves large banks' use of internal value-at-risk models for market risks.

Does the same firm audit the bank's accounts and their compliance with regulation?

Yes, but we have just split these functions into a financial and a regulatory audit. For the regulatory audit, the auditor has to confirm that the bank is complying with the full range of regulatory rules including the self-regulatory standards of the industry.

To what extent are your new rules the result of international pressures or extraterritorial regulation imposed by the US or EU?

Obviously the extraterritorial impact of measures like the Sarbanes-Oxley Act (where we need to legislate at home so that Swiss companies can stay on the New York Stock Exchange) affect us, in this case mainly firms outside the financial sector. When introducing the Audit Supervision Act in Parliament, our minister of justice openly declared that this new legislation would not have been proposed without the pressure from Sarbanes-Oxley.

Equally, it is plain that international minimum standards now drive a lot of the regulation done at a national level. I don't think Switzerland is unusual in this respect. For banking regulation, the Basel Committee on Banking Supervision makes the running and we are a member. On the asset management side, the EU now requires that managers of investment funds, which are sold in the EU, be regulated whether they reside in the EU or not. So we now offer, but don't require, a securities firm license for independent asset managers who want a passport into the EU. This licence is the price of admission to the EU market.

Do we face a spiral of over-regulation from this kind of development?

Everyone is very concerned about over-regulation, and obviously since the international regulatory agenda drives a lot of new regulation, many people point the finger in this direction. But where would we be without international standards and some degree of harmonisation? The result would be chaos. The better situation is obviously one – like the Basel accord – where you can be

involved in the process, and have a say in the outcome.

The EBK has complained about the burden of new FATF standards. Are there enough restraining mechanisms to stop international standard-setters over-regulating "at long distance"?

We and the industry did not criticise the revised FATF recommendations, but rather the implementation proposed by a Swiss working party. We do worry about over-regulation, and where we are a member of the rule-making body we make ourselves heard. However, there is a growing awareness, within the EU for instance, of the need not to overload the financial services industry. But this dynamic starts with the media and from politicians. Some kind of problem occurs and the media gets excited, and politicians feel they need to be seen to be doing something. Things escalate and we have to manage expectations. Now we see a counter-reaction, which has also come to the attention of politicians, and they now worry about over-regulation.
From our perspective, it is small firms that are especially vulnerable, and the answer here is to have differentiated regulation. The Basel accord provides a good example with its wide range of menus from simple standards to highly sophisticated internal approaches. Much of the accord is aimed at globally-active international firms. We don't want, or expect, small local firms to aspire to the same kind of risk management perfection. There is no need for them to implement IRB or AMA merely for the purpose of calculating regulatory capital. You can't count the number of pages in our banking ordinances and deduce that the regulatory burden is rising or falling. Firms can just look at what concerns them and forget about the rest. If I want to eat a simple meal in a restaurant, I don't need to read the full selection of exquisite gourmet menus.

How will Basel II be implemented in Switzerland?

Unlike the US, but like the EU, we are implementing the full Basel menus. However, the vast majority of Swiss banks will apply the standardised approach. We will offer a Swiss version of the standardised approach and a "Basel pure" approach, which precisely follows the EU directive based on the Basel committee's framework.

For Swiss banks already on the Swiss version of Basel I (which is somewhat more sophisticated than the basic version and has capital requirements well above the Basel minimum), the new Swiss standardised version will allow them to make the switch with minimum disruption. Those banks for which it is more important to be aligned precisely with the international standardised approach can go down the "Basel pure" route. However, we are going to apply three multipliers so that this group of banks does not gain an advantage over those remaining on the Swiss version.

On the subject of competitive equality, do you share the concerns (especially prevalent in the US) that Basel II will give large sophisticated banks an unfair advantage?

We don't expect capital requirements for our largest banks to fall dramatically. They may not even fall at all. We certainly don't want the biggest and systemically-important banks to get away with much less capital than they carry under Basel I, and we won't allow this to happen. Our goal for Switzerland is the same as that of the Basel committee: to maintain the level of capital in the system. If we see too much of a fall, we will have a discussion in Basel about imposing multipliers to prevent this.

How long can regulators maintain a capital floor for large banks? Eventually won't they argue that they have done all the work, and spent all the money, and so they should be allowed the capital reductions?

We are talking about a transitional regime. We don't want a bank with the same risk positions to suddenly have a wildly different capital minimum because of a rule change. If the result of applying Basel II in any individual case is a huge drop in capital, then we are going to want to ask whether the sums are right. However, if, as Basel II continues in use, banks indeed reduce their risks, then it is appropriate for their capital charge to fall.

There is some concern about the complexity of supervisory cooperation under the new accord. How easy will it be for hundreds of supervisors to cooperate?

Complicated cross-border coordination issues only arise with the use of IRB for credit risk and AMA for operational risk elements of Basel II in global banks. We are both a home supervisor (and therefore lead supervisors of two global banks) and a host supervisor. As host supervisor we have told the 140-odd foreign banks (mainly subsidiaries focused on private banking) that we will not force them to adopt any particular option of the accord. If they want to go along the advanced route, we will have a simplified approval process relying on the assessment of their home supervisors. As a compensation for this simplified process we will impose a multiplier to make sure that they remain at least at the level of the standardised approach. But this should be no problem since these subsidiaries are already very well capitalised.
As regards our own large banks, look at the plans of UBS. UBS subsidiaries abroad are going to apply the local standardised approaches to avoid the burden of multiple approval processes and cross-border issues among supervisors (which come about because of the need for local verification of elements of the internal approaches). At the parent and group level, UBS will apply the advanced approaches.

Increasingly, small countries face the problem that their biggest bank is a rather unimportant subsidiary of a bank headquartered elsewhere. How big a problem does this represent do you think?

Well, it is not a situation we have, unless one of our big babies were to be taken over by a foreign bank. However, host countries have a legitimate interest in their systemic banks, and this is something under discussion between the Basel committee and the non-G10 supervisors. We have to find pragmatic solutions. Host supervisors can't turn the normal process upside down by demanding the right to come and supervise a parent bank in another country.

What is the status of the proposal that Switzerland should move to a single regulator?

We expect that the government will table a bill proposing the creation of the new integrated financial regulator, "FINMA", in the fourth quarter of 2005. One political party believes that this represents the birth of an over-regulating monster, and thus opposes the idea. However if the proposal finds favour in parliament we would merge in 2008.

We see advantages in the proposal: in particular the idea that the core of the financial sector – banks and insurance companies – should come under the same risk measurement methodologies. Of course we recognise that unifying regulatory authorities is a major undertaking! Originally the idea was driven by the need to supervise bancassurance and financial conglomerates. Now, in the Swiss market, financial conglomerates are on the retreat, and those that are left, like Credit Suisse and Wintherthur, are contemplating de-merger. And we are not alone in seeing this trend. In the US, for instance, Citigroup has sold Travellers.

Does that undermine the idea of a merged regulator?

No. Some of the risks are similar and you need an integrated approach to tackle them. The retreat from financial conglomeration reduces the urgency of the project a little.

Currently the EBK lacks the power to fine banks. Is that likely to change?

We can demand management or organisational changes within banks and still have the nuclear option of withdrawing licenses, but we lack the power to levy monetary fines. We submitted a report in May 2003 to the group of experts drafting the FINMA legislation which proposed that the new regulator should have the power to fine banks and financial firms up to CHF50m. This was a long shot and was fiercely opposed by banks and politicians, so the idea has been buried. A proposal that funds derived from breaches of regulatory rules should be liable

for confiscation as well as an explicit power for naming and shaming is still on the table.

We particularly wanted the option to sanction market participants who are not regulated in cases of insider trading or other market abuses. Currently we only have the option to make a criminal referral, and the scope for this in market-abuse cases is rather narrow under Swiss criminal law, and it would not them be the EBK handing out the sanction.

I think your submission also argued against a requirement that the EBK should undertake a cost/benefit analysis of all new regulation. Why did you take that view?

Any reasonable regulator considers the costs and benefits of new regulation – at least through some kind of qualitative analysis. You need to consider alternative ways to reach a public policy goal, and look at whether this could be achieved in a less costly way. We are sceptical about having to perform *ex ante* a quantitative cost/benefit study.

What one tends to find is that all you can calculate with any certainty are the direct costs, but those are the smallest part. You can estimate indirect or compliance costs (audit fees and so on). Concerning opportunity costs, you need to hypothesise what would have happened if the regulation were not in force, and this is just speculation. When you come to the benefit side, any quantification *ex ante* seems impossible. Sometimes the benefits are highly tangible in the sense that a new regulation (as we were discussing earlier) is the price of staying in a certain market.

Alan Greenspan and others have worried publicly about hedge funds, and banks like UBS and Credit Suisse now make quite a bit of money offering brokerage services to hedge funds. Are you confident they are managing their hedge fund exposures well?

One question is whether we need to regulate hedge funds directly. We already have legislation defining the scope for public marketing of hedge funds to small investors. That covers the consumer protection side of regulation. We then need to ask whether hedge funds pose a systemic risk. Clearly the key to containing any risks hedge funds pose is via their banking counterparties. The message we hear from banks is that there is strong competition for hedge fund brokerage, and we thus need to be vigilant that banks are not lowering standards (especially for risk mitigation) to win business. But we do not see a need to supervise hedge funds directly, as long as they do not publicly solicit funds.

What about private banking flows? Are these funds becoming more volatile?

There is increased competition for private banking business and margins are going down. Banks have responded by going onshore, and locating in the countries where

the customers are. But you need a lot of capital to carry this through the initial stages of the venture. Our domestic banks are still seeing money flow in, and although margins may be falling, they are in pretty good health.

Some argue that UBS and Credit Suisse, rather than being too big to fail, are too big to save. How would you react if one of these banks got into trouble?

No public authority wishes to publicise how it would react for reasons of moral hazard. Obviously we need to be prepared for the worst, and this would involve cooperation with international partners which has to be discussed in advance because it is too late to try and make these arrangements in a crisis.

Doesn't having a credible plan to liquidate a bank reduce moral hazard by showing counterparties that such-and-such a bank could indeed fail?

When Union Bank of Switzerland and Swiss Bank Corporation merged to form UBS in 1998 the question came up in Parliament whether there was a factual guarantee by the federal government for large banks. The government's answer in a nutshell was "in principle no, but it depends on the circumstances and a balancing of interests." This rather avoids the issue, but it does not mean that we don't think about what we would do. The recent change to Swiss bankruptcy laws for banks should make it easier to wind down companies.

Does banking secrecy impact your ability to cooperate with other regulators?

Bank customer secrecy does not generally impede cooperation with foreign regulators, with one exception in our Securities and Exchanges Act. The conditions for an exchange of customer-related information with foreign securities regulators in market-abuse cases are too narrowly defined in the present legislation. We have been pushing for reform of the law since 2002 and this is finally being considered by parliament. We had a particular problem exchanging information with the US Securities and Exchange Commission because of their practice of issuing a litigation release on the internet when they introduce a complaint in court. Our supreme court objected to that, and so we have to change this law. The second chamber of parliament rejected this change, 17 to 16, but the primary chamber remains in favour and we may get this through on a second try. Parliament already has accepted that dual criminality and the prior consent of the EBK to the retransmission of information from the foreign securities regulator to other authorities are no longer a condition for the exchange of information provided it used for supervisory purposes only. Clearly this would not cover investigations in tax cases.