Finanz und Wirtschaft Forum, 5 September 2024
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Effective financial market supervision for sustained prosperity – risk-based and proportionate, but with teeth

Key points

1. The financial sector, or to be more specific the banks, have been at the centre of many serious economic crises in the past. Alongside an independent monetary policy and conservative fiscal policy, strong and independent financial market supervision is therefore critical for the prosperity of this country and its citizens.

2. Effective financial market supervision needs to be rigorous and have teeth, but also proportionate and risk-based in how it implements its tools.

3. To really have teeth, supervisors must be able to intervene early and in a targeted way in the governance, risk culture and business model of supervised institutions. It is often in these areas that problems are first identifiable and can therefore be resolved with relatively minor interventions. But to do this FINMA needs new instruments, a clearer statutory basis and probably also more resources.

4. In this early intervention, supervisors need to act quickly in well-founded exceptional cases and intervene with suitable instruments to resolve the problem. But supervisors should not take responsibility for the areas in question in place of the institution.

5. FINMA already deploys its tools proportionately today and takes a risk-based approach. The statistics for on-site reviews, investigations and enforcement procedures show clearly that supervisors are by no means tougher on smaller market players than the bigger institutions – on the contrary.

6. Since 2018, under its small banks regime, FINMA has granted certain qualified institutions simplified requirements for calculating and disclosing capital and liquidity along with exemptions in qualitative risk management, internal control requirements and reporting. A similar system applies to small insurers.

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Ladies and Gentlemen,

I have given a number of talks on the topic of best-in-class supervision in recent months. And while you will probably recognise some elements from previous talks in my remarks today, I would like to look at this issue again from a slightly different angle.

The points I will discuss are as follows:

1. Why is effective best-in-class supervision so important for the citizens of Switzerland?

2. What does best-in-class supervision mean in practice?

3. How can robust financial market supervision that protects citizens be proportionate and risk-based for the supervised institutions at the same time?

Protecting citizens and the financial system

Let's begin with the first point: why is effective financial market supervision essential for prosperity in Switzerland?

I am convinced that sustainable growth and prosperity for citizens is founded on three important pillars:

1. Independent monetary policy that targets price stability. After the experience of the 1970s there is a clear consensus here about how we secure sustainable growth.

2. Conservative fiscal policy – in Switzerland this is standard practice, but in many other countries it is an ideal to aim for.

3. Robust, independent financial market supervision. The importance of this third pillar is often not as widely recognised.

So why is independent and effective supervision so important? We have learned from bitter experience that many of the most severe economic crises are caused by crises in the financial sector – particularly those with banks at the centre, as I discussed at length in my speech in Frankfurt in

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June. This is because banks are systemically important on account of their role in maturity transformation, their position at the centre of credit intermediation, their central role in securing the payments system and because they are the transmission channel for monetary policy.

Banks can therefore be systemically important – either individually or, in the case of smaller institutions, as part of a larger group.

The overwhelming importance of banks in triggering financial crises and their severity is also the reason why they are more highly regulated than other sectors of the economy – through to depositor protection and the minimum capital and liquidity buffers. Among banks that are individually identified as systemically important, system-wide contagion risks are controlled by means of even higher capital buffers along with credible recovery and resolution plans.

Although insurance companies are not necessarily systemically important if we are thinking about the risk of contagion, they are economically important. Some of these companies have a very large market share and their failure would have a significant impact on the economy.

And finally, good conduct, integrity and compliance with sanctions are essential for all financial institutions. All of this contributes to consumer protection, protecting the markets and preventing money laundering. Misconduct can cause immense damage to individual citizens in Switzerland and moreover have an adverse impact on the reputation and competitiveness of the Swiss financial centre as a whole.

As already discussed, the “third pillar” of independent and effective supervision is thus all the more important for Switzerland, because the financial sector plays a disproportionately large role in the Swiss economy compared to other countries. Banks and insurers (including asset management companies and independent wealth managers) generated more than 9% of gross value added in Switzerland in 2023 and accounted for more than 5% of employment. Switzerland is also the leading centre for cross-border wealth management.

On top of this there is now also a unique cluster risk in the banking sector in the form of UBS. You can measure it how you want – compared to other jurisdictions such as the eurozone or the US, Switzerland is exposed at multiple levels and this needs to be reflected in the way supervision is conducted.

As you can see, investing in independent and effective financial market and banking supervision always pays off – for the country as a whole and for each individual.

What does best-in-class supervision mean in practice?

Supervision needs to have two main elements to be effective: it needs to have teeth, and it needs to be proportionate.

1. Effective supervision that has teeth

Financial market supervision needs to be rigorous and have teeth if it is to effectively protect creditors, customers, markets and ultimately the financial system. The key words here are early intervention, which is something I have talked about many times. In other words FINMA needs the required statutory powers and must convert these into effective supervisory practices to be able to act effectively and in good time, which means taking action when we are still in a period of calm.

An earlier intervention is always more efficient than a later intervention, which would probably have to be much deeper and more painful. In extreme cases the government may have to provide support, as happened in the crises of 2008 and March 2023. This is something we want to avoid wherever possible. That is why further strengthening the too big to fail framework – as is currently being discussed against the backdrop of the Federal Council report – is so hugely important.

The crisis in March 2023 also demonstrated that banks can still get into difficulties even if they are compliant with capital and liquidity rules. It is often qualitative, multi-faceted and hard-to measure factors that bring an institution down – long before regulatory thresholds or market indicators send a warning signal. Supervisors therefore need the full range of powers to be able to intervene at an early stage at a qualitative and quantitative level. And the ability of supervisors to intervene should not depend on just a handful of key indicators.

But what does this mean in practice? Early intervention obviously doesn’t mean putting out the fire when the entire building is already ablaze, or at least everyone can see that smoke is rising. Instead early intervention means ensuring during the period of calm that the fire extinguishers have been installed and are operational, the fire doors are in the right places and work properly and a smoking ban has not just been imposed, but is actually enforced.

Our experience shows that the problems at distressed financial institutions often start with weak governance and poor risk culture which is then reflected in an unsustainable business model. It is not until later that losses emerge, whether in the form of non-performing loans, trading or in the institution’s reputation. Later still the unsustainable business model is also reflected in falling capital and liquidity ratios. Market indicators can provide important additional information – supervisors follow

these closely, but the signals sometimes only appear late in the day and can also be distorted, for instance if there is insufficient market liquidity.

As every crisis is different, there are no automatic indicators that show when and where one should intervene. So it is better to have the full toolbox of quantitative and qualitative measures at one's disposal which can then be implemented at an early stage depending on the circumstances.

As I have already discussed on several occasions, supervisors in Switzerland lack important powers to do this, such as the ability to systematically limit dividends and compensation if forward-looking stress tests show a capital shortfall. A further power we don't have and which I want to talk about here, mainly in connection with systemically important banks, is the power to intervene in business models that could hinder an effective resolution of the institution. This is essential if we want to address the too big to fail problem in a preventive way.

In this context early intervention can be impeded by the suspensive effect that usually comes into force if an institution appeals to the courts against a supervisory decision. In practice this means that the institution can block the implementation of supervisory measures for years by lodging an appeal – including in serious cases where the protection of creditors, market participants, consumers or even the financial system is under threat.

It is important for FINMA's powers to be laid down more clearly in law so that interventions can be implemented quickly, particularly when early action is taken. FINMA must be able to reference clearly worded powers of intervention in the event of an appeal; it cannot just be a general article, as is the case today in Art. 31 of the Financial Market Supervision Act, which states that FINMA is responsible for restoring compliance with the law. Clearer wording in the legislation enables a court to make a more precise preliminary judgement. Moreover, it increases the likelihood that the appeal will be denied a suspensive effect and the measures ordered by FINMA take effect straight away.

From FINMA's perspective it would obviously be preferable if appeals did not have suspensive effect for certain predetermined groups of cases, as is generally the practice in other countries such as the US, eurozone and the UK. It cannot be right that a financial institution represents a threat to the financial system, but we first have to discuss it in court for several years while the institution becomes destabilised in the meantime.

Because the risks to the financial system are so high, particularly when we are dealing with systemically important banks, and because it is essential to avoid a fire from spreading, a very high

importance needs to be attached to the protection of the public interest compared to the interests of an individual institution.

2. Proportionate and risk-based supervision

This brings me to my second topic, the proportionality of supervision. Supervisors are responsible for deploying tools and powers in a balanced and proportionate way, i.e. the measures must be proportionate to the risks to creditors, consumers, the markets and the financial system.

If supervisors have to intervene in a specific institution’s governance and risk culture in the way I indicated previously, which is so important for effective early intervention, I advocate what I call the outlier approach. Normally a financial institution has a functioning governance system. Management, the board and shareholders are responsible for the business strategy and for running the institution. However, if there are enough signs that the checks and balances and market incentives are not working or result in governance that jeopardises the institution, depositors or customers, then supervisors can – indeed they must – take action and intervene, obviously always in accordance with their mandate. We all know that examples of poor governance and risk culture are unfortunately not becoming any less common.

In most cases supervisors demand that the problems are resolved promptly, and when governance works properly this is normally what happens. Only in extreme cases, if the board or management are not meeting their responsibility and the problems identified by supervisors are not resolved, would we deploy more severe measures such as withdrawing an institution's fit and proper designation, although it should be noted that the legal hurdles to such measures are very high in Switzerland. We are therefore also calling for a senior manager regime that lays down clear responsibilities.

Another example is intervention by supervisors in business models. In normal conditions the board and management are responsible for an institution’s business model and strategy. But problems can emerge here too, and there are good reasons why supervisors should intervene early in certain cases. Although an institution may continue to be compliant with the minimum capital and liquidity requirements, there may be growing signs that the manner in which the institution is implementing its business model represents a threat to the solvency of the institution or to creditors, customers or the markets. The following are possible examples:

1. Stress tests show there is an imbalanced relationship between risk and return.

2. The institution is growing strongly, but management and the board are not taking adequate responsibility for risk control, risk management, infrastructure and compliance, which may also be reflected in a one-sided compensation system.

3. The business model is incompatible with resolvability that could actually be implemented if the institution got into difficulties.

In all of these examples the supervisory measures should always be proportionate to the problems that need to be resolved. In addition the least invasive tools needed to restore compliance with the law should be used. We always need to work towards achieving the maximum effect with the minimum possible means.

Proportionality also means that effective supervision takes account of the size and risks of the supervised institutions and acts in proportion to these. In short, it doesn't jump around on small players while simultaneously neglecting effective supervision of the big players.

Financial market regulation in Switzerland is guided by the size, complexity and risks within the financial sector. FINMA takes the same approach to its supervision. The supervised financial market participants are divided into five categories based on their size and potential risks for investors, creditors and insurance policyholders, as well as the entire financial centre. Category one comprises the largest institutions, category five the smallest.

FINMA's supervision is risk-based and is guided both by the supervisory category and the specific risks of the supervised institutions. The smaller the institution and the lower the risks, the less regulation and supervision the institution is subject to.

Allow me to illustrate this with some numbers:

In the banking sector we carried out a total of 52 on-site reviews at the around 220 banks in supervisory categories 4 and 5 between 2021 and 2023 and in the same period we held 116 on-site reviews at the two banks in category 1 (and from 2023 at just one bank) – so there were almost 300 times as many on-site reviews at category 1 banks.

It is a similar picture in the insurance sector. We carry out between one and five on-site reviews annually at the big insurers and go into the small insurers once every five to eight years.

Finally a look at our enforcement activities: in the last ten years FINMA has carried out 20% of its investigations and enforcement proceedings at large banks in categories 1 and 2, even though these account for only 2% of supervised institutions.

And that isn't everything. We know that banking regulation has grown substantially in recent years – mainly driven by global requirements – particularly with regard to capital and liquidity, but also reporting and risk management and control requirements. From the middle of 2018, together with the industry, FINMA therefore tested exemptions for particularly liquid and well capitalised small banks and securities firms. The small banks regime was then launched in 2020. It contains simplified requirements if the relevant small banks meet certain criteria, especially for calculating and disclosing the required capital and liquidity. Exemptions also apply in the areas of qualitative risk management, internal control requirements and reporting. A similar system applies to small insurers.

However, proportionality cannot be applied in the same way everywhere. Although proportionate regulation and supervision means that small institutions do not need to do as much as big players, they still have to identify and limit their risks and ensure that deposits are protected.

And there are areas where no exemptions can be granted. This relates in particular to the conduct areas of anti-money laundering, suitability, market conduct and cross-border services. So as not to jeopardise the reputation of the financial centre, even small institutions need to implement the anti-money laundering regulations and rules on risk management when offering financial services abroad. Nor can the protection of customers when marketing financial services or carrying out securities orders be counterbalanced against a firm's capital or liquidity.

Conclusions

Allow me to summarise. Robust and independent supervision is important for the prosperity of this country and its citizens – alongside an independent monetary policy and prudent fiscal policy.

We need to drive forward qualitative supervision and early intervention on the basis of robust regulation. This applies particularly to the areas where problems usually begin at banks and other financial institutions, namely weaknesses in risk culture, governance and business models. Supervisors can identify problems in these areas at an early stage based on "red flags". Then we have to act quickly and intervene with suitable instruments where necessary to resolve the problem. Early intervention can be achieved with targeted measures, without supervisors taking responsibility for the

areas in question in place of the institution. But to do so FINMA needs new instruments, a clearer statutory basis and probably also more resources.

But it is equally important that supervisors are aware of their responsibilities and use their tools in a proportionate manner. In this context – and this is already FINMA's practice – it is also essential that acting proportionately and in a risk-based manner means supervising large and riskier institutions more intensively than small and low-risk ones. The statistics paint a clear picture here: we focus our supervision on those things that create most value for Switzerland. For FINMA this value consists in preventing harm to the country, the financial system or individual citizens wherever possible, in the interests of promoting sustainable prosperity.

Thank you for your attention.