Supervisory Instruments and the Organisation of FINMA

Expert advice for
the Federal Department of Finance

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November 2011

Expert advice on supervisory instruments and the organisation of FINMA

(prepared by Peter Hayward – November 2011)

Introduction

The Control Committees of the Federal Assembly, in their report of 31st May 2010, invited the Federal Council to report, *inter alia*, on the measures the Swiss Financial Market Supervisory Authority (FINMA) has taken to improve its supervisory instruments and practices (recommendation 3) and on FINMA's work processes, its new organisation and the existence of good communication between its divisions, in particular on the exchange of information (recommendation 6). As part of the preparation of its response to this request, the Federal Department of Finance has invited me to report to it on FINMA's supervisory approach with regard to the supervision of banks and its capacity to identify risk in the light of the reforms initiated in the aftermath of the financial crisis. I was asked to consider in particular eight specific questions and this report is therefore organised around these questions. These make clear that the focus of my report should be on the changes that have been introduced in the supervision of banks, as opposed to other financial institutions, and particularly of the large banks where any weaknesses could have systemic implications.

In preparing this report I have taken particular account of FINMA's strategic goals as approved by the Federal Council in September 2009, as well as FINMA's report "Effectiveness and efficiency in supervision" of April 2011, which sets out the changes introduced by FINMA in response to the crisis and in implementation of its strategic goals. I have also read other reports and comments prepared in recent years which describe in detail the origins and development of the crisis and the authorities' response to it. I have also discussed implementation of the April 2011 report with management and staff of FINMA and had discussions with other relevant parties in Switzerland and elsewhere. I have taken account of developments in other countries in order to be able to compare the reforms introduced in Switzerland with those in other countries with large and complex banks. While this report reviews the changes FINMA has introduced, and is in the process of introducing, it is not a comprehensive assessment of the effectiveness of the supervisory framework. It will probably be appropriate to have another external assessment, for example as part of the International Monetary Fund's Financial Sector Assessment Program (FSAP), but only once the reforms are fully established and FINMA has had more experience of operating with its new procedures and processes.[1]

[1] The IMF has conducted two assessments under the FSAP program, in 2001 and 2009, so it is not likely that a third assessment is imminent.

This report does not deal with structural issues especially those relating to very large banks, such as the desirability of restricting certain high risk activities (the Volcker rule), or protecting retailing banking by erecting firewalls around the business as envisaged in the UK Vickers Report.[2] These were dealt with by the 'Commission of Experts for Limiting the Risks posed by Large Companies' which reported in 2010 and instead recommended precautionary arrangements to erect such firewalls in the event of a serious threat to a bank's solvency. Switzerland has, however, been well to the fore in the international discussion of Systemically Important Financial Institutions (SIFIs) and had already increased the capital and liquidity requirements for the two large banks even before the Basel Committee on Banking Supervision (BCBS) released its requirements for globally systemically important banks.[3] The list of such banks published by the Financial Stability Board in November 2011 includes both the two large Swiss banks.[4]

This report begins with some general observations and conclusions and then deals with the specific questions posed to me individually.

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[2] The final report of the United Kingdom Independent Commission on Banking, chaired by Sir John Vickers was published in September 2011. See http://bankingcommission.independent.gov.uk/

[3] Although major structural changes in Switzerland were ruled out by the Commission of Experts, the authorities have considerably increased the capital requirement for investment banking and other trading activities, tightened liquidity requirements, and introduced limits on interbank claims, so reducing the incentive to indulge in the more high risk activities where the problems arose in the crisis period. The Commission also proposed that banks have plans, triggered by a decline in capital ratios below a prescribed level, that would transfer certain systemically important functions, such as the payment systems and domestic deposit and lending functions, to a separately incorporated legal entity. These recommendations have now been adopted. Nevertheless, since the Commission reported there have been further developments in other countries. See, for example, a speech by Stefan Ingves, Governor of the Sveriges Riksbank and Chairman of the BCBS, in November 2011, which notes that Sweden ranks after Switzerland and the UK in terms of the size of bank assets relative to GDP and argues that more onerous prudential requirements are necessary in Sweden too.
http://www.riksbank.com/templates/Page.aspx?id=51158

[4] "Policy measures to address systemically important financial institutions" published by the FSB in November 2011 (see http://www.financialstabilityboard.org/publications/r_111104bb.pdf). See also the methodology for determining which banks should be included as published by the BCBS in November 2011, "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement", http://www.bis.org/publ/bcbs207.htm

General Considerations

Background

As many have noted, Switzerland has a highly unusual financial system. It is very large in relation to the size of the economy. Many of the services that are offered to its customers are offered on an international basis so that Swiss banks have to compete extensively with foreign banks. Moreover, the banking system is dominated by two very large players much of whose business is not only with foreigners but is carried on outside Switzerland in branches and subsidiaries located in other financial centres. Significantly, the majority of the higher risk activity carried out by the two large banks is performed almost entirely outside Switzerland in other major international financial centres, mainly London and New York, but also in Asia as well. Thus their main competitors are banks based in other countries.

These factors comprise a particularly challenging environment in which the supervisory authorities, as well as the banks themselves, have to operate. Whereas international banks have a legal status in many countries and management is dispersed around the world (and the management of the risks which caused the problems in the crisis were mainly in London and New York), supervisory authorities are national and their powers are defined in national law that applies only in the home country.[5] The challenge is increased by the tradition of government in Switzerland which seeks to minimise the role of public authorities, especially at the Federal level.

Following developments in the late 1990s, when two of the then three large banks merged, reforms were made to the supervisory process. These reforms included the setting up of dedicated teams dealing with each of the two large banks and the establishment of a risk management function. But these reforms were not sufficient to enable the EBK, the then banking supervisory authority, to forestall the problems that arose in UBS. Subsequently, but well before the recent crisis, it was decided to merge the existing regulatory authorities into one comprehensive authority which, fortuitously, began life in the middle of the crisis period.[6]

Although the reform that established FINMA was put in train much earlier, it has clearly been justified by events. It is in the interest of the taxpayer, as well as the customers of banks, that FINMA be so equipped as to be able to anticipate and resolve major problems in one of the two

[5] The EU has recently established a European Banking Authority designed to coordinate the supervision of EU based banks, so has some extra-territorial reach. But it still relies on national supervisors to exercise licensing and other powers over authorised institutions. Switzerland is not, of course, a party to this arrangement.

[6] FINMA came into being in 2009 but Parliamentary approval was obtained in 2007 on a proposal by the Federal Council the previous year.

banks more speedily in the future. It has therefore taken advantage of its experience to set in place further changes to meet these challenges.

Rationale for supervision

No supervisory authority seeks to avoid, even if that were desirable, all bank failures, nor do supervisors seek to take responsibility for the management of banks; that is the responsibility of the directors elected by the shareholders. But most supervisory authorities seek to ensure that any problems do not hinder the effective operation of the financial system as a whole and seek to prevent the risk of contagion arising so that problems in weak institutions do not lead to problems with otherwise sound institutions, as well as limiting any damage to the real economy. It is difficult to achieve these objectives in Switzerland especially given the dominance of the two large banking groups.

The implication is that Swiss supervision has not only to be in line with international good practice but to be better. In other words, as the Control Commission report of 2010 noted, higher standards than elsewhere are essential, because the risks to the system and indeed to the economy generally are so much higher than they would be if Switzerland did not have such a sophisticated, concentrated, and large financial system. The Swiss authorities have appreciated this fact and so have been one of the prime movers in the drive to strengthen bank regulation and supervision worldwide. This movement has now resulted in higher capital ratios for 'systemically important financial institutions' agreed in the Basel Committee on Banking Supervision (BCBS).[7]

But higher capital and liquidity standards will not necessarily by themselves be enough to protect the system in the event of some unforeseen risk becoming systemically threatening. The only safeguard in that case is more effective supervision involving a full understanding by the supervisory authorities of the full range of risks run by the systemically important banks and an ability and will to act forcefully and effectively when threats are detected.

As with all security related questions there is no answer to the question: "are sufficient resources deployed?" FINMA has taken the view that it is not numbers that is important but quality that counts. Certainly the numbers involved, at least within FINMA itself, are still on the low side compared with other supervisory authorities which supervise highly sophisticated universal

[7] See, for example, the package of measures commonly referred to as Basel III published in December 2010, and the requirements for systemically important banks published in 2011. As has been noted elsewhere, the Swiss authorities had attempted to strengthen the rules at an earlier stage but their initiative did not find enough support from other countries. In November 2011, the BCBS and the Financial Services Board issued the additional requirements for global systemically important banks referred to above.

banks comparable to the two large Swiss groups. The important aspect is the ability of the supervisory authority to detect weaknesses and to have sufficient confidence in its judgement to require a bank to correct the problem or mitigate the risks involved. It is important, however, to take account of resources elsewhere that contribute to the overall supervisory effort. The roles of external auditors and foreign supervisors are discussed below.

Another way of asking the same question is to ask: "how much risk is the Swiss public willing to accept?" Supervision is a trade-off between providing freedom to financial intermediaries to provide the services demanded by their customers and their shareholders, and the need to protect depositors and the users of financial services.[8] No doubt, as a result of the recent crisis, the trade-off has shifted in many countries, and legislatures are now demanding greater safety and requiring banks to operate with less freedom. This is, of course, a political choice and the supervisor must therefore operate within the politically determined trade-off.

But FINMA has additional resources to call upon. First, the host supervisors in the major countries in which the two large banks operate can help provide assistance in locating the risks and assessing the ability of local management. Secondly, the external auditors, on whom FINMA has traditionally relied, are tasked with the assessment of risk in the group worldwide. Because these firms have staff in all the countries in which the banks operate they should be well qualified to identify weaknesses in any country as well as to take an overall global view. Indeed FINMA could not operate without them. Finally, the Swiss National Bank (SNB) also monitors the banks, especially their Swiss business, in the markets, as part of its relatively new responsibility to monitor the stability of the financial system as a whole.

FINMA has embarked on two main initiatives to improve the quality of supervision. First, it has set in train an improvement in its ability to assess risk and require change where necessary. This has involved strengthening the quality of staff involved with the addition of market experience and skills. Secondly, it is attempting to make the use of external auditors and foreign supervisors more effective. Observations on these and other reforms are considered below in response to the specific questions.

Implementation and Enforcement

Much of the work done by FINMA to reform the system has dealt with the process of analysis and identification of weaknesses in the banks. But at the end of the day it is the ability of the supervisor to effect changes within the banks to mitigate the risks or correct the problems that is crucial to success. This can require tough enforcement action, which in turn requires the

[8] See Conduct of Financial Market Supervision during the Financial Crisis by David Green, January 2010, advice to the Federal Department of Finance.

availability and use of powers not otherwise granted to public authorities. It is clearly easier to use these powers if the bank is in breach of, or threatens to become in breach of, a specific regulation. For example, if a bank is required to make provision against the value of its assets and as a result ceases to comply with the minimum capital requirements, there is a clear breach of a regulation and enforcement cannot easily be resisted. It is less easy to enforce the supervisor's point of view if the weakness it has detected does not give rise to failure to meet a specific regulatory requirement. To enforce the supervisor's point of view requires the ability to argue the case and convince the bank's board and management of the need for change. One of the thrusts of the recent changes to the supervisory approach has been to deal with this issue.[9]

The initial reaction to the crisis has been, understandably, in all countries to tighten the regulatory framework. However, regulatory initiatives can and often do have unintended consequences and it is likely that over time that some of the tougher formal regulations will be simplified and made less onerous and expensive for banks and their customers.[10] In the longer term, therefore, it is important that FINMA has a depth of supervisory expertise and sufficient authority to deal with incipient problems without having to base its actions solely on breaches of specific regulations.

Conclusions and recommendations

Although FINMA failed to anticipate the problems at UBS, it was not alone. Neither did the bank's external auditors or, indeed, its senior management. Moreover, FINMA has earned a good reputation among fellow supervisory authorities for effective and responsive supervision. Nonetheless, the agency has felt it necessary to institute a number of reforms to increase its effectiveness and these will take time to come to fruition.

Perhaps the most important element of the reforms has been to make the processes of supervision more robust so that the supervisor can challenge bank managements more effectively. This has involved more structured analysis and the recruitment of more experienced staff, some of whom have direct market experience of their own. Mixing the best of the old and the new elements in the staff will continue to demand skill and application.

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[9] For example, in evidence to the Parliamentary Committee considering the draft Financial Services Bill in the UK, Sir Mervyn King, Governor of the Bank of England, said on November 3rd, 2011:"it will be important for regulators to exercise judgment [which is] why we need to make a break from the style of regulation in the past….The only way that regulation can have an effect is if the regulators have the freedom to impose their judgment and not base it purely on a myriad of detailed rules."

[10] The move to deregulation in the decades before the crisis was triggered by just such considerations.

A major challenge on which the agency is working is to make the role of the external auditor more effective and responsive to the needs of the supervisor. This will require more specific scoping of the auditor's work and a greater distinction between what the auditor can do most effectively and what is best left to the supervisor. At its simplest, this means that the auditor should concentrate on verification, including the challenging of management's own assessment, e.g. of asset quality etc., and the adequacy of systems and controls, and the risk assessment is best done, albeit with advice from the auditor, by the supervisor. The overall supervisory judgment cannot be outsourced.

While cooperation with foreign supervisors, especially in London and New York, has long been actively encouraged and the processes are well developed, further thought will be needed to ensure that the maximum benefit is obtained from the process and that gaps and overlaps are avoided. Greater participation in host countries' examinations may be one way of increasing the output from the relationships. In addition, more use can probably be made of the skills and experience of external auditors.

Relations with the central bank suggest a certain degree of tension. While this is not uncommon in many countries and may be creative, the process needs to be managed so that the parties have trust in each other's capabilities despite differing but overlapping objectives. The new MOU will need to be reviewed periodically to make sure that the relationship is as productive as possible to the achievement of the statutory objectives of both parties.

Governance of large institutions in relatively small economies is never easy. The right mix of skills and experience is difficult to find and conflicts of interest difficult to avoid. But effective corporate governance of banks is the first defence against ineffective management. The opportunity needs to be taken of the crisis for FINMA to take whatever opportunities present themselves to strengthen the corporate governance of financial institutions. For example, a more intrusive approach to the vetting of members of bank boards to ensure that boards contain the required mix of skills and experience, and that they function effectively, may be necessary.

FINMA's supervisory approach

> **1. How would you assess the effectiveness of FINMA's new risk-based supervisory approach? What are the strengths and weaknesses as well as the risks of a supervision whose intensity and instruments are based on the categorisation of supervised institutions and the individual rating of each institution?**

A risk-based approach to supervision involves, first, the allocation of resources by reference to the importance of each institution to the system as whole. That is, institutions whose failure could have a substantial impact on the viability of the system are given priority. This approach is premised on the basis that it is not possible or even desirable to attempt to organise a supervisory system that prevents all failures. Rather the system is designed to ensure that where failures do occur the impact is containable and the viability of the system is preserved. More simply, shareholders can be allowed to lose money but depositors, particularly small depositors and other customers, including borrowers, should not be deprived of essential banking services. FINMA’s approach is, therefore, based on a categorisation of institutions and is set out in their April 2011 paper. Banks are allocated to one of five categories based principally on balance sheet and deposit size. So, category 1 consist of the two largest banks, category 2 consist of the two next largest and the remainder are allocated to categories 3, 4, and 5. Most of the resources of supervision are devoted to the first three categories of banks which comprise 90 percent of the system’s deposits with a particularly heavy use of resources devoted to the two banking groups in category 1. Although size is only a rough proxy for the potential threat to the system of a problem developing in a particular bank, it is not an unreasonable one. The weakness of such a system is that a relatively small bank may incorporate relatively large risks and these risks may not be identified by the supervisor because the bank is not subject to intensive supervision. This could be a weakness in the supervision of minor banks but is not likely to be so in the supervision of banks whose failure could pose problems for the system as a whole.

The effectiveness of risk-based supervision depends not just on the categorisation of banks but also on the identification of high risk areas and activities within an individual bank. The risk profile and rating system is designed to achieve this objective. Banks are rated for a number of risk categories based on the well established US CAMELS system.[11] The criteria used include both quantitative elements and qualitative judgments and the ratings are regularly reviewed on a quarterly basis. So although changes in the categorisation are relatively rare, changes in the ratings are more frequent and reflect changes in the evolving view of supervisors. The ratings are then used to determine the intensity of supervision applied to the particular bank. The strength of such a system is that it should enable the supervisor to identify serious problems quickly and ensure that the resources are allocated to deal with the most urgent problems promptly. Its effectiveness of course depends on an accurate diagnosis of the risks in an institution. It also depends on the ability of the supervisor to manage the supervisory work load so that priority is indeed given to the risks that the rating system identifies as meriting attention. The ability of the supervisor to ‘manage the agenda’ is crucial. If supervisory resources are, on the contrary, diverted to dealing with issues raised by the supervised bank which may not be high risk then the system will not in practice be effectively risk-based.

The risk-based approach adopted by FINMA is similar to that adopted by most other major supervisory authorities. Its effectiveness will depend on how well it is used. In particular, can the

[11] The CAMELS system rates banks by six criteria: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to risk.

system detect weaknesses and does FINMA have the experience and knowledge to react sufficiently promptly where needed?[12] FINMA now develops supervisory approaches for each bank based on the rating and profiling exercises which are used in a more dynamic fashion than before. This is necessary to get the full benefit from a risk-based approach. A good supervisory approach will concentrate on the weaknesses and the problems identified in the risk assessment on which the rating is based. The advantage of this methodology is that it can set the agenda for supervision and help avoid the danger mentioned above, common especially with large banks, that too much time is spent on dealing with issues that the bank raises with the supervisor and not enough on the issues identified by the supervisor as deserving attention.

The supervisory agenda is set out in the assessment letters sent to each bank periodically and particularly after supervisory reviews. These letters require actions by the bank to rectify any weaknesses on regulatory infringements within specified timescales.

2. How would you evaluate FINMA's new supervisory approach in comparison to the supervisory approach of financial market authorities in other major financial centres? Do you propose other or additional measures?

In formalising a risk-based approach as described above, FINMA is consistent with the risk-based practice as it has developed in other major financial centres, such as the US, Canada, and European countries.[13] As noted earlier, the fact that the financial centre is not only very large in Switzerland, but heavily dependent on international business and dominated by two of the largest financial groups in the world means that Switzerland has to have a state of the art supervisory approach. The design of the approach meets that test; time will tell whether it is used effectively.

One aspect of risk-based supervision that is sometimes difficult to handle is quality control. Some large supervisory agencies have dedicated quality control teams who essentially examine a supervisor's supervision of a specific bank to assess the degree to which the supervisor has fulfilled the agency's requirements to an acceptable standard. Such a system is perhaps less

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[12] One of the major problems in the UBS case was that the senior management of the bank were not aware of the extent of the risk being run. In these circumstances it is indeed a challenge to devise a supervisory approach that will bring to light problems so well hidden within the bank. Supervisory staff need to be able to drill down within an institution to be able to uncover problems that the management were not aware of.

[13] See for example "the FSA's Risk-Assessment Framework" of 2006 (www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf) which sets out the so-called ARROW (Advanced Risk Responsive Operation Framework) approach used by the FSA. See also a speech by the then General Manger of the BIS in Mexico in 2001 when Andrew Crockett said "But one of the important trends has been, and continues to be, a move away from regulation, and towards supervision - a move, in other words, away from compliance with portfolio constraints, and toward an assessment of whether the overall management of a financial firm's business is being prudently conducted." http://www.bis.org/speeches/sp010330.htm Some of the supervisory failures in the recent crisis have been attributed to a failure to implement this approach to supervision.

necessary in a smaller agency where the senior management of the agency are close enough to the day-to-day supervisory process to be able to discharge that function without a specific group of experienced supervisors being established solely for the purpose, but nonetheless FINMA will need to give consideration to this aspect and determine whether its organisation and processes take sufficient account of the need to maintain a consistent quality of supervision for each institution. In addition, there is the danger that individual supervisors, and FINMA's senior management, will become too close to the supervised institution, perhaps more likely in a small agency, and so a system which challenges the day-to-day supervisors may be even more necessary. Although FINMA has an internal audit function it would need substantial change to transform it into an effective quality control instrument. FINMA will need to consider whether this can be done or whether it would be more efficient to develop an entirely separate function for this purpose.

It is not so much additional measures that are needed as the full development of the systems and processes set up by FINMA. The full fruits of these reforms are not yet apparent and will necessarily take time to become so. A full external assessment of the system, say in the context of the next FSAP by the International Monetary Fund once FINMA is satisfied that the reform process is completely effective could be an appropriate opportunity.

Banking supervision especially of large banks

> **3. How would you evaluate FINMA's further development of its supervisory instruments in the aftermath of the financial crisis in respect of banking supervision, especially supervision of large banks? How would you evaluate the further development in comparison with the supervisory orientation of financial market supervisory authorities in other financial centres? Do you propose additional measures?**

FINMA and its predecessor organisation, the EBK, traditionally relied on external audit firms, more than most other countries, to do on-site verification and fact finding. In 1998, the EBK set up dedicated units to supervise the two big banks and then envisaged more direct on-site work. In fact relatively little such work appears to have been done and the agency continued to rely mainly on the work of the external auditors. Although not alone in 'outsourcing' much of the on-site investigation, this approach is less usual in the sense that auditors were expected to carry out a full 'risk assessment' and give a certification that the bank met its supervisory requirements. Most countries that use auditors use them to support the work of the supervisors, whereas the Swiss approach amounted to outsourcing the core of the supervisory process. Indeed the auditors were known as the 'extended arm' of the EBK. Most other supervisory authorities have built up over time extensive bank examination or inspection teams of their own staff which carry out the bulk, if not all, on-site work. However, under the new organisation on-site work done by FINMA staff has been considerably stepped up. In 2011 FINMA expects to conduct some 40 on-site supervisory reviews and one third of the time spent on supervision is now devoted to on-site reviews. Nonetheless, the fact that these two big banks have such a high proportion of their business outside Switzerland must mean that the external audit firms, who have large staff permanently based in the major centres in which the banks operate and some staff at least in virtually all countries concerned, will have to continue to play a role. Although FINMA can and indeed does send staff from Switzerland to do on-site work in the banks' foreign offices, they do not have local experience and knowledge of the local environment. Supervisory agencies in some countries have staff permanently based in foreign countries. The OCC, for example, has staff permanently in London. But it would hardly be practical for an agency with a limited number of banks with international operations to match that capability. Host supervisors in major centres also play a role (on which see below) but they do not have a view of the bank as whole in the way that the external audit firms should have.[14]

FINMA has experienced some difficulty with the role of external auditors as the 'extended arm' of FINMA. This suggests that a more precise definition of the scope of regulatory reports would be beneficial in maximising the utility of this instrument of supervision. It will also be necessary to refine further the borderline between what the external auditor does and what the supervisor does. Auditors can be helpful in establishing the facts, compliance with regulations, assessing compliance with controls, and so on. They have proved less reliable when it comes to assessing risk and the adequacy of mitigatory policies. The Swiss system where the auditor has to come to an overall judgment as to the risk in a bank is perhaps straying too far into the province of the supervisor. To make a risk assessment requires judgment and awareness that the judgment may be wrong. But fear of getting it wrong should not be a concern for a supervisor whereas an auditor who has to sign a report may well feel inhibited and take refuge in a negative assurance.[15] What is needed from the auditor is not so much a certification that the bank meets the licensing requirements but a critical report that identifies strengths and weaknesses in the bank's risk management systems and internal controls. By this means it should be possible for the external auditor's regulatory work to add more value to the process of supervision than it currently does. Some reforms have already been put in place. For example, for the major banks, the external auditor is expected to appoint separate engagement partners for the regulatory work and the financial audit work. This is intended to clarify the distinction between the two tasks and

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[14] In practice, auditors at group level may depend on the view of local auditors in individual foreign countries in the same way that home supervisors can be dependent on the host supervisor of foreign subsidiaries and other operations.

[15] It is apparently conventional for auditors to report that during their work they have learnt nothing that leads them to suppose the bank is not in full compliance with its authorisation requirements. The report would then list any exceptions where changes are needed. Such a negative response is not really an adequate substitute for the overall assessment summarised in the FINMA rating described above.

heighten the importance of the work done for FINMA, which has sometimes been seen merely as an offshoot of the certification of the financial statements done for the shareholders.[16]

The use of foreign supervisory authorities also contributes largely to the supervision of groups with extensive international business such as the two large banks. This aspect is dealt with in the next section.

The final step in risk-based supervision is the communication by the supervisor to the bank conveying the supervisory assessment, and setting out what steps the bank is expected to take to mitigate the risks identified or resolve the problems uncovered. FINMA refers to these communications as 'assessment letters' and these are now used routinely and include a requirement that implementation of the changes required in the letters be introduced over an agreed time table. This instrument needs to be used vigorously. There is some suggestion (by Green, for example[17]) that the legal powers are not sufficiently robust in the sense that the onus of proof is on the supervisor to establish that a weakness exists rather than on the banks to convince FINMA that its controls and system are adequate. FINMA responds that the only deficiency is in FINMA's ability to levy financial penalties etc. It believes that it has sufficient general powers to enforce its supervisory directives and requirements.

4. Do you consider inquiries, analyses, cross sector surveys or comparisons effective and efficient supervisory instruments? How would you evaluate FINMA's further development and use of these instruments in terms of international comparison?

One essential component of good supervision is the identification of good practice, and ensuring that banks take steps to approach that ideal, whether through discussion with boards and management or through the use of enforcement measures. One way of promoting this objective is through the use of peer reviews, that is by comparison of the supervised bank with its comparators. This can be fairly straightforward for small conventional banks where each bank may operate in a market segment that has a number of players. It is more difficult when dealing with a bank that has a business model that has few or no comparators. There is a particular

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[16] The FSA in London has recently revisited its own relationship with external audit firms and published a code of practice to help guide supervisors and auditors. Discussions between supervisors and auditors are ongoing as to how to make this code operational. See "Code of practice for the relationship between the external auditor and the supervisor" FSA London, May 2011. It is likely that the new UK supervisory authority will make more use of work done by external auditors which has declined in importance over the last decade since the FSA was established.

[17] See footnote 8 above.

problem for the two very large Swiss banks whose competitors are mainly foreign banks. FINMA is not in a position to make comparative assessments in these cases.[18]

For smaller domestic banks FINMA is now making more use of off-site desk analysis and through the use of theme based on-site work. This is a technique increasingly used by most other large supervisory authorities. Changes have also been made for the two large banks where the charge has been made that little use was made of the knowledge that Credit Suisse had managed more effectively the risks in the US sub-prime securitisation market than UBS. The new organisational structure is designed to ensure that this weakness does not persist by ensuring that the two banks are supervised jointly where it comes to the management of more complex risks, although each bank retains a dedicated team handling day-to-day relationships.

However, it remains a problem that it is difficult to undertake effective peer reviews of the two banks while their main competitors are supervised elsewhere. FINMA has two instruments that provide an opportunity for mitigating this risk. First, by using major international audit firms to conduct much of the on-site work, FINMA has access to experience gained in auditing other major banking groups. It also has access to the experience and skills built up in the firms' consulting business and in their so-called 'regulatory practices'. Second, through links with other regulators, especially in London and New York, FINMA has the opportunity, through information sharing arrangements, to access other supervisors' experience and knowledge. Indeed FINMA, and the EBK before it, makes greater use than many supervisors of cooperation with foreign regulators. It is generally agreed that Swiss supervisors have established particularly close and productive links with both the FSA in London and the New York Federal Reserve Bank and meet trilaterally twice a year with much more frequent contact bilaterally.

Of course both of these links have limitations. Confidentiality requirements clearly restrict the information that can be passed to FINMA by both external audit firms and by other supervisory authorities on the techniques and quality of, say, risk management in the banks that are the main competitors of the two large Swiss banks. FINMA may need to discuss with the accounting profession the extent of the constraints on specific audit firms to divulge information derived from work with other clients, in order to establish whether it is possible to make greater use of their knowledge. FINMA does, however, inquire of host supervisors how the Swiss banks compare with other banks, but again there are legal confidentiality constraints on host supervisors in responding to these inquiries. The only solution is to persist with, and intensify, cooperative work with other supervisory authorities.

[18] FINMA can and does use peer group analysis in respect of sectors, such as mortgage lending, where the two big banks have strong local competitors among much smaller Swiss banks.

5. How would you assess that FINMA itself carries out on-site inspections more often? What are the conditions for effectiveness and efficiency of such inspections? What should be considered according to the experience of financial market supervisory authorities in other major financial centres with on-site inspections?

Until recently, FINMA and the EBK before it made very little use of direct on-site work by its own staff, relying in the main, as discussed above, on external auditors, its 'external arm' for this purpose. In the previous reforms in 1998, the EBK decided not to rely entirely on the audit firms but in practice it appears to have done relatively little on-site work using its own staff. In part this may have been because it did not feel it had the skills and knowledge to engage in a dialogue with the banks' senior management. More recently, however, it has substantially stepped up its on-site work, mainly in Switzerland, but occasionally with visits to other offices of the two large banks. However, given FINMA's expanded but still relatively small staff, the amount of time spent on-site is not large in comparison with that deployed by the audit firms and most visits are short and with small teams.[19]

Although practice varies considerably among large countries, all now do some work at least on-site in major banks. Some, including the US and Spain, have staff permanently resident in the offices of major supervised banks. Others prefer to do pre-announced and, occasionally, unannounced visits, but these can vary in extent from just a few days to several weeks with teams that vary in size considerably.[20] There is clearly no ideal solution. Some countries that do relatively little on-site have sound banking systems with few problems while some that deploy extensive resources on-site can still miss significant risks. It clearly depends very much on how the work is directed, the quality of the staff employed, and their ability to achieve change on the ground. Many supervisors have difficulty in recruiting the skills needed and especially staff with the appropriate kind of experience. FINMA seems to have suffered from this problem in the past and this no doubt is one reason why little on-site work was done. FINMA now reports that the market for specialist skills is much easier for FINMA to access and the agency has had little difficulty in recruiting. Of course, this state of affairs, which is also the case in several other countries where large banks have reduced staffing levels, is unlikely to persist and staffing may again become an issue.

One practical impediment often quoted is the fact that FINMA's offices are in Berne and the large banks are in Zurich. The distance is not great but FINMA does claim that it is a problem for recruitment. This is a factor that has affected several other countries. The German supervisory agency is in Bonn and the Canadian agency is in Ottawa. The Canadians at least now do have a

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[19] Although, as noted above, FINMA now claims its analysts devote about one third of their time to on-site reviews.

[20] But there does appear to be a trend away from long and large so-called 'full scope' examinations towards more focussed thematic investigations, especially those involved in examining the same aspect of several banks at once.

number of Toronto based staff in order to overcome this problem. It may be advisable for FINMA to do the same and extend its present very small office in Zurich to include at least those whose activity is principally dealing with the major banks. On the other hand, the distance is not large and the public transport system ensures that the time taken is predictable. The downside of this policy is that FINMA may find it more difficult to retain Zurich-based staff with skills attractive to banks and other firms in Zurich. On the other hand the fact that none of FINMA's staff is based in Zurich may reduce the risk of regulatory capture.

Another requirement for effective on-site supervision is that the staff involved should have sufficient experience to be able to deal with senior management in the field. Compliance testing is a relatively straight forward process and can be done by relatively junior staff but to question a major bank on its risk management and especially on the quality of its management for example, requires staff with some experience of dealing with senior managers of commercial banks.

FINMA has made substantial efforts to enrich its staff with skills and experience developed in the market. It claims that the quality of the analysis is substantially improved and therefore its ability to challenge the banks is the greater. Supervisory authorities around the world always have a problem in recruiting market experience. Even with financial independence which FINMA now has, clearly there are limits on how much a public authority can pay.[21] Moreover, good bankers do not always make good supervisors. Both may require similar knowledge but the use to which it is put can be very different. Moreover, the skills required are different. There is also the problem that too great a reliance on market experience can mean that new recruits simply serve a minimum period to gain some experience of supervision and then leave before the supervisor has obtained much benefit from their skills. Supervisory authorities need, therefore, a mix of staff and, more important, enlightened human relations policies to ensure that the mix is well managed. This is not an easy task. All change can be uncomfortable and especially in this area. Although FINMA has lost some valuable staff, in the majority of cases, FINMA state that these were relatively recent recruits and few of these were not capable of being replaced. It has also lost some longer-serving staff but some turnover is desirable in a regulatory agency in order to ensure it is in touch with developments in the market. This report cannot assess the extent to which this process of staff turnover may have weakened, or indeed strengthened, the agency. FINMA's management claim that turnover has not so far weakened the agency's effectiveness. FINMA has also taken steps to ensure that knowledge is retained in the institution by more fully documenting its processes so that the experience does not remain solely in the heads of individuals and leaves when they do.

To conclude, it is evident that FINMA has substantially increased the proportion of the supervisory effort fulfilled by on-site work by its own staff and has ensured that their work is

[21] There is a requirement that salaries above a certain level need government approval, although FINMA claims that this has not been a practical impediment.

more effectively documented. Whether it will need to do more may well depend on its success in refining the scope of the work done by external audit firms so obtaining more value from that process.[22]

6. How would you evaluate the organisation and work processes of banking supervision, especially supervision of large banks, regarding the information streams and exchange of views within and between divisions and functions? Do you see need for further improvement?

Many supervisory agencies have experimented with organisational structures in an endeavour to find the ideal. The results of these trials suggest that no structure is perfect. The important aspect is that there should be good vertical and horizontal communication and interaction. So some systems stress the need for all those involved with any one institution to be in the same structure, others see the benefits of specialisation with one group of staff dealing with the same aspect or risk in a number of institutions. FINMA now includes elements of both points of view. Each of the major banks is dealt with by a group whose members deal only with one bank. In addition there is also a group that deals with risk management in both the major banks and to some extent with some of the other banks as well. So, for example, where it comes to the assessment of the adequacy of controls in a trading function both groups will be involved. Such an approach clearly requires considerable and careful coordination between the two groups and those supervising their work. But it is not just coordination that is required. There needs to be an encouragement of debate among those involved. One of the criticisms made of the old authority was that it was subject to 'group think' with unwillingness of individual staff to challenge accepted views. Very often supervision requires the balancing of opposing views in reaching a judgment. A dialogue within the supervisory agency can help make this process of reaching a conclusion well reasoned. To an extent, FINMA has attempted to remedy this fault by making the risk profiling and assessment process more rigorous. An argument based on data and evidence can be held more robustly than one simply based on intuition.

There was some criticism of the old structure on the grounds that the supervisors of UBS were not sufficiently aware of the way in which Credit Suisse was managing similar risks. If they had been they might have been more proactive in ensuring better management of those risks in UBS. If true, this criticism suggests that there was not sufficient dialogue between the supervisors of both banks. One way in encouraging a dialogue is to ensure that staff change their responsibilities periodically so that all staff can have knowledge of the point of view of others with different responsibilities within the organisation. Rotating staff ensures that all staff members have a wide portfolio of experience and can compare one bank with another. On the

[22] FINMA has given considerable thought to the role of external auditors, and, as a result of the UBS problems, the relationship has changed; but it is clear that the relationship is not yet ideal and more work needs to be done.

other hand, there are advantages in leaving staff for a significant period in any one position so that they gain knowledge and experience of the bank being supervised. It is difficult to agree on the right trade-off between these two factors. The answer can only be found in a degree of experimentation. There may be other ways of ensuring that supervisory staff acquire the breadth and depth of experience needed to enable them to be fully effective and FINMA will need to be alive to the possibilities for ways of improving the efficacy of its staff. One possibility would be some temporary exchange of personnel between FINMA and the SNB and more involvement at all levels of staff with the work of the external auditors and host supervisory authorities.

One advantage of relatively small agencies is that these organisational questions tend to be less problematic. There should be less scope for a ‘silo’ mentality.

The governance of a supervisory agency is also an issue that has attracted comments in many countries. It is important that a supervisory authority can act when it detects a weakness or fault in a supervised institution. FINMA is a stronger and more independent institution than its predecessors, although its constitution does imply that certain decisions, even those concerning a specific institution, can be taken by the board and not by the management of the agency. It is acceptable for the management to be able to seek advice from the board in such a case but not that a decision is deferred, or worse, countermanded by the board. Fortunately, it is said that it is now rare for a decision relating to the supervision of a single bank to be taken at board level. But it would be preferable for the law to be amended to make clear that decisions on an individual institution are for FINMA’s management, although of course management should be held to account after the fact for the way in which it discharges its responsibilities.

One aspect that has received attention is the risk of so-called “regulatory capture”, that is the danger that supervisors are too close to the banks they supervise, see things the banks’ way, and are not sufficiently critical. This is a difficult charge to avoid. To some extent it can be countered by collegiate decision-making and some form of quality assurance. Regular rotation of staff can also contribute. FINMA’s approach of having the two large banks supervised by both a relationship team and a group of expert supervisors who deal with specific risks may also help to encourage a debate within FINMA and thus avoid the problem. This form of organisation may also avoid the charge of ‘Group think’ which has been levied against the supervisors’ behaviour in the past.

Early risk identification

7. How would you evaluate FINMA’s instruments for early risk identification? Are its tools sufficient to conduct this task effectively?

FINMA's ability to spot developments that could lead to losses early in the process may not have been especially strong as reliance on annual regulatory reports by external auditors tended to be backward-looking and more compliance oriented, but the substantial step-up in on-site work and greater contact with management at several levels should improve matters. Nonetheless, all supervisors are inevitably behind the risk curve. Although well designed statistical reporting can help supervisors to identify incipient problems, the most effective solution is for the supervisor to have the skills and resources to be able to understand the business and the risks being run better and this requires a good deal of familiarity with the bank, its business, and its management at several levels. The discipline of regular profiling and rating each bank should encourage a process of early risk identification. This involves not just being able to assess the quality of senior management but where necessary, drilling down to lower levels to obtain the necessary assurances. One of the problems with the UBS case was that the bank's senior management did not appear to be fully aware of the risks being run so continuous contact with senior management was not in itself enough to give early warning of problems developing. This is very often the case in problem banks, especially those that operate in sophisticated markets. The answer is more in depth analysis and examination, including the use of peer reviews, close contact with foreign supervisors, coordination with them to ensure that all the risks are covered by at least one supervisory authority, and better use of the external auditors and other experts available to the supervisors.

An important aspect of supervisory effectiveness in the Swiss case lies in the relationship between FINMA and the SNB. Both organisations have close relations with the larger banks but these relationships are of a rather different character. The SNB's interest is mainly related to the central bank's market operations where it has day-to-day contact with its counterparties. But the central bank also now has a statutory responsibility for the stability of the financial system as a whole and thus an interest in the soundness of the larger players.[23] There is clearly some tension between the differing interests of FINMA and the SNB. To some extent that can be creative and should be encouraged. But at some stage it could be destructive, so it is important for the two bodies to be clear as to what precisely their respective interests are in order to avoid overlap and confusion. For example, there appears to be the possibility that especially during consultation on revisions to the regulatory structure banks are inclined to play off one of the two agencies against the other. There is an MOU which governs the relationship and this was revised in February 2010. The MOU now provides that the two organisations should coordinate their activities with relation to the large banks and exchange information. While FINMA is responsible for supervision, the SNB may meet with the systemically important banks but must inform the FINMA of its intentions and share the results. This is the appropriate mechanism to ensure that information is freely shared and that it is clear where the responsibilities lie.

[23] This responsibility was made explicit in the 2004 revision of the SNB law although most central banks have traditionally regarded themselves as being responsible for the stability of the financial system as a whole.

8. What improvements do you propose in general regarding FINMA's activities in the field of early risk identification in international terms?

Switzerland poses exceptional challenges for bank supervisors because the large two banks are not only extremely large relative to the size of the economy and to the rest of the financial system but a very large part of the business, including most of the risks in the high-risk types of business, are located outside Switzerland. FINMA, and the EBK before it, has always cultivated close relationships with other supervisors especially in the US and the UK where the bulk of the two large banks' investment banking and trading business takes place. FINMA is therefore well placed to benefit from the experience and knowledge of US and UK supervisors, who monitor the activities of the two Swiss banks in their markets, but also most of their other major competitors as well. Of course, the foreign supervisors are not able to share with FINMA their detailed assessments of these other banks but they can give some indication as to how the Swiss banks stand compared with the market generally. FINMA claim that they do gain considerable benefit from this collaborative process. Although the relationships have always been close, the extent of cooperation may need to be further enhanced.

Switzerland is also a long standing member of the BCBS and other international regulatory bodies and this has enabled FINMA staff to keep abreast of international developments and constantly changing best practice. FINMA takes this opportunity seriously and has always been to the fore in reforms and improvements in the regulatory and supervisory standard setting processes and plays an active role in these bodies. This participation should be encouraged. Personal contacts developed in this process can be extremely helpful when operational requirements dictate urgent international coordination and cooperation.

Of course, there is always scope for increasing the element of cooperation and the realisation world wide of inadequacies in supervision in many countries has created an opportunity for more contact with other supervisors. One aspect is whether there is scope for joint examinations or audits with host supervisors. FINMA argues that jointly-led teams would be a mistake because they could lead to a confusion of responsibility, but supervisors in other countries argue that a jointly-led team can add force to its recommendations if they are seen to be shared by both authorities. Some participation in the work of the external auditors might also yield benefits in ensuring that both parties are aware of the work being done by the other. This could help in the process of defining the scope of the work done by auditors. Both of these processes would enable FINMA to monitor the work of both host supervisors and auditors as well as to enhance the degree of skill transfer to the benefit of FINMA.