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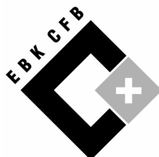

Eidgenössische Bankenkommission
Commission fédérale des banques
Commissione federale delle banche
Swiss Federal Banking Commission

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Risk based supervision – implications for our stakeholders

The concept of risk based supervision belongs to the latest trends and discussion topics in the domain of financial market regulation and supervision. The draft of the Federal Act on Financial Market Supervision actually grants it a law-like status.[1] In practice, however, the principles of a risk based approach are already enforced in the "Guidelines for Financial Market Regulation", that have been issued by the Federal Department of Finance in September 2005.[2] And to be sure, the ongoing supervisory activities as well as the regulatory duties (conception of ordinances and circulars) of the SFBC have been guided by this principle for longer than that. Moreover the SFBC is dedicated to shaping this risk based approach further and tries unabatedly to apply it both systematically and consistently. The most recent step in this respect involves the implementation of a risk based supervision of small and medium-sized banks as well as of securities dealers based upon an early warning and rating system developed internally.

What is risk based regulation and supervision?

The purpose of financial market supervision is the protection of the financial system and of the consumers (from the viewpoint of the SFBC this concerns more specifically the creditor and the investor) of financial services from financial and reputational risks, that are prejudicial both for the society and the market. Financial market supervision cannot – nor is it designed to – bar all risks in the sense of a zero-risk tolerance, because this would simultaneously hamper business activity, slowdown income generation, not to mention innovation processes. The resources available to financial intermediaries and supervisory authorities for the purposes of risk control will always be limited and this should remain as such. Thus these limited resources should always be allocated – in the sense of maintaining an optimal relation between costs and benefits – in such a way as to target those areas, both where the risks are highest (in terms of potential damage

[1] Art. 7 para. 2 litt. c FINMAG

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

and likelihood of occurrence) and where there is an increased need for protection emanating from the financial system, the creditors or the investors. The forgoing of a uniform and homogeneous control of the risks presupposes both a certain boldness with respect to potential loopholes and, an acceptance of minor incidents.

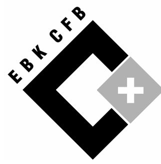
Risk based approaches have already been implemented in many areas of supervision: the different approaches adopted in the supervision of large banks on the one hand, and of small and medium-sized banks on the other are the most obvious examples.

Intensive and bespoke supervision of large Swiss banks

The structure of banking supervision at the SFBC was reorganised in 1998 – the year in which the former Union Bank of Switzerland and Swiss Bank Corporation merged to form UBS and, also the year of the LTCM debacle. The supervision of Switzerland's two largest banking corporations – UBS and Credit Suisse – was spinned off from the SFBC Banks and Securities Firms department to constitute a new Large Banking Groups department. This department’s task was to organise and systematize the supervision of the two aforementioned (“*large*”) banks. Although the same regulations are applied to all institutions in Switzerland, one must reckon that the supervision exercised over these two banks differs both in its intensity and its approaches from that exerted over the other banks and securities dealers under the attribution of the SFBC.

The focuses of the SFBC supervisory activity with respect to these two Swiss large banks is based both on economic facts and risk considerations. Both UBS and CSG are banks that exert a global activity; they are among the world's largest institutions in the domains of investment banking and asset management (comprised Private Banking). The Swiss banking system is extremely concentrated by international standards. Indeed the two Swiss *large* banks account for at least 50 percent of the market share in most lines of business, and no less in terms of employment, net equity or net profit generated, for the Swiss banking system taken as a whole. Their business is predominantly conducted abroad. They are tightly interwoven into the global financial system, as well as connected to the key financial markets and the other major market participants through their investment banking operations. Their complex investment banking business conducted primarily from the US or from London, would be impossible to supervise were it not for the close collaboration with the Federal Reserve Bank of New York and the UK Financial Services Authority.

The insolvency of one of these large banks would indisputably have such devastating implications for both the Swiss financial system and the economy, that the traumatic grounding of the Swissair fleet would appear innocuous by comparison. Thus it is more on the basis of the extent of potential damage rather than upon concerns on the probability of its occurrence (small from an actual prospective) that an intensive supervision of these banks is warranted. Our task is, in collaboration with the Swiss National Bank (responsible for ensuring the systemic stability), to see that no catastrophe scenario ever take place.



Risk based supervision of small and medium-sized banks

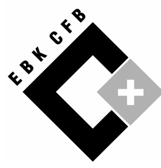
There exists a galore of financial institutions apart from the special class constituted by the aforementioned two banks that are under bespoke supervision. They differ in size, business activity, ownership structure, both organisational and product complexity, and finally in terms of either international or national focus. The SFBC adopts, here as well, a nuanced approach in its supervisory strategy. This approach aims at reflecting the heterogeneous nature of these institutions. It thus conditions the intensity and priority of its supervision to those institutions that are significant (in terms either of size or international exposure) or to those that show indications of extended risks.

The newly-developed SFBC early warning and rating system, launched in 2006, enables from now on the Banks and Securities Firms department of the SFBC to center its supervisory activities on the risks attached to the authorized institutions in a more systematic and more consistent fashion. A detailed description of this early warning and rating system as well as its functioning is available on the SFBC website. This principle underlying this SFBC supervision tool is similar to that enacted in banks (via internal rating systems) to assess credit risks based on the evaluation of the creditworthiness of individual counterparties. It will assign each bank to a “supervisory class” (defining a grade of supervisory intensity) on the basis of both of quantitative and qualitative factors, the later entailing subjective assessments issued by the responsible line supervisor as well.

Limited communication of “supervisory ratings and classes”

The “supervisory rating” and “supervisory class” assigned by the SFBC to each individually supervised institution will be communicated to this institution as well as to its associated auditors. The parties knowing how they have been rated by an independent body may proceed to compare that view with their own assessments. By way of this instrument, the institutions are provided with a transparent and self-explaining rationale to the particular level of supervision to which they are subjected. We stress that the information on supervisory ratings and classes is designed for internal and supervisory purposes only. It is indeed based partly on privileged information that is both confidential and subject to official secrecy. Therefore, the SFBC fully in line with the practice of foreign supervisory authorities, does not make this information public. More importantly, the concerned institution may neither publish it – e.g. for marketing purposes – nor use it in its dealings with third parties.

This new early warning and rating system for small and medium-sized banks and securities dealers is, however, no silver bullet, for it will not prevent either single losses or accidents to happen. It should rather be viewed as a tool that helps allocating limited supervisory resources to the most significant risks in as objective and efficient a fashion as possible. Moreover it is based, as one expects, on historical data that do not warrant accurate future predictions, on human judgments that may err, and finally on simplifying modelling assumptions. We are fully acknowledgeable of these limitations – they under-



lie all supervisory activity – therefore we behold with caution as one would expect from a watchdog.