

## **Peer Review of Switzerland**

### Review Report

25 January 2012

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## Foreword

The peer review of Switzerland is the fifth country peer review under the Financial Stability Board's (FSB) *Framework for Strengthening Adherence to International Standards*.<sup>1</sup> FSB member jurisdictions have committed to undergo periodic peer reviews focused on the implementation of financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving the desired outcomes. As part of this commitment, Switzerland volunteered to undertake a country peer review in 2011.

This report describes the findings and conclusions of the Switzerland peer review, including the key elements of the discussion in the FSB's Standing Committee on Standards Implementation (SCSI) on 13-14 December 2011. The draft report for discussion was prepared by a team chaired by Paul Rochon (Canada Department of Finance) and comprising Alexandria Luk (United States Office of the Comptroller of the Currency), Lim Cheng Khai (Monetary Authority of Singapore), Caio Ferreira (Central Bank of Brazil), Jonathan Griffiths (United Kingdom Financial Services Authority) and Juan Yermo (Organisation for Economic Cooperation and Development). Jason George and Costas Stephanou (both FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

The analysis and conclusions of the peer review are largely based on the Swiss financial authorities' responses to a questionnaire designed to gather information about the actions taken in response to the relevant recommendations of the most recent Financial Sector Assessment Program (FSAP) assessment for Switzerland.<sup>2</sup> The review has benefited from dialogue with the Swiss authorities as well as discussion in the FSB SCSI.

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<sup>1</sup> A note describing the framework is at [http://www.financialstabilityboard.org/publications/r\\_100109a.pdf](http://www.financialstabilityboard.org/publications/r_100109a.pdf).

<sup>2</sup> The FSAP report for Switzerland is available at [www.imf.org/external/pubs/ft/scr/2007/cr07187.pdf](http://www.imf.org/external/pubs/ft/scr/2007/cr07187.pdf).

## Glossary

BBA	Building Block Analysis
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principle
BVG	Sicherheitsfonds (pension guarantee fund)
CET1	Common Equity Tier 1
CFC	Committee on Financial Crises
CHF	Swiss Franc
CoCo	Contingent Capital Security
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
EU	European Union
FDF	Federal Department of Finance
FINMA	Financial Market Supervisory Authority
FINMASA	Financial Market Supervisory Act
FOPI	Federal Office of Private Insurance
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principle
IGT	Intra-Group Transaction
IMF	International Monetary Fund
IOPS	International Organisation of Pension Supervisors
ISL	Insurance Supervision Law
LCR	Liquidity Coverage Ratio
LPA	Loss Potential Analysis
MOU	Memorandum of Understanding
NSFR	Net Stable Funding Ratio
OAK	Oberaufsichtskommission (central pension supervisory commission)
OECD	Organization for Economic Cooperation and Development
SCSI	FSB Standing Committee on Standards Implementation
SFBC	Swiss Federal Banking Commission
SIB	Systemically Important Bank
SIFI	Systemically Important Financial Institution
SNB	Swiss National Bank
SQA	Swiss Qualitative Assessment
SST	Swiss Solvency Test
TBTF	Too Big to Fail
USD	US Dollar

## **FSB country peer reviews**

The FSB has established a regular programme of country peer reviews of its member jurisdictions. The objective of the reviews is to examine the steps taken or planned by national authorities to address International Monetary Fund (IMF)-World Bank FSAP recommendations concerning financial regulation and supervision as well as institutional and market infrastructure. FSB member jurisdictions have committed to undergo an FSAP assessment every 5 years, and peer reviews taking place typically around 2-3 years following an FSAP will complement that cycle.

A country peer review evaluates the progress made by the jurisdiction in implementing FSAP recommendations against the background of subsequent developments that may have influenced the policy reform agenda. It provides an opportunity for FSB members to engage in dialogue with their peers and to share lessons and experiences. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, nor does it provide an assessment of its conjunctural vulnerabilities or its compliance with international financial standards.

## **Executive summary**

Switzerland underwent an assessment update under the Financial Sector Assessment Program (FSAP) in 2006–07. The FSAP team concluded that the macroeconomic and financial sector environment at the time was favourable and that the Swiss banking sector appeared resilient to shocks. It also noted that impressive progress had been made to strengthen the financial supervisory framework since the 2001 FSAP, but that further attention should be devoted to the capital and liquidity requirements of UBS and Credit Suisse, the two large and systemically important banks (SIBs); stronger independence, more funding, and deeper staff resources to the new regulatory and supervisory authority; inspections and capital adequacy of high risk insurers; and supervision of occupational pension schemes.

The main purpose of this report is to assess Switzerland's progress in addressing these issues. To give some context, section 1 provides a brief overview of market and regulatory developments since the FSAP was published. Sections 2 to 5 examine the main areas identified by the FSAP.

### **Background**

The response of the Swiss authorities to the problems of one of the two SIBs during the financial crisis was swift and effective (see section 1). Their actions, in combination with strong macroeconomic fundamentals, allowed the economy to recover fairly quickly with very limited fiscal stimulus. The successful response was achieved with only limited formal institutional arrangements for cooperation among the different agencies.

However, the crisis did reveal the considerable macroeconomic and financial system risks arising from a SIB's failure, and demonstrated that large losses by these institutions were not merely a theoretical possibility. As a result, strengthening their resilience has become a key

priority for the authorities. The lynchpin of their response is the too-big-to-fail (TBTF) package, which was approved by the Swiss Parliament in September 2011 and is due to come into force on 1 March 2012. The core elements of the package include capital and liquidity requirements, organisational structure, risk diversification and resolution measures. The package is particularly demanding in terms of capital requirements - in fact, the 10% common equity tier 1 capital requirement under the package exceeds both Basel III and any internationally agreed capital surcharge for global SIBs. The FSB commends the Swiss authorities for developing this package, particularly in the absence of an internationally agreed framework at the time on how to deal with systemically important firms. The package goes beyond international minimum standards in terms of regulatory capital requirements and has been influential in the international policy debate on this issue.

Implementation issues will be important for the success of the TBTF package. First, Switzerland's experience with the use of contingent capital instruments (CoCos), which are a relatively new instrument and represent a large portion of the additional capital requirements, will be useful in determining the broader use of these instruments at the international level. The initial market reaction to the issuance of CoCos by one of the two SIBs has been favourable. Second, it will be important to maintain the integrity of the TBTF framework by limiting the size of any regulatory capital "rebates" that are envisaged if firms are able to demonstrate resolvability and resolution beyond minimum requirements. Finally, at least as important as higher capital levels and liquidity buffers is ensuring: (1) a rigorous corporate governance framework in SIBs to ensure that their risks are well-understood and adequately managed internally; and (2) a robust supervisory framework in FINMA with sufficient resources and intensive supervision. These two factors are particularly relevant given the size, global reach and business models of the two large banks.

The regulatory reforms underway, both at national and international levels, have already begun to impact the business models of the two big banks. Both SIBs have shrunk their balance sheets since the financial crisis and have recently announced adjustments in their strategy to reduce the importance of investment banking activities.

Another important issue is the recent introduction of the CHF-EUR floor and its potential impact on the financial system. The combination of the floor with a protracted low interest rate environment could potentially result in excessive credit creation and contribute to the build-up of imbalances in the domestic real estate and mortgage markets. It is therefore essential that the authorities remain vigilant in monitoring trends and maintaining sound underwriting and credit risk management in this sector.

### **FSAP recommendations**

The prudential authority's (FINMA) operational independence from the federal government has been enhanced compared to its predecessor authorities in areas such as hiring and budget setting. However, the concerns expressed in the FSAP with respect to Article 7 of the FINMA Act (the competitiveness clause) remain unresolved since the relevant provisions have not been revised (see section 2). The authorities believe that Article 5 of the Act clearly states the primacy of FINMA's prudential objectives, with the outcomes contributing to the reputation and competitiveness of the Swiss financial centre. Article 7 is intended to reflect the need for cost-benefit analysis as one of the basic principles of regulation. However, these

Articles do not address situations where there are tensions or direct conflicts between prudential objectives and competitiveness. The FINMA Act has also not been revised (as recommended by the FSAP) to grant FINMA the powers to impose civil money penalties to enhance its prudential powers. Progress on addressing these issues would be desirable.

FINMA has made good progress in strengthening its resources and headcount as recommended by the FSAP, in spite of difficulties in recruiting specialists. While resources have generally increased in response to the crisis, the need and expectations for increased supervisory intensity and effectiveness have also correspondingly increased. FINMA should continue to increase its resources - both on the banking and on the insurance side - and enhance its in-house expertise to keep pace with market and regulatory developments.

FINMA is making a number of improvements to its supervisory framework, including a new risk-based supervisory approach (see section 3). However, reliance on these third parties remains strong. While the outsourcing of supervisory functions to third parties is appropriate in certain cases (e.g. to tap additional expertise and resources), FSB members encourage the Swiss authorities to continue to enhance FINMA's supervisory capacity and its ability to perform more on-site examinations itself, including with respect to bank risk management practices and internal controls.

One important concern with respect to outsourcing is the independence of the work carried out by third parties. In that respect, FINMA is encouraged to continue to improve its oversight of banks' external auditors, as envisaged in its current plans. In particular, FINMA should assume primary responsibility for developing the terms of reference for regulatory audit work, selecting the audit firm that is going to undertake this work (which should be different than the one employed for the financial audit), and paying that firm based on performance by charging supervised financial institutions accordingly.

Cantonal banks weathered the crisis fairly well and were able to gain market share at the expense of the two large banks; they are also generally well capitalized and have a higher quality of capital than the two SIBs. Cantonal banks are subject to supervision by FINMA and operate under the same corporate governance regulation that applies to private banks, including in terms of board member requirements. However, some of these banks have their liabilities fully guaranteed by their respective cantons (often for a fee). In order to promote a level playing field, the Swiss authorities should consider eliminating these guarantees.

Significant progress has been made in implementing insurance sector reforms since the FSAP (see section 4). The Swiss Solvency Test (SST) came into full effect in 2011; FINMA has expanded its supervisory resources and undertakes focused inspections of high risk insurers; there is enhanced data collection for intra-group transactions (IGTs); an internal audit function within FINMA has been established; and quarterly reporting of selected key indicators for insurance companies has been implemented.

Looking ahead, FINMA needs to ensure the proper operation of the SST for all relevant (re)insurers, and data quality and other modelling issues should be resolved for firms that are not yet fully compliant. Although the SST includes an assessment of group risk, it can be difficult to fully understand the web of constantly changing and numerous IGTs of complex groups. Accordingly, further development (such as the planned data warehouse) is necessary to support in-depth analysis of the use of IGTs. FINMA is also encouraged to take additional steps to expand public disclosure, an issue that it is currently considering.

The impending change in the supervisory structure for pension funds, while falling short of the FSAP's main recommendation (i.e. to establish a single, centralised supervisory authority for the whole country), still represents a major improvement compared to the current situation (see section 5). The new law, adopted by the Swiss parliament in March 2010, addresses the independence, resources and powers of the cantonal supervisors and establishes a central supervisory commission (OAK) to oversee them and to ensure the application of common supervisory standards for pension funds across Switzerland, particularly over governance, investment and solvency. However, it is unclear that the current resources allocated to OAK will be sufficient to ensure that goal. It is also essential to ensure a clear line of communication and cooperation with FINMA, via a Memorandum of Understanding, given the role of insurance companies in the private pension system.

Significant progress has been achieved in strengthening governance provisions of pension funds following the FSAP. The new provisions are welcome and should help contain the problems of fraud and mismanagement that had been observed in some pension funds in recent years. On the other hand, the new legislation does not specifically address other aspects of risk management. The development of supervisory guidelines on risk management, should therefore be one of the first priorities of the OAK.

The FSAP recommendation on a risk-based solvency test also remains to be implemented. In particular, the valuation standards for pension assets and liabilities would need to be reformed to better reflect market conditions. However, fully transferring market volatility to solvency valuations may not make sense given very long-term contracts where there is little risk of members leaving the fund and where benefit promises can be adjusted. Some pension funds are also backed by the sponsoring employer, while there is a guarantee fund in the case of insolvency. Any new funding regulations would need to take all of these factors into account.

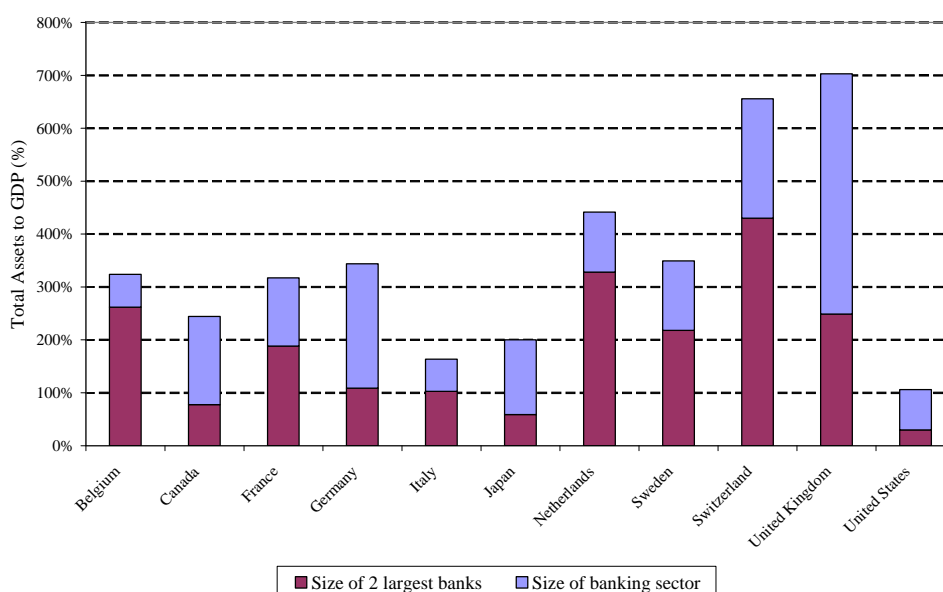


# 1. Recent market developments and regulatory issues

## Financial system structure

The Swiss financial system is large by international standards and plays an important role both domestically and internationally. It makes a key contribution to the Swiss economy, accounting for 10.7% of value added, 5.7% of the workforce and roughly 12-15% of annual tax receipts. Its two largest banks (UBS and Credit Suisse) and insurance companies (Swiss Re and Zurich Financial Services) are ranked among the largest global financial institutions.

**Figure 1: Total Assets of the Banking Sector to GDP (year-end 2010)**



Source: Bank of Canada, Bank of Japan, Bankscope, European Central Bank, US Federal Financial Institutions Examinations Council, Japanese Bankers Association, OECD, SNB.

Although the size of the banking sector has declined since 2006 from over 9 times Gross Domestic Product (GDP) to 6.6 times GDP in 2010, its relative size and concentration remain among the highest in the G10 countries (see Figure 1). With operations in over 40 countries, UBS and Credit Suisse comprise a large part of the sector. The total assets of each bank are more than twice Switzerland's GDP (a large part of which comes from foreign operations), and together these two banks accounted for 38% of the domestic credit market at end-2010. Although they operate as universal banks providing a wide range of financial services, their main business lines are asset/wealth management<sup>3</sup> and investment banking. In addition to these two large banks, the Swiss banking sector comprises cantonal banks (which are controlled and most of which are guaranteed by Switzerland's cantons), regional and other banks as well as the Raiffeisen Group (a cooperative with 328 independent members), most of which have a domestic client focused business model (see Table 1).

<sup>3</sup> Wealth management is a core business for Swiss banks. At year-end 2010, assets under management in Switzerland totalled around Swiss Franc (CHF) 5.5 trillion, half of which came from foreign clients.

**Table 1: Domestic market share of different types of Swiss banks (in %)**

	Big Banks	Cantonal Banks	Raiffeisen Banks	Regional Banks	Other Banks
<b>2006</b>					
Claims against customers	44	24	5	4	23
Mortgage claims	35	34	14	11	7
Deposits at Swiss bank offices	31	32	18	11	8
Total Assets	37	29	10	8	15
<b>2010</b>					
Claims against customers	38	27	5	4	27
Mortgage claims	31	34	16	10	9
Deposits at Swiss bank offices	26	35	20	10	9
Total Assets	32	29	11	7	20

Source: FINMA, SNB.

The Swiss insurance sector accounts for around 3% of GDP, while its investments represent approximately 100% of GDP. Its two large institutions - Zurich Financial Services ranks 13<sup>th</sup> in size amongst global insurers, while Swiss Re is the second largest global reinsurer - dominate in overall size but are of less significance in terms of market share domestically. The sector remains dualistic in nature, with a few large international groups and numerous smaller insurance companies dedicated solely to the Swiss insurance market.

Pension funds are the largest institutional investors in Switzerland with assets under management representing over 110% of GDP. The industry is highly dispersed, with over 2,800 pension funds around the country, some of the largest being those established for the government employees of the largest cantons. They operate primarily defined contribution plans (over three quarters of the total).<sup>4</sup>

The SIX Group operates Switzerland's financial market infrastructure and offers securities trading, clearing and settlement services, payment transactions and financial information. The SIX Swiss Exchange offers a wide product range, and ranked fourth in market capitalisation (USD 1.2 trillion) at end-2010 among regulated European stock markets.

### Regulatory framework

The Swiss Financial Market Supervisory Authority (FINMA) is the regulatory and supervisory authority responsible for the supervision of banks, insurance companies, stock exchanges, securities dealers, and other financial intermediaries (except pension funds - see section 5). It was created in June 2007 by the Financial Market Supervisory Act (FINMASA) and was given full power on 1 January 2009.<sup>5</sup> The Swiss National Bank (SNB) and the Federal Department of Finance (FDF) are FINMA's most important domestic partner agencies.

<sup>4</sup> Defined contribution pension plans in Switzerland must offer minimum benefits that are calculated on the basis of a minimum investment return (currently 1.5% annually) and a fixed annuity conversion rate.

<sup>5</sup> The Act essentially merged three government agencies: the Federal Office of Private Insurance (FOPI), the Anti-money Laundering Control Authority and the Swiss Federal Banking Commission (SFBC).

Cooperation between the SNB, FINMA and the FDF is governed by two Memoranda of Understanding (MOU). The SNB and the SFBC had a MOU in place since 2007 that was continued after the creation of FINMA. This bilateral MOU was revised in February 2010 to focus on financial stability based on lessons from the financial crisis.<sup>6</sup> It provides a clear division between the respective tasks of each of the two institutions, describes their common areas of interest and governs their collaboration in these areas. In addition, there is a trilateral MOU between the FDF, FINMA and the SNB that was signed in January 2011.<sup>7</sup> It governs collaboration between the three authorities, including the exchange of information on financial stability and financial market regulation issues, as well as coordination in the event of a crisis that could threaten the financial system's stability. The three authorities' statutory responsibilities and decision-making powers remain unchanged under both MOUs.

Two main committees are in place to effect inter-agency coordination: the Steering Committee and the Committee on Financial Crises (CFC). The Steering Committee - comprising the FDF head (Committee chair), the SNB Governing Board Chair and the FINMA Chairman coordinates any policy responses in the event of a crisis. The CFC - comprising the FINMA Chief Executive Officer (Committee chair), FDF State Secretary, the SNB Governing Board Vice Chairman, and the Director of the Federal Finance Administration - meets at least twice a year. In the event of a crisis, it coordinates preparatory work for decision-making on crisis responses on behalf of the Steering Committee.

FINMA has also signed bilateral and multilateral MOUs with a number of foreign supervisory authorities<sup>8</sup>, and it has created supervisory colleges with important host regulators for the largest Swiss banks and insurance companies.

## **Crisis response**

The recent global financial crisis highlighted the vulnerability of the Swiss economy and the financial system to the two large banks. Prior to the crisis (2006), when the combined total assets of UBS and Credit Suisse represented over 7 times Switzerland's GDP, both banks had large proprietary trading portfolios in US asset-backed securities and in complex structured products. The collapse in the market prices of those products generated substantial losses, particularly for UBS that had substantial investments in US subprime mortgage-backed securities.<sup>9</sup> These losses were compounded by the fact that the two banks were highly leveraged, had inadequate capital buffers and their profitability and funding were heavily dependent on global capital markets.<sup>10</sup>

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<sup>6</sup> See <http://www.finma.ch/e/aktuell/pages/mm-mou-snb-finma-20100312.aspx>.

<sup>7</sup> See <http://www.finma.ch/e/aktuell/pages/mm-mou-20110117.aspx>.

<sup>8</sup> See <http://www.finma.ch/archiv/ebk/e/internat/mous.html> for details.

<sup>9</sup> For more information, see the "Shareholder Report on UBS's Write-Downs" (April 2008, [http://www.ubs.com/1/e/investors/share\\_information/shareholderreport.html](http://www.ubs.com/1/e/investors/share_information/shareholderreport.html)) and the "Transparency report to the shareholders of UBS AG" (October 2010, <http://www.ubs.com/1/e/transparencyreport.html>).

<sup>10</sup> UBS recorded total write-downs and credit losses of USD 53 billion in connection with the financial crisis between 2007 and mid-2009, while Credit Suisse's losses amounted to USD 19 billion. See "Financial market crisis and financial supervision" by FINMA (September 2009, available at [http://www.finma.ch/e/aktuell/Documents/Finanzmarktkrise-und-Finanzmarktaufsicht\\_e.pdf](http://www.finma.ch/e/aktuell/Documents/Finanzmarktkrise-und-Finanzmarktaufsicht_e.pdf)).

By contrast to the 2 big banks, small and medium-sized Swiss banks weathered the crisis fairly well and were able to gain market share at the expense of the two large banks. In addition, most Swiss insurance companies (with the exception of some large ones) did not have significant exposures to US asset-backed securities or similar investments and, in spite of their large investment portfolios, were not significantly impacted and were able to meet solvency and tied/pledged assets requirements.

The problems of the two big banks threatened to spill over to the rest of the financial system and to the economy. In response, the SNB took a number of extraordinary policy measures to secure the supply of liquidity to banks and to ease private borrowers' access to capital, including money market and foreign exchange swap operations and the temporary purchase (until year-end 2009) of CHF-denominated bonds by private sector issuers. Depositor protection was also raised to CHF 100,000 in December 2008, an amount that is comparable to the level of protection adopted in European Union (EU) countries following the crisis<sup>11</sup> – although other features of the deposit insurance system in Switzerland raise some concerns.<sup>12</sup>

*Measures to stabilize UBS:* The Swiss authorities approved a package of measures in October 2008 to restore confidence in the financial system. The SNB created the Stabilisation Fund, a special purpose vehicle designed to receive up to USD 60 billion in illiquid assets from UBS's balance sheet, primarily US and European residential and commercial real estate mortgages, for orderly liquidation. UBS was required to provide this vehicle with equity capital of 10% of the assets purchased, while the SNB granted a loan (secured by the Fund's assets and a warrant for 100 million UBS shares) for the remaining 90%. With private capital markets disrupted by the crisis, the Swiss authorities were forced to inject the equity capital into UBS by subscribing to mandatory convertible notes in the amount of CHF 6 billion.<sup>13</sup>

Since it was established, the Stabilisation Fund has managed to reduce its portfolio of assets from USD 34.7 billion to USD 11 billion through interest payments, repayments, asset sales, and the closing of derivative positions. As of 30 June 2011, equity had increased to USD 3.4 billion with a year-to-date six month profit of USD 1.3 billion. The main objective remains the full repayment of the SNB's loan while maximizing the proceeds from the portfolio.<sup>14</sup>

*Prudential measures for Systemically Important Banks (SIBs):* In 2008, FINMA developed a new capital adequacy regime in close cooperation with the SNB to increase the resilience of Switzerland's two large banks. The higher capital adequacy targets were defined and communicated to the two large banks via a formal decree on 20 November 2008, and they must be complied with by 2013 subject to future profitability. The regime calls for an increase in risk-weighted capital for the large banks between 50% and 100% above the minimum international requirements under Pillar 1 of Basel II. This additional capital

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<sup>11</sup> The revised ceiling was made permanent via a revision of the law in March 2011. The revised law also extends FINMA's powers to resolve failing banks, specifically through the creation of a bridge bank.

<sup>12</sup> See the forthcoming FSB peer review report on deposit insurance systems for more information.

<sup>13</sup> On 19 August 2009, the Swiss government announced the conversion of their Swiss Franc (CHF) 6 billion mandatory convertible notes, which were sold to institutional investors at a net gain of CHF 1.2 billion. The Swiss government waived its rights for future coupon payments.

<sup>14</sup> Detailed information on the business activities and results of the Stabilisation Fund can be found in the 2008, 2009 and 2010 editions of the SNB's Annual Report (<http://www.snb.ch/en/i/about/pub/annrep>).

requirement is being implemented under Pillar 2 of Basel II. In good periods, the banks should build up their capital to a target level of 200%. This buffer will then be available to the banks during periods of crisis and can be run down to an intervention level of 150%. In addition, a leverage ratio was introduced so that the minimum proportion of Tier 1 capital to total assets for both banks is 3% at group level and 4% for individual institutions.<sup>15</sup>

FINMA and the SNB also substantially revised the liquidity regime for the two large banks (see section 3). The new regime, which came into force on 30 June 2010, involves a stringent stress scenario covering a general crisis in financial markets coupled with creditors' loss of trust in the bank. The new regulations, originally introduced with the agreement of the two banks, now have a legal basis since the too-big to-fail (TBTF) package has recently been approved. They require that these banks, by holding an adequate reserve of first-class liquid assets, are able to cover estimated outflows over a period of at least 30 days.

*Recent developments:* The Swiss economy recovered fairly quickly from the financial crisis, with a broad-based recovery driven by robust domestic demand and a rebound in exports.<sup>16</sup> More recently, however, extreme risk aversion prompted by problems in the Eurozone led to a 'flight to safety' by international investors, resulting in a steep appreciation of the CHF that - together with the worsening global economic environment - has adversely affected Swiss exports and the overall economy. In September 2011, the SNB announced a minimum CHF-Euro exchange rate of 1.20. According to the SNB, the massive overvaluation of the CHF at the time of the announcement posed an acute threat to the Swiss economy and carried the risk of a deflationary development. To maintain this minimum exchange rate level, the SNB stated that it is prepared to buy foreign currency in unlimited quantities.<sup>17</sup>

The Swiss authorities have evaluated the potential implications of the CHF-Euro exchange rate floor and of a protracted low interest rate environment, including the risk that it would result in substantial domestic credit creation. The authorities have consequently stepped up their communication with the banks regarding the potential build-up of risk in the financial system, including the residential mortgage market. The SNB has also been monitoring the banks and conducting surveys to assess their exposure to the real estate sector. FINMA has increased its supervisory focus on the domestic mortgage market by working with the Swiss Bankers' Association to tighten self-regulation and to require the uniform application of residential mortgage underwriting standards. In addition to these qualitative parameters, the Federal Council has decided to introduce higher risk weights for mortgage lending and a countercyclical buffer that are supposed to come into effect in early 2012.

## Major regulatory initiatives

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<sup>15</sup> The supervisory authority expects the two large banks to exceed this minimum level in good periods. It is worth noting that the domestic lending business of both banks has been excluded from the leverage ratio since, at the time of its implementation, there was concern over a long lasting deep recession. A new leverage ratio based on the Basel III requirements will address this weakness.

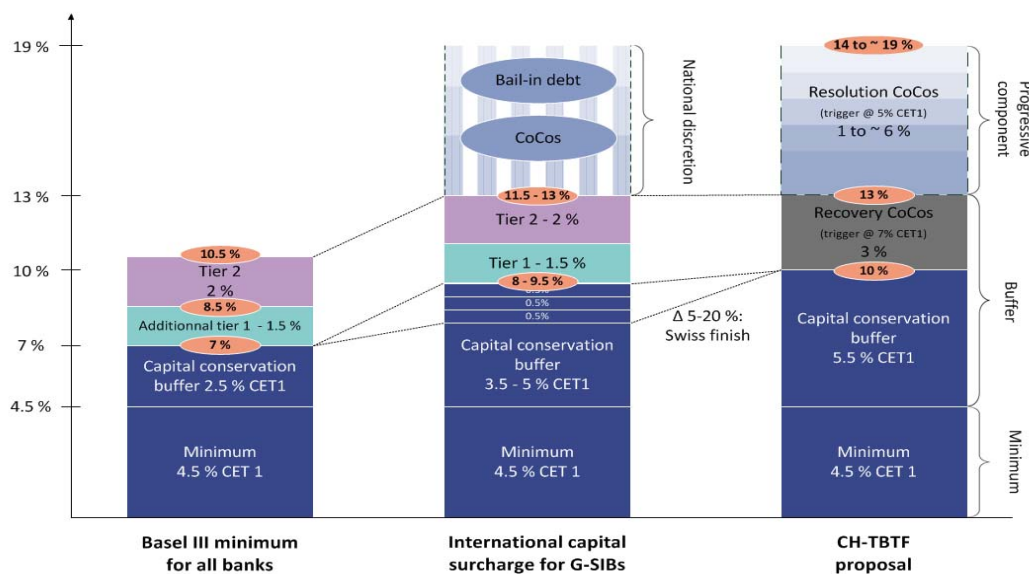
<sup>16</sup> See the 2010 Article IV report on Switzerland for details (IMF Country Report No. 10/140, April 2010, available at <http://www.imf.org/external/pubs/ft/scr/2010/cr10140.pdf>).

<sup>17</sup> Additional supportive measures include the SNB continuing to target a three-month Libor rate at 0% and a target level for the maintenance of total sight deposits by banks at the SNB of CHF 200 billion.

*TBTF package:* Given the lessons from the financial crisis, the Swiss authorities have concluded that it is crucial to strengthen the resilience of the two SIBs in order to reduce the possibility of future bailouts and emergency assistance measures for them. On 20 April 2011, the Federal Council submitted a proposed package to Parliament detailing measures designed to strengthen the stability of the financial system and to prevent public bail-out of SIBs.<sup>18</sup> The core elements of the TBTF package address capital and liquidity requirements, organisational structure, risk diversification and resolution (see Box 1 and section 3). Under the proposed capital framework and given the current situation of the two large banks, the total minimum capital adequacy requirement for each of them will be around 19% of risk-weighted assets (RWAs). The Federal Council's bill, based upon recommendations from a commission of appointed experts<sup>19</sup>, was approved by the Swiss Parliament on 30 September 2011 and is due to come into force on 1 March 2012.

*Basel III:* The Basel III framework is expected to be adopted into law for all Swiss banks with effect from January 2013, and to follow the transition period up to 2019 as agreed by the BCBS. Basel III is expected to have a higher impact on large banks, particularly with regard to eligible capital as well as capital requirements for over-the-counter derivatives (see Figure 2 for a comparison of risk-based capital requirements under the Basel III framework and the Swiss TBTF regulation).

**Figure 2: TBTF package – comparison of risk-based capital requirements**



Source: FINMA.

<sup>18</sup> See <http://www.news.admin.ch/NSBSubscriber/message/attachments/22798.pdf> for details.

<sup>19</sup> See <http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en> for details. The Swiss government followed the Commission of Experts' conclusion and decided not to include the two big Swiss insurance companies in the TBTF package since their size and market share were deemed not to constitute a TBTF risk. The Commission considered an orderly resolution of an insurance (and reinsurance) company – in contrast to the situation with the large banks – a viable option both under current law and in practice.

### Box 1: The TBTF package

Under the Swiss TBTF regime, systemically important financial institutions (SIFIs) are defined as “banks, financial groups and bank-dominated financial conglomerates whose failure would do considerable harm to the Swiss economy and the Swiss financial system.” Determination of SIFI status is delegated to the SNB based on criteria such as market share and interconnectedness, deposits, size compared to GDP and risk profile.

*Capital requirements:* The minimum capital requirements for the two large banks are three-fold in nature and apply to both the risk-weighted capital ratio and to the leverage ratio. Part of them can be held in the form of contingent capital instruments (CoCos), i.e. bonds that convert into common equity or written off once a contractually defined trigger is reached.<sup>20</sup>

1. The *basic requirement* is a regulatory minimum - 4.5% Core Tier 1 ratio to RWAs, as in Basel III - must be met on an on-going basis.
2. The *capital buffer* (8.5% of RWAs, comprising both common equity and high-trigger CoCos) allows banks to absorb losses without falling short of the basic requirement and without having to suspend normal business activities.
3. The *progressive component* (1-6% of RWAs, made up of low-trigger CoCos) is a systemic surcharge that increases with the bank's size and domestic market share.

The Swiss authorities believe that banks that issue CoCos will have an incentive to lower their risk and that such instruments can provide the bank with additional capital when it may be difficult to raise it from the market. They are revising the tax framework to ensure the attractiveness of these instruments to investors and to promote issuance in Switzerland.

*Liquidity requirements:* The TBTF amendments provide a legal basis for introducing differentiated liquidity requirements for SIBs. Based on the regime introduced in June 2010, they will complement the Basel III requirements once the latter become effective.

*Risk diversification:* The main objective of these measures is to reduce interconnectedness in the banking sector by reducing the dependence of other banks on the SIBs. The Swiss Capital Adequacy Ordinance was revised as of 1 January 2011 to implement the more stringent BCBS provisions for market risks and securitisation as well as risk diversification standards.

*Organisational structure:* The TBTF framework places responsibility for the continuation of systemically important functions (payment transactions, deposit and lending business) on the SIB. It must demonstrate by means of an emergency plan (which gets triggered if its capital ratio falls below 5%) that such functions can be maintained. The Federal Council will set out in an ordinance the criteria and standards for assessing the emergency plan (Resolution Effectiveness Test) and recovery arrangements, and will provide FINMA with the authority to apply corrective actions. In addition, the Banking Act has been amended to provide FINMA with the necessary tools to reorganise distressed banks.

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<sup>20</sup> High-trigger CoCos convert into shares (or participation certificates) or trigger a write-off if common equity falls below 7% of RWAs, while low-trigger CoCos convert if common equity falls below 5% of RWAs. The former convert during a firm's deterioration to improve loss absorbing capacity in order to stabilise the company, while the latter are designed to generate capital necessary to finance the maintenance of systemically important functions in the event of threatened insolvency (akin to an internal resolution fund). FINMA will have to approve the term sheet of all CoCos that would be eligible for capital requirements.



*Macroprudential supervision:* In April 2011, the FDF established a working group (with high-level participation from FINMA and the SNB) on financial stability to evaluate Switzerland's macroprudential framework and to propose improvements as needed. The working group concluded in November 2011 that the following two macroprudential instruments should be considered for enforcement as of March 2012:

- a countercyclical buffer of up to 2.5% of RWAs made up of Common Equity Tier 1 capital, in accordance with the Basel III framework. According to the proposal, the buffer could be limited to assets in specific market segments (e.g. a bank's domestic mortgage business) that may give rise to systemic risks. Upon the SNB's request, in consultation with FINMA, the Federal Council would be in charge of activating the buffer. Since current and expected developments in the Swiss banks' lending activities may justify activation of the buffer prior to Switzerland's introduction of Basel III, the working group's proposal includes an amendment of the current ordinance to allow activation before 2013 based on current capital definitions as needed.
- an improvement in the classification of risk-weights for exposures related to mortgage-backed real estate financing. In particular, the working group is following up on the Federal Council's August 2011 proposal to improve the classification of risk-weights for banks' exposures related to such financing. The new classification will be more risk-oriented, taking account of the debtor's risk profile and assigning a 100% risk-weight to high-risk exposures.

Public consultation for both regulatory instruments has commenced in November 2011 and will end in mid-January 2012. This time schedule would allow the respective amendments in the ordinance to enter into force on 1 March 2012, conditional on governmental approval. The working group considers these amendments key to completing the authorities' macroprudential toolkit. In line with its mandate, the working group will also publish its assessment of Switzerland's macroprudential framework in early 2012.

*Swiss Solvency Test (SST):* Insurance companies had been preparing for the SST since 2006. As of 1 January 2011, FINMA requires all insurance companies and conglomerates to conduct this test based upon an extensive set of parameters set by the supervisor. The SST enables a market-consistent assessment of the firm's risks (market, insurance and credit) and balance sheet, including risks from non-insurance and capital-market-related transactions to be captured (see section 4). The SST also includes scenario testing against the impact on the target capital to be estimated. A comprehensive report detailing the results of the test is sent to FINMA annually.

### **Lessons and issues going forward**

The response of the Swiss authorities to the problems of one of the two SIBs during the financial crisis was swift and effective. Their actions, in combination with strong macroeconomic fundamentals, allowed the economy to recover fairly quickly with very limited fiscal stimulus. The successful response was achieved with only limited formal institutional arrangements for cooperation among the different agencies.



However, the crisis did reveal the considerable macroeconomic and financial system risks arising from a SIB's failure, and demonstrated that large losses by these institutions were not merely a theoretical possibility. As a result, strengthening the resilience of the SIBs and ensuring that taxpayers do not assume financial risks to save them has become a key priority for the authorities. From a supervisory perspective, FINMA concluded that the lessons from the crisis centred around inadequate capital adequacy requirements and liquidity standards, insufficient attention paid to excessive growth, insufficient independent testing of information (including overreliance to internal and external auditors), and a less than adequate range of banking commission powers including sanctions.<sup>21</sup>

The lynchpin of the Swiss authorities' response to the crisis is the recently-approved TBTF package, which has been developed as a way to strengthen the resilience of SIBs. The framework is multi-faceted and particularly demanding in terms of capital requirements, and the Swiss authorities are to be commended for developing this package in the absence of an internationally agreed framework at the time on how to deal with SIFIs. The package has been influential in the international policy debate on this issue and is more ambitious in certain respects than the policy measures subsequently developed by the FSB on global SIFIs<sup>22</sup> because of the specific challenges involved in the case of the two big Swiss banks. In fact, the 10% common equity tier 1 capital requirement under the package exceeds both Basel III and any internationally agreed capital surcharge for global SIBs. The TBTF package is expected to contribute significantly to the stability of the Swiss financial system by reducing the vulnerability of the large banks to external shocks and the probability of contagion in a financial crisis.

Implementation issues will be important for the success of the TBTF package. First, Switzerland's experience with the use of CoCos, which are a relatively new instrument and represent a large portion of the additional capital requirements, will be useful in determining the broader use of these instruments at the international level.<sup>23</sup> Second, a crucial feature of the TBTF package is the capital buffers. Although it may be reasonable to grant some kind of rebates – as is currently envisaged – to the progressive capital component requirement if firms are able to demonstrate resolvability and resolution beyond minimum requirements (such as the continuation of systemically relevant functions), it will be important to maintain the integrity of the framework by limiting the size of such rebates.<sup>24</sup> Finally, at least as important as higher capital levels and liquidity buffers is ensuring: (1) a rigorous corporate governance framework in SIBs to ensure that their risks are well-understood and adequately managed internally; and (2) a robust supervisory framework in FINMA with sufficient resources and intensive supervision. These two factors are particularly relevant given the size,

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<sup>21</sup> See “Financial market crisis and financial supervision” by FINMA (September 2009, *ibid*).

<sup>22</sup> See “Policy Measures to Address Systemically Important Financial Institutions” by the FSB (November 2011, available at [http://www.financialstabilityboard.org/publications/r\\_111104bb.pdf](http://www.financialstabilityboard.org/publications/r_111104bb.pdf)).

<sup>23</sup> In this context, it should be noted that Credit Suisse successfully placed USD 2 billion of Tier-2 Buffer Capital Notes (a form of CoCo) in February 2011, which represent approximately 70% of its high-trigger CoCo requirements under the new capital regime. It plans to place Tier-1 Buffer Capital Notes in 2013.

<sup>24</sup> The rebate system is still being developed and the ordinances are not yet enacted. Given the complexities of cross-border resolution, it is likely to be a challenge for the relevant firms to prove, and for FINMA to accurately evaluate, their resolvability from a global perspective.

global reach and business models of the two large banks. FINMA has made some progress in building its supervisory resources and expertise but continues to rely heavily on auditors and to outsource a significant amount of supervisory work (see sections 2 and 3).

The regulatory reforms underway, both at national and international levels, have already begun to impact the business models of the two big banks, which are based on wealth management as well as on volatile trading income and investment banking activities. Both SIBs have shrunk their balance sheets since the financial crisis and have recently announced adjustments in their strategy to reduce the importance of investment banking activities. Part of the wealth management sector has also seen a number of tax issues that impacted business strategies. The changing regulatory landscape is an important challenge for the Swiss banking sector, which the Swiss authorities and the banking industry are actively addressing.

Another important issue is the recent introduction of the CHF-EUR floor and its potential impact on the financial system. The SNB has taken a bold stance against an overvaluation of the currency and the negative impact it may have on the economy. However, the combination of the floor with a protracted low interest rate environment could potentially result in excessive credit creation and contribute to the build-up of imbalances in the domestic real estate and mortgage markets. It is therefore essential that the authorities remain vigilant in monitoring trends and maintaining sound underwriting and credit risk management in this sector. Inter-agency cooperation is essential and the authorities have made good progress recently in establishing a cooperation framework to improve macroprudential oversight - notwithstanding the fact that the framework does not provide a formal designation of safety net responsibilities and obligations, and it leaves some operational aspects unclear.<sup>25</sup>

## **2. Banking and supervisory framework**

The FSAP noted that Switzerland had been actively upgrading its regulatory and supervisory arrangements and strengthening cooperation and information exchange with foreign regulators. It noted the need for effective supervision of the major Swiss financial institutions via a strong, independent regulator. In that context, it recommended a review of the provisions of the draft FINMASA to ensure that FINMA is provided with sufficient operational independence and prudential powers. The FSAP also recommended further strengthening the resources and expertise of the banking and insurance supervisors. In particular, the Swiss authorities were advised to:

- review the provisions of the draft FINMASA to avoid provisions that might limit FINMA's operational independence and prudential powers;
- provide FINMA with the powers to impose civil money penalties; and
- strengthen the resources and expertise of the supervisors.

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<sup>25</sup> See the 2011 Article IV report on Switzerland for details (IMF Country Report No. 11/115, May 2011, available at <http://www.imf.org/external/pubs/ft/scr/2011/cr11115.pdf>).

## Steps Taken and Actions Planned

*Operational independence and powers of FINMA:* FINMA's independence from the federal government has been enhanced since its creation in areas such as hiring and budget setting. In particular, FINMA staff are not employed under the Federal Personnel Ordinance but under the FINMA Personnel Ordinance that was enacted by FINMA's Board of Directors and accords it with greater flexibility in hiring and retaining staff. This is in contrast to the SFBC, where the creation of new positions and a corresponding salary class were required to be approved by the FDF. Furthermore, FINMA keeps its own accounts and is financially independent from the federal budget. Its budget is approved by its Board of Directors and is not subject to further approval by the government or parliament. The FINMA Fees and Charges Ordinance empowers FINMA to charge supervised financial institutions to cover its general costs, and to levy additional charges in cases where the usual fees are insufficient to cover its costs. This Ordinance does not restrict the size of FINMA's budget or the application of funds.

FINMASA includes provisions regarding FINMA's accountability vis-à-vis the public, the parliament and the Federal Council. Article 7 (the competitiveness clause) requires FINMA to take into account the competitiveness of the Swiss financial centre when regulating financial institutions and markets. Although this article could potentially give industry representatives some leverage in opposing regulation, no FINMA regulation has been challenged in court due to the competitiveness clause since the enactment of the Act. FINMA emphasises that it does not accept or promote inadequate or ineffective regulation in favour of competition and that, in fact, it considers the proposed TBTF regulations for the two SIBs as a competitive advantage for the Swiss financial centre. Furthermore, the Swiss authorities note that, while the cost of regulation and competition are taken into account in policy formulation, the primacy of FINMA's responsibilities are prudential and supervisory in nature.

*Powers to impose civil money penalties:* The FINMASA has not been revised to grant FINMA the powers to impose civil money penalties. Somewhat mitigating this point, in comparison to its antecedents, FINMA's sanctioning powers have been strengthened by enabling it to confiscate illegal profits as well to remove banking officials from their position and prohibit them from employment in the banking sector. FINMA also supports the work of criminal authorities and files criminal complaints against parties in cases where reasonable grounds exist to suspect offenses against the criminal provisions of financial markets acts.

*Strengthening resources and expertise of supervisors:* The strengthening of FINMA's workforce by hiring staff with experience in senior roles within the finance and risk management sector has been a strategic objective - particularly given the high staff turnover experienced at the time of its creation. FINMA has made progress in terms of resources, as the number of full time equivalents has increased from approximately 330 in 2009 to 380 currently. This includes a number of senior-level hires from the private sector. The current exceptional market circumstances have facilitated the recruitment of staff with the required credentials and experience when compared to the past. However, FINMA is well aware that the current situation may not continue and, as a consequence, is taking steps to improve its ability to attract and retain qualified staff. To this end, it has introduced in April 2011 a technical specialists career path that parallels the traditional management career path.

FINMA also has plans to further improve its talent management, leadership development and employee branding as part of its 2012 goals. Responsibility for fleshing out these initiatives has been assigned to a newly created Operations Department. As a pilot phase, FINMA recently started a mentoring program in the Banking Division and a rotation program for young hires in the Markets Division.

### **Lessons and issues going forward**

*Operational independence and powers of FINMA:* FINMA's operational independence from the federal government has been enhanced compared to its predecessor authorities in areas such as hiring and budget setting. However, the concerns expressed in the FSAP surrounding FINMA's operational independence, particularly with respect to the competitiveness clause, remain unresolved since the relevant provisions in the FINMA Act have not been revised. The authorities believe that Article 5 of the Act clearly states the primacy of FINMA's prudential objectives, with the outcomes contributing to the reputation and competitiveness of the Swiss financial centre. Article 7 is intended to reflect the need for cost-benefit analysis as one of the basic principles of regulation. However, these Articles do not address situations where there are tensions or direct conflicts between prudential objectives and competitiveness.

FINMA has not had its regulations challenged in court on grounds of competitiveness since its formation. Going forward, the Swiss authorities should continue to ensure that their financial regulations and supervisory standards are not compromised on the grounds of promoting competitiveness.<sup>26</sup> In addition, FINMA should articulate clearly in other forms of communication that, in instances where prudential objectives and the competitiveness of the Swiss financial centre are in direct conflict, the primacy of prudential objectives will prevail.

*Powers to impose civil money penalties:* FINMA believes that its ability to take measures such as the confiscation of profits and the removal of bank executives can be more effective than imposing civil money penalties. A civil money penalty has to be sufficiently large in order to achieve a similar deterrent effect, in which case it is likely that a criminal charge might also be warranted. However, powers to pursue civil penalties provide more supervisory options that can be pursued for offences of moderate severity. The alternative, which is taking action under criminal statutes, may be less effective given the longer legal process and resources required to examine additional aspects such as criminal intent. It is also not uncommon internationally for regulatory agencies to have powers to impose civil money penalties. In fact, achieving full compliance with BCP 23 (Corrective and Remedial Powers of Supervisors) requires supervisors to have powers to impose such penalties at their disposal.<sup>27</sup>

*Strengthening resources and expertise of supervisors:* FINMA has made good progress in the strengthening of its resources and headcount. The adequacy of resources is a challenge that is

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<sup>26</sup> The Swiss financial regulation framework accords the industry a relatively more significant role, compared to other countries, through a system of self regulation set out in the FINMA Act.

<sup>27</sup> See the FSB report on "Intensity and Effectiveness of SIFI Supervision: Progress report on implementing the recommendations on enhanced supervision" (October 2011, [http://www.financialstabilityboard.org/publications/r\\_111104ee.pdf](http://www.financialstabilityboard.org/publications/r_111104ee.pdf)).

a common theme across supervisors. While resources have generally increased in response to the lessons from the crisis, the need and expectations for increased intensity and effectiveness of supervision have also correspondingly increased. FINMA acknowledges that individuals with more specialised expertise, such as actuaries and risk managers, are harder to recruit. Demand for such skills will also continue to increase as FINMA moves toward relying less on external auditors and performing more of its own on-site examinations (see section 3).

FINMA is prepared to increase its staff further if its responsibilities are extended formally in its statutes. However, the demand for supervisory resources can increase even without additional legislative responsibilities. This may be to support a more intrusive and intensive supervision that is commensurate with the scale and complexity of the banks under its supervision (especially the two SIBs). In this regard, FINMA should continue to increase its resources and enhance its in-house expertise to keep pace with market and regulatory developments.

### **3. Banking supervision**

The 2007 FSAP Update acknowledged that Switzerland had made “impressive progress... to strengthen the financial sector supervisory framework since the 2001 FSAP”. Nevertheless, it highlighted three areas presenting key challenges that should be addressed: i) supervisory issues regarding the two largest Swiss banks; ii) the use of external auditors; and iii) the operation of the cantonal banks.

Given the complex nature of the two large banks and their systemic importance, the FSAP made the following recommendations: a) an in-depth review of their capital adequacy as part of Basel II implementation, focusing particularly on Pillar 2 capital requirements and additional on-site supervisory work; b) strengthened supervision of their liquidity risks; and c) focused audits to evaluate their risk management vis-à-vis hedge funds. With regard to external auditors, the FSAP recommended: a) strengthening the oversight of banks’ external auditors; b) considering the use of a range of international experts and audit firms for the special audits; and c) considering the periodic rotation of audit firms. Finally, with respect to the cantonal banks, the FSAP recommended that their governance structures should be strengthened and that they could be given the overriding goal of profit maximization while dedicating part of their profits through the fiscal process to achieve their social function.

#### **Steps taken and actions planned**

*Supervision of the two large banks:* Following the weaknesses highlighted by the financial crisis, a new capital adequacy regime for the two large banks was introduced in November 2008 (see section 1). This action addressed some of the issues identified by the FSAP - in particular, a bank-specific amount of additional capital was required as a Pillar 2 measure. In addition, in April 2011, the Federal Council submitted a proposed package of measures designed to strengthen the stability of the financial system and to prevent the government from having to use tax revenues in the future to bail out SIBs (see section 1).

The deadline for meeting the new target for Core Equity tier 1 capital requirements is 1 January 2013 and a “gliding path” to comply with the final requirements by 1 January 2019

was agreed with the banks. The current capital adequacy ratios of the 2 big banks compare favorably with peers<sup>28</sup>, although the banks remain relatively more leveraged. In addition, the implementation of a stricter definition of capital under Basel III is likely to reduce significantly their capital ratios. The Swiss authorities hold regular capital planning meetings with the banks to discuss progress in achieving the agreed SIB requirements.

One of the main tools for assessing the adequacy of the banks' capital within the context of supervisory review process (Pillar 2) is supervisory stress tests. In light of the lessons learned from the financial crisis, supervisory expectations surrounding sound stress testing practices for banks have been enhanced. In the Swiss context, since the beginning of 2008, FINMA has mandated stress testing exercises (so-called "Building Block Analysis" or BBA). The design of the stress test and scenarios to be evaluated are developed jointly by FINMA and the SNB. Results from these quarterly run exercises are discussed by FINMA, the SNB and the banks in order to understand the evolution of risk or detect reconciliation issues with internal risk reports. Since the beginning of 2009, the BBA has been complemented by a semi-annual "Loss Potential Analysis" (LPA), whose objective is to identify significant sources of risk within the two large banks, to estimate loss potential on a stand-alone basis, and to estimate each bank's potential cumulative loss in case of substantial financial market deterioration. The impact of such a loss on the banks' capital position is assessed against supervisory expectations with respect to their shock absorption capacity, taking into account their systemic relevance. The results of the LPA form an important part of assessing the adequacy of a bank's internal capital planning process. There are no hard triggers that lead in a mechanical manner to additional capital requirements, although such requirements may result from the overall supervisory review process.

FINMA has recently developed a new supervisory approach under which all supervised institutions are allocated to one of six categories according to their risk impact on creditors, investors, policy holders and the system as a whole, as well as the reputation of the Swiss financial system.<sup>29</sup> In addition, each institution receives a rating corresponding to FINMA's assessment of its current state. On the basis of these two parameters, FINMA determines the intensity of supervision, such as the use of on-site visits to complement the regulatory audit. Direct reviews are currently being carried out on a regular basis at the 2 large SIBs (the only two institutions currently allocated to category 1), and selectively at other banks and insurance companies. FINMA's high level assessment is formalized in an annual assessment letter to the board of the bank where an overall supervisory rating and necessary remediation actions to close significant gaps are communicated.

FINMA has also established expert teams to conduct on-site examinations and horizontal reviews at the 2 large banks, particularly for their investment banking divisions. These measures were accompanied by selective hiring of senior managers and experts with longstanding experience in banking and audit (see section 2). Approximately 20 supervisory reviews have been scheduled in 2011 (compared to two reviews in 2007 and 2008) in areas

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<sup>28</sup> As of the third quarter of 2011, the core tier 1 capital adequacy ratios (based on the Basel 2 framework) of UBS and Credit Suisse were 16.3% and 12.6% respectively.

<sup>29</sup> See "Effectiveness and efficiency in supervision: Supervisory instruments, working processes and organisation at FINMA" (April 2011, <http://www.finma.ch/e/finma/publikationen/Documents/br-aufsicht-20110421-e.pdf>).

such as interest rate risk in the banking book, compensation systems, information technology risk, market risks not captured by value-at-risk models, collateral management, risk profit-and-loss and stop-loss triggers, and fixed income emerging markets. The reviews contain recommendations to which the banks are required to respond. Since the two banks have a substantial part of their operations overseas, much of the on-site supervisory work has been conducted abroad in collaboration with relevant host authorities.

FINMA and the SNB have substantially revised the liquidity regime for the two large banks. The new liquidity regime came into force on 30 June 2010 and resembles the design of Basel III's Liquidity Coverage Ratio (LCR). In addition, FINMA established a new monitoring approach for liquidity risks of the two large banks based on a mix of the new liquidity requirements, bank internal reports, monthly update calls and the BCBS Quantitative Impact Study results of the LCR and the Net Stable Funding Ratio (NSFR) - an important issue in light of the relatively strong reliance of these banks on external wholesale funding. The authorities have also introduced regular liquidity planning meetings with the two large banks.

FINMA has also assessed the banks' risk management practices, in particular margining practices, hedge fund exposure measures and reporting. The results of those assessments were deemed to be satisfactory overall. The banks' risk management practices were put to the test during 2008-09 when the hedge fund industry was heavily hit by the financial crisis, which led to the liquidation of some funds as a result of severe losses incurred. The supervised banks did not suffer significant losses on their hedge fund exposures, which can be attributed in large part to the high degree of collateralisation and close monitoring of these exposures.

*Use of external auditors:* Switzerland uses a dualistic approach under which, in addition to supervisors, approved audit firms play a significant role in the supervisory process. The so-called regulatory audit essentially looks into compliance with licensing regulations and other requirements imposed under supervisory law. Audit firms are hired by the banks directly (subject to FINMA's approval) and undertake the regulatory audit work, particularly resource-intensive and standardised work processes, on the basis of a risk analysis/audit strategy that is updated yearly. This strategy is developed by the audit company itself and must be discussed with FINMA. A copy of all audit reports of banks must be sent to FINMA. In addition to the regulatory audit work, FINMA staff review special issues directly with the banks (on-site supervisory reviews).

FINMA, in close cooperation with the Federal Audit Supervisory Authority, assesses the quality of audit firms' work on an ongoing basis to ensure that they meet the conditions for recognition and comply with regulatory provisions and relevant professional codes of conduct. FINMA verifies that the audit methodologies defined in the audit firms' manuals and codes of conduct are applied. It also performs targeted quality control tests on the organisational structures and mandate procedures of audit firms and analyses their audit expenditures and fees. If no weaknesses or problems are identified, FINMA will "approve" the audit firm and place it on a list of firms that may be used by the bank.

While FINMA does not prescribe periodic rotations for audit firms, it does mandate the periodic rotation of lead auditors. In addition, audit firms must normally use two separate teams for the financial and the regulatory audit, each with its own mandate and lead auditor - although the composition of the two teams may overlap, especially for small and medium-



sized banks. FINMA reserves the right to demand that two different audit firms be used in individual cases, or even that an audit firm be replaced.

There are plans to further improve the oversight of banks' external auditors. In particular, a strict distinction will be drawn between the audit of the annual accounts and the regulatory audit in the future, while the potential for formulating standardised, regular audit mandates versus supplementary exceptional or case-specific audit mandates will be explored. The audit firm's freedom to decide the audit depth for certain topics will be restricted and there will be clearer reporting rules aimed at producing unambiguous, precise and comparable results. Additional measures include new rules governing various aspects of audit firms' independence from supervised institutions, to be introduced via circulars coming into force in 2013 with provision for transition periods.

*Cantonal Banks:* Cantonal banks are subject to supervision by FINMA and operate under the same corporate governance regulation that applies to private banks, including in terms of board member requirements. In particular, they must comply with FINMA circular 2008/24 on "Supervision and internal control within the banking sector". The corporate governance requirements - which relate to the composition of governing bodies, their organisation and activities as well as the segregation of duty and guarantee of proper business conduct - for cantonal banks are examined every year by external auditors and reported to FINMA.

The influence of the cantons on the day-to-day business activities of such banks is minimal - in fact, the general trend since the Swiss banking crisis of the 1990s has been to depoliticise their boards. However, cantonal banks' progress in terms of the reduction of political influence in their boards does not appear uniform since board members continue to be appointed by the government or parliament on the suggestion of political parties in some cantons. By contrast, some cantons or cantonal banks have adopted more formal qualification criteria than the ones found in the FINMA Circular.<sup>30</sup> Nevertheless, since the cantons are treated similarly to private owners with regard to supervisory requirements, they also have the same rights to define the strategy of those banks. In addition to owning the banks, some cantons provide full guarantees to their banks' liabilities.<sup>31</sup>

## **Lessons learned and issues going forward**

The Swiss authorities appear to have heeded the lessons from the financial crisis and are drawing upon them to make improvements to their supervisory framework. Enhancements to the framework also include the implementation of Basel III within the internationally agreed timeframe and the monitoring of liquidity gaps by currency as a way to remain vigilant on liquidity risks. The TBTF package will further strengthen capital requirements, although the CoCos proposed for inclusion in the package are largely untested instruments (see section 1). FINMA also continues to regularly discuss with the two big banks any infrastructure developments in collateral management, particularly as it relates to hedge funds.

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<sup>30</sup> Circular 08/24 states that board members must have the required qualifications, experience and timely resources to fulfill their mandate.

<sup>31</sup> See <http://www.kantonalbank.ch/e/gruppe/markt/staatsgarantie.php> for details. Given Switzerland's federalist structure, the cantons have their own tax revenue streams backing these guarantees. Some cantons charge a fee (e.g. an annual payment of 0.5% of the required equity capital) in return for the state guarantee.



Reliance on third parties for supervisory purposes remains strong. For example, FINMA currently employs almost 400 staff while total outsourced activities account for roughly 800 full-time equivalents. While the outsourcing of supervisory functions to third parties is appropriate in certain cases (e.g. to tap additional expertise and resources), experience shows that it is generally a poor substitute for work done in-house by the supervisory authorities. Supervisory responsibility, which rests with FINMA, cannot and should not be delegated. The supervision of SIFIs demands a minimum acceptable amount of work that should be conducted by the supervisory authority. Despite improvements observed in the last couple of years, the ratio of own supervisory work performed by FINMA in relation to the work outsourced to auditing firms appears low and well below peer supervisors of global SIBs. Tough regulation, although highly desired and very important, is also not a substitute for thorough supervision and on-site analysis. FINMA should therefore continue to enhance its own supervisory capacity and perform more on-site examinations itself.

One important concern with respect to outsourcing is the independence of the work carried out by third parties. The ability of external auditors to competently identify risks and to challenge financial institutions has also been raised in past bank failures. In that respect, FINMA is encouraged to continue to improve its oversight of banks' external auditors, as envisaged in its current plans. In particular, it should assume primary responsibility for developing the terms of reference for the regulatory audit work, selecting the audit firm that is going to undertake this work (which should be different than the one employed for the financial audit), and paying that firm based on performance by charging supervised financial institutions accordingly.

The regulation and oversight of risk management and internal controls at the largest banks has assumed even greater importance given the various problems that have surfaced in this area over the past few years. It is the supervisors' responsibility to ensure that banks have appropriate risk management practices and strong internal controls. The most recent UBS trading scandal<sup>32</sup> suggests that there may be areas where more supervisory attention may be required. FINMA should analyze carefully the result of the independent investigation into this issue (which will include an assessment of internal controls in UBS's investment bank) and take appropriate actions.

Cantonal banks weathered the crisis fairly well and were able to gain market share at the expense of the two large banks; they are also generally well capitalized and have a higher quality of capital than the two SIBs. In order to promote a level playing field, the Swiss authorities should consider eliminating the unlimited guarantee currently provided to some cantonal banks.

#### **4. (Re)insurance regulation and supervision**

The FSAP noted that reforms since 2003 had updated the regulation and supervision of the insurance industry, with the newly-introduced SST being at the forefront of risk-based

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<sup>32</sup> See <http://www.ubs.com/1/e/unauthorizedtrading.html>. On 15 September 2011, UBS announced that it had discovered unauthorized trading - concealed by the booking of fictitious trades - by a trader in its investment bank in London, which caused UBS to book a loss resulting from the incident of USD 2.3 billion.

measurement. While the updated framework had a high level of observance with the Insurance Core Principles (ICPs) issued by the International Association of Insurance Supervisors (IAIS)<sup>33</sup>, the reform process was not yet complete and the FSAP recommended that adequate supervisory resources be devoted to implementation and that focused inspections of high-risk insurers<sup>34</sup> take place in order to strengthen their risk management practices and to reduce their vulnerability to market risks. In order to minimise contagion risk within group entities, it also recommended that the authorities continue to work closely with relevant (re)insurers to bring down intra-group balances (in the form of lending and equity investments) that were relatively high.

With regard to the reinsurance industry, the detailed ICP assessment recommended that the authorities take actions to enhance supervisory independence and accountability, expand supervisory resources, and strengthen ongoing supervision (particularly with respect to on-site inspections). Several of those recommendations are also applicable to the regulation of the insurance sector as a whole.

### **Steps taken and action planned**

*Inspections of high risk insurers:* Due to resource constraints, there were no inspections of reinsurers during 2006, while on-site visits to other insurers were generally not risk-based. FINMA now conducts on-site inspections of reinsurers and has generally increased the number of inspections to approximately 100 in 2010, including numerous focused inspections of high risk (re)insurers. Since 2008, several on-site reviews were conducted on themes relating to the financial crisis, including alternative investments, the real-estate and mortgage market, and asset-backed securities. The main focus of these reviews has been the implementation of adequate systems and processes in the firm as well as the risk management and valuation of financial assets.

With the SST becoming effective as of 1 January 2011, the risks taken by insurers, including financial market risks, are directly reflected in their capital requirements.<sup>35</sup> The SST coverage ratios for the insurance sector in aggregate were generally satisfactory at end-2010, although insurers with a ratio under 100% were asked to present a timely recovery plan.<sup>36</sup> Five life insurers out of 128 solo-entity SST submissions had, as at the end of 2010, coverage ratios under 100%. More broadly, the life insurance sector in general has a relatively low aggregate coverage ratio of 145%, compared with 205% for the entire insurance market. Financial

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<sup>33</sup> The assessment of Switzerland was undertaken before the ICPs were revised, so the principles mentioned in this report correspond to the ones that have been issued in 2003 and were in use until October 2011.

<sup>34</sup> High-risk insurers in this context meant those insurers that could be distressed by relatively moderate financial market risk scenarios. That category included many life insurers and some other (re)insurers.

<sup>35</sup> The SST applies to approximately 99% of the insurance sector. Reinsurance captives are exempt if they are not large and/or complex; they are subject instead to a simpler and less onerous solvency regime.

<sup>36</sup> If the SST coverage ratio falls below 100%, supervision becomes more intense and intrusive. Appendix 4 of Circular 2008/44 (<http://www.finma.ch/e/regulierung/Documents/finma-rs-2008-44-e.pdf>) sets out the actions that FINMA may initiate according to various thresholds where an insurance company does not satisfy the solvency requirements of the SST. FINMA will normally order a causal analysis and action plan from companies in the yellow zone.

market risk is substantial for life insurers because of the interest rate sensitivity of their large investment holdings.

The Swiss Qualitative Assessment (SQA) complements the SST by focusing on the governance, risk management and internal controls processes with a view to a more effective monitoring of the financial condition of insurers. SQA I was launched in 2008 with a survey of over 160 insurers, and follow-up targeted on-site reviews where necessary. A second survey of firms began in 2011 (SQA II).

FINMA's approach to inspections and supervision is evolving to one that is more risk-based (see section 3). As such, a higher level of resources will be devoted to high risk insurers; similarly, expertise will focus on areas deemed to be of higher risk, for example liquidity risks, technical provisions and business exposed to natural catastrophes. The risk-based framework was largely operational at the end of 2011, with monitoring and fine-tuning continuing in 2012.

*Intra-group balances:* Overall intra-group balances remain relatively high, with intra-group loans and investments representing 14.5% of total assets for the insurance market as a whole at the end of 2010 compared with 13.5% at the time of the FSAP; the percentage has averaged approximately 14% over the past eight years. That level is not easily reduced without significant group restructuring because most Swiss life insurance companies are owned by non-life insurance companies; as a result, if a life insurance subsidiary needs additional capital, the parent company generally has to increase its investment or use other intra-group transactions (IGTs) to meet capital requirements.

The high intra-group balances are monitored by FINMA in both solo and group supervision. FINMA requires standardized analysis of capital gearing, regulatory arbitrage and increased risk from capital usage. Intra-group reinsurance is also analysed. Current efforts are focused on less transparent IGTs, in particular to identify and eliminate unlimited guarantees of any kind that may lead to contagion risk. All material transactions must be reported promptly. The SST takes IGTs into account and requires capital to cover the group risk arising from IGTs. All IGTs are reflected in the group SST, including those eliminated on consolidation. This means that capital invested in subsidiaries is not double-counted.

While FINMA has made progress with collecting IGT data, its analysis to determine consistently whether group risk is acceptable is still work in progress. Although SST factors in group risk, it can be very hard to get a comprehensive picture of group risk where IGTs are complex (as they are for the larger groups). Currently, FINMA uses Excel tools to analyse IGTs. FINMA intends to develop a data warehouse to support systematic in-depth analysis of market use of IGTs and allow for implementation of risk indicators.

*ICP 2 (Supervisory objectives):* The FSAP recommended providing greater clarity regarding the authority, circumstances and processes to address potential conflicts in supervisory objectives are set forth in the Insurance Supervision Law (ISL). Those potential conflicts arise though Article 7 of FINMASA, which requires FINMA to take into account the competitiveness of the Swiss financial centre when regulating financial institutions and markets (see section 2).

*ICP 3 (Supervisory authority):* The FSAP recommended that independence and accountability be enhanced through the public disclosure of the reasons if the Director of the

FOPI is removed from office.<sup>37</sup> However, there is at present no legal obligation to publicly disclose the reasons for removal from office, although the parliamentary commission responsible for the oversight of FINMA would have the right to demand such information. The FSAP also recommended the establishment of an internal audit function within the FOPI. At its inception, FINMA established such a function that reports directly to the Board of Directors.

*Supervisory resources:* FOPI had few staff dedicated to reinsurance supervision, including the supervision of sophisticated and globally diversified reinsurers. The FSAP recommendations included building adequate regulatory resources and cost-effective systems and processes to: (a) enhance global market analysis (*ICP 11*); (b) conduct risk-focused on-site inspections (*ICP 13*); (c) enforce preventive and corrective measures (*ICP 15*); and (d) conduct group/conglomerate supervision. FINMA has generally increased its resources since its establishment, particularly the number of skilled staff in group supervision as well as qualitative and quantitative risk supervision (see sections 2 and 3). Resources have also been shifted into risk-based supervision, which includes greater focus on the large and globally diversified reinsurers to allow their on-site inspections (this was not possible in 2006 due to resource constraints) and group/conglomerate supervision, whilst traditional supervision has been trimmed to be more efficient and effective.

*ICP 12 (Off-site monitoring):* The FSAP recommended that insurance companies complete quarterly reports on selected key financial indicators, particularly on solvency and asset-liability management, to facilitate ongoing off-site surveillance and timely intervention. Quarterly reports on solvency, assets and tied assets have been filed with FINMA since January 2009 (monthly from July 2010) for groups and reported to FINMA management for consideration. Additional data has also been collected in the case of special situations (e.g. exposures on EU member states).

*ICP 5 (Supervisory cooperation and information sharing):* For large global reinsurers, the FSAP recommended the establishment of formal regulatory cooperation and information exchange arrangements with foreign regulators outside the European Economic Area (EEA). In response, FINMA has strengthened its cooperation with foreign regulators by establishing multiple supervisory colleges. As the home supervisor, FINMA takes the lead in planning and coordinating the activities of its supervisory colleges for Swiss groups. FINMA also participates in insurance supervisory colleges organised by foreign supervisory authorities where the Swiss subsidiary is of strategic importance for the group. In addition, FINMA is a Signatory of the IAIS Multilateral MoU on cooperation and information exchange, in addition to existing bilateral agreements.

*ICP 6 (Licensing):* No steps have been taken to explicitly require composite reinsurers<sup>38</sup> to ensure proper segregation of life and non-life risks into separate funds. This is consistent with the EU Reinsurance Directive, introduced since the FSAP, which permits composite pure

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<sup>37</sup> In accordance with FINMASA, the Federal Council can remove members of FINMA's Board of Directors from office if the requirements for holding office are no longer fulfilled. Similarly, the Board of Directors can terminate the employment of the Chief Executive Officer, subject to the consent of the Federal Council.

<sup>38</sup> Swiss insurance companies are only allowed to conduct either life or non-life business. Pure reinsurers may write both types of businesses.

reinsurers. FINMA believes that the current risk management requirements adequately safeguard the interests of cedants.

*ICP 8 (Portfolio transfers):* Although reinsurers<sup>39</sup> are not explicitly required to seek approval before they transfer all or any part of their reinsurance business (as recommended for consideration by the FSAP), FINMA considers such a transfer to be a change to the business plan and requires reinsurers to notify it of such changes in advance. In general, FINMA then elects to examine the transfer and will only approve it if it does not endanger the interests of the reinsured.

*ICP 26 (Information, disclosure & transparency towards the market):* In 2010, FINMA began to study public disclosures with a view to expanding their scope. FINMA's review is still ongoing, but FINMA notes that an expansion of public disclosure requirements would most likely require a change in legislation. Insurer or insurance specific data provided to FINMA is subject to professional secrecy as long as it does not relate to the annual accounts.

### **Lessons and issues going forward**

Significant progress has been made in implementing insurance sector reforms since the FSAP. The SST came into full effect in 2011; FINMA has expanded its supervisory resources and undertakes focused inspections of high risk insurers; there is enhanced data collection for IGTs; an internal audit function within FINMA has been established; and quarterly reporting of selected key indicators for insurance companies has been implemented.

Looking ahead, FINMA needs to ensure the proper operation of the SST for all relevant (re)insurers, and data quality and other modelling issues should be resolved for firms that are not yet fully compliant. Although the SST includes an assessment of group risk, it can be difficult to fully understand the web of constantly changing and numerous IGTs of complex groups. Accordingly, further steps (such as the planned development of a data warehouse) are necessary to support in-depth analysis of the use of IGTs and allow for implementation of risk indicators to assess the level and nature of group risk arising through IGTs in a systematic manner. The continuation of the SQA is also important to underpin the quantitative assessment.

As noted in section 2, the difficulty in recruiting specialists such as actuaries and risk managers is a common theme across supervisory authorities, particularly in Europe because of the demands of implementing Solvency II. This is a constraint on the development of SST and to some extent the SQA. Targeting scarce resources toward higher risk (re)insurers will therefore remain important. FINMA should continue to focus on increasing its resources in order to deliver on its supervisory objectives.

It is worth noting that the European Insurance and Occupational Pensions Authority (EIOPA) has recently published its advice to the European Commission on its equivalence assessment of the Swiss supervisory system in relation to the Solvency II Directive.<sup>40</sup> EIOPA finds the

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<sup>39</sup> Reinsurers are exempted from Article 62 of ISL, which requires insurers to seek prior approval for portfolio transfers.

<sup>40</sup> See [https://eiopa.europa.eu/fileadmin/tx\\_dam/files/publications/submissionstotheec/EIOPA-BoS-11-028-Swiss-Equivalence-advice.pdf](https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/submissionstotheec/EIOPA-BoS-11-028-Swiss-Equivalence-advice.pdf).

Swiss system to be largely equivalent with a few caveats, one of which is the issue of public disclosure mentioned above. EIOPA notes that FINMA's public disclosure requirements are not as extensive as those under Solvency II. FINMA is encouraged to take additional steps to expand public disclosure by revising the ISL as needed, an issue that it is currently considering.

## **5. Pensions regulation and supervision**

The FSAP noted that the supervision of the pension fund sector (membership of which is mandatory for all Swiss employees, both in the public and private sector) is divided between the federal agency and the cantons, and that it continues to be fragmented and uneven. It made a series of recommendations to upgrade the regulatory and supervisory framework for pension funds, in particular to:

- upgrade the proposed supervisory framework by establishing a centralized body with supervisory responsibility;
- strengthen funding requirements by adopting a risk-based standard solvency test after an agreement on adequate coverage margins, and enhance the procedures in the case of underfunding; and
- enhance standards on governance, structure of investments, and risk management.

### **Steps taken and actions planned**

The so-called structural reform ("Strukturreform") of the Occupational Pensions Law was adopted by the Swiss parliament in March 2010. The legislation is based on the principles of transparency, governance and independence, and includes new provisions on supervision (implemented in January 2012) and governance, with a particular focus on conflicts of interest and internal controls (implemented in August 2011). Standards on the structure of investments and other aspects of risk management were not addressed in the structural reform, but should be included in the planned review of solvency regulations.

*Supervisory structure:* The main feature of the new supervisory structure is the complete delegation of direct supervisory responsibilities to the 26 cantons and the establishment of the Oberaufsichtskommission (OAK), a central supervisory commission to oversee the cantonal supervisors and ensure the application of common supervisory standards for pension funds across Switzerland, particularly over governance, investment and solvency.

OAK began operations in January 2012 and initially consists of eight independent experts<sup>41</sup> supported by a secretariat (approximately 15 staff) attached to the Federal Office of Social Affairs. The new law gives substantial operational autonomy and independence to OAK. In particular, article 64 of the reformed law states that the Commission cannot receive any commands from the government. OAK is funded primarily from fees paid by the cantonal

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<sup>41</sup> The law allows between 7 and 9 members, each with a four-year mandate. The president and vice-president are appointed by the government, and there is one representative each from the employers' and employees' associations. All members must have demonstrable expertise in pension matters and be independent, although this term is not defined in the law.

supervisors. The law gives key responsibilities and powers to OAK, including the review of the annual reports of the cantonal supervisors, the ability to carry out inspections of the supervisors and the power to issue general guidance for pension supervision, pension fund auditors and so-called “pension experts” (equivalent to actuaries in other jurisdictions). OAK is also responsible for overseeing the pension guarantee fund.<sup>42</sup>

The structural reform also requires the cantonal supervisors to be established as autonomous public sector agencies, independent of the local government administration. Similar to article 64, article 61 of the reformed law states that the cantonal supervisors cannot be subject to any external directive in the exercise of their functions. The supervisors have been granted new powers, including the ability to replace a pension fund’s audit committee and pension expert.

The reform also permits the cantonal supervisors to merge into a single supervisory entity. At present, three large groupings of supervisors have been established along regional lines: Central (cantons of Luzern, Uri, Schwyz, Ob- und Nidwalden, Zug), East (cantons of Glarus, Appenzell inner- und ausserrhoden, St. Gallen, Graubünden, Thurgau) and West (cantons of Jura, Neuenburg, Wallis, Waadt). Other bilateral associations are also planned, such as those of the canton of Freiburg to Bern, Schaffhausen to Zurich, and Basel-Land to Basel-Stadt.

*Governance standards:* As part of the structural reform of the Occupational Pensions Law, new regulations on pension fund governance came into force in August 2011. The main changes are the introduction of the basic fiduciary duty of loyalty of the board of directors of a pension fund towards the beneficiaries, supported by a requirement to avoid conflicts of interest, a detailed description of the board’s responsibilities, and a requirement that “those responsible for managing or administering the pension fund or its assets shall be persons of good reputation and offer every guarantee of proper business conduct.”

The new legal provisions specifically prohibit certain transactions that are considered to generate a conflict of interest and to damage pension fund members (e.g. front-, parallel- and after-running). They also oblige pension fund board members and staff to report any gifts received by third parties. Pension funds are also required to disclose administration and asset management costs in detail in their annual report. Pension funds have until 2012 to bring their internal statutes, governance structures and practices in line with the new rules.

The new regulations have also clarified the role of the independent external audit and of the “pension expert”. In addition to their current responsibility of ensuring compliance of the fund and annual accounts with the law, auditors must determine the adherence of the board of directors to the fiduciary duty of loyalty. They must also verify that there are adequate internal controls in place in line with the size and complexity of the pension fund, that is, corresponding to the risk profile of the institution. The auditors have also been granted with stronger “whistle-blowing” responsibilities. In particular, if the auditor becomes aware of facts which would undermine the performance of a pension fund, he or she shall notify the pension fund’s board at the same time as the supervisory authority.

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<sup>42</sup> The Sicherheitsfonds (BVG) guarantees all mandatory pension benefits in case of pension fund insolvency. It covers all pension funds for both public and private sector employees. When a pension fund becomes insolvent (which usually only happens when the sponsor itself is bankrupt), the BVG takes over the fund’s assets and uses them to purchase market annuities for the fund’s members. The guarantee fund is financed from a levy charged on the size of the liabilities.

The independence of the pension expert has also been reinforced, as he or she can no longer accept other service contracts from the pension fund or serve in any capacity in its board or management. There should also be no family or economic links between the pension expert and those with decision-making power in the pension fund. The new legal provisions require pension experts to obtain a license from OAK. The pension expert's main role remains to determine periodically whether pension institutions are able to meet their obligations.

*Solvency regulation:* The FSAP recommended the adoption of a risk-based standard solvency test, valuing pension liabilities on a market-consistent basis. Swiss solvency rules are not consistent with this requirement, since official actuarial valuations rely on a fixed discount rate to calculate pension liabilities. The current rate is set on average at 3.6%, which is rather high compared to current 10-year government bond yields (around 1%) but close to the average over the period 1994-2011 (3.1%). OAK is expected to develop new solvency regulations after its establishment.

In December 2010, the Swiss Parliament adopted provisions relating to the financing of public sector pension funds, which until then were not subject to any funding or solvency regulation. The objective of the rules is to strengthen the financial security of those institutions. To this end, the new rules require public pension funds to reach a funding ratio of 80% within 40 years. In addition, such institutions should be legally and administratively independent entities, separated from the structure of the public administration that sponsors them.

### **Lessons and issues going forward**

The impending change in supervisory structure, while falling short of the FSAP's main recommendation (establish a single, centralised supervisory authority for the whole country), still represents a major improvement compared to the current situation. In particular, the law addresses the independence, resources and powers of OAK as well as those of the cantonal supervisors, which follow (at a high level) much of the guidance provided in the November 2010 International Organisation of Pension Supervisors' (IOPS) *Principles of Private Pension Supervision*.<sup>43</sup> The groupings of cantonal supervisors would ensure better pooling of resources and greater convergence in supervisory methods. The new legal provisions should also ensure greater separation between cantonal public sector pension funds and their supervisory entity. While a further regrouping of the supervisors may be desirable, there are also advantages in the regional structure currently emerging (such as a common language).

Under the new supervisory structure, OAK will play a critical role in ensuring consistent supervisory standards across the country. However, it is unclear that the current resources allocated will be sufficient to ensure that goal. It is also essential to ensure a clear line of communication and cooperation with FINMA, given the role of insurance companies in the private pension system. It would therefore be advisable to establish a MOU similar to the one signed between the other agencies responsible for financial sector regulation and supervision.

Significant progress has been achieved in strengthening governance provisions following the FSAP and in bringing them in conformance with the June 2009 OECD *Guidelines for*

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<sup>43</sup> See <http://www.iopsweb.org/dataoecd/59/7/40329249.pdf?contentId=40329250>.



*Pension Fund Governance*.<sup>44</sup> The new governance provisions, particularly the enhanced independence and responsibilities of auditors and pension experts and the new conflict of interest rules applicable to the board of directors and pension fund staff, are welcome and should help contain the problems of fraud and mismanagement that had been observed in some pension funds in recent years.

On the other hand, the new legislation does not specifically address other aspects of risk management. In particular, one obvious gap in the Swiss pension fund legislation is the absence of requirements for pension funds to establish a risk management strategy, while there is no supervisory guidance on the internal processes, internal controls and reporting procedures to identify and manage the various risks (market, liquidity, counterparty, operational etc.) that the pension fund might be exposed to. The oversight of internal risk management is effectively carried out by the auditor, while the pension expert is in charge of overseeing the level of solvency of the pension fund. There is also no requirement under Swiss legislation for appointing an external asset custodian.

The development of supervisory guidelines on risk management, in accordance with the January 2011 OECD/IOPS *Good Practices for Pension Funds' Risk Management Systems*<sup>45</sup> and addressed to the board and management of the pension funds, should be one of the first priorities of the OAK. Such an initiative would also help strengthen the control over the structure of investments, performance and costs, as recommended in the FSAP report.

The FSAP recommendation on a risk-based solvency test also remains to be implemented. In particular, the valuation standards for pension assets and liabilities would need to be reformed to better reflect market conditions. However, fully transferring market volatility to solvency valuations may not make sense in the context of what are very long-term contracts where there is little risk of members leaving the fund (membership is mandatory as part of employment contract) and where benefit promises (above the minimum required by the law) can be adjusted. In addition, some pension funds (all in the public sector) are backed by the sponsoring employer, which means that the main risk that members are exposed to is not the funding level of the pension fund but the insolvency of the plan sponsor. There is also a guarantee fund in the case of insolvency, which provides an additional layer of protection to pension benefits. Any new funding regulations would need to take all of these factors into account.<sup>46</sup>

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<sup>44</sup> See <http://www.oecd.org/dataoecd/18/52/34799965.pdf>.

<sup>45</sup> See <http://www.oecd.org/dataoecd/19/6/46864889.pdf>.

<sup>46</sup> A useful framework for solvency reform is contained in the May 2007 OECD *Guidelines on Funding and Benefit Security in Occupational Pension Plans* (<http://www.oecd.org/dataoecd/3/22/38547978.pdf>).

## Annex: Switzerland peer review – Selected FSAP recommendations

### a. Regulatory and supervisory framework

<b>Relevant FSAP Recommendations</b>	<ul style="list-style-type: none"> <li>• Ensure that the proposed unified financial markets authority is provided with sufficient independence: <ul style="list-style-type: none"> <li>➤ Review the provisions of the draft FINMA Act to avoid provisions that might limit FINMA’s operational independence and prudential powers.</li> <li>➤ Provide FINMA with the powers to impose civil money penalties.</li> </ul> </li> <li>• Strengthen the resources and expertise of the supervisors: <ul style="list-style-type: none"> <li>➤ Continue to increase the SFBC’s staff resources and expertise given the global nature of the two large banks and the systemic risks they pose.</li> <li>➤ Provide the Federal Office of Private Insurance (FOPI) with adequate resources especially for the implementation of the new solvency regime.</li> </ul> </li> </ul>
<b>Relevant BCP Factual Update Recommendations</b>	<p><u>Objectives, independence, powers, transparency, and cooperation (BCP 1)</u></p> <ul style="list-style-type: none"> <li>• Revise provisions in Article 7 of the draft FINMA Act, which presently could give industry representatives excessive leverage in opposing regulation.</li> <li>• Continue to advance the depth of staff expertise and skills.</li> </ul> <p><u>Corrective and remedial power of supervisors (BCP 23)</u></p> <ul style="list-style-type: none"> <li>• The SFBC should have the authority to impose direct civil monetary penalties on banks, directors, or managers.</li> </ul>

### b. Banking supervision

<b>Relevant FSAP Recommendations</b>	<ul style="list-style-type: none"> <li>• Review in depth the capital adequacy of the two large banks as part of Basel II implementation: <ul style="list-style-type: none"> <li>➤ Pillar II capital requirements should be considered. These need to be thoroughly assessed and reviewed on an annual basis for each bank to reflect the institution-specific risk profile and supervisory/regulatory concerns.</li> <li>➤ The SFBC should continue to gain expertise and engagement by performing more on-site discovery work itself.</li> </ul> </li> <li>• Strengthen supervision of the two large banks’ liquidity risks to include advanced analysis of potential risks such as contingency funding plans, disruptions in cross-border funding, and incremental default risk.</li> </ul>
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	<ul style="list-style-type: none"> <li>• Conduct focused audits to evaluate the two banks' risk management vis-à-vis hedge funds.</li> <li>• Further improve oversight of bank external auditors.</li> <li>• The governance structures of cantonal banks could be strengthened. The cantonal banks could be given the overriding goal of profit maximization while dedicating part of their profits through the fiscal process to achieve their social function.</li> </ul>
<b>Relevant BCP Factual Update Recommendations</b>	<p><u>Prudential regulation and requirements (BCP 6-18)</u></p> <ul style="list-style-type: none"> <li>• As part of Basel II implementation, review in depth the capital adequacy of the two large banks.</li> <li>• Develop an advanced supervisory framework for bank-specific liquidity risks.</li> </ul> <p><u>Methods of ongoing banking supervision (BCP 9-21)</u></p> <ul style="list-style-type: none"> <li>• Consider advancing engagement with banks, through performing more on-site discovery work.</li> </ul> <p><u>Accounting and disclosure (BCP 22)</u></p> <ul style="list-style-type: none"> <li>• Consider using a range of international experts and audit firms for the special audits.</li> <li>• Consider the periodic rotation of audit firms.</li> </ul>

**c. (Re)insurance regulation and supervision**

<b>Relevant FSAP Recommendations</b>	<ul style="list-style-type: none"> <li>• Conduct focused inspections of high risk insurers. If needed, require an increase in capital and reserves or a reduction in risk exposures.</li> <li>• Continue to work closely with the (re)insurers concerned to bring down intra-group balances, which are relatively high.</li> </ul>
<b>Relevant ICP Assessment Recommendations</b>	<p><u>The supervisory system (ICP 2-5)</u></p> <ul style="list-style-type: none"> <li>• Consider providing greater clarity regarding the authority, circumstances and processes in addressing potential conflicts in supervisory objectives.</li> <li>• Enhance the FOPI's independence and accountability through: (a) public disclosure of the reasons if the Director of the FOPI is removed from office; and (b) establishment of an internal audit function within the FOPI.</li> <li>• Push ahead with the regulatory reforms under the ISL.</li> <li>• Strengthen regulatory resources to effectively supervise a sophisticated and globally diversified reinsurance industry and implement the regulatory reforms.</li> <li>• Consider formal regulatory cooperation and information exchanges with foreign regulators outside the EU/EEA.</li> </ul>

	<p><u><i>The supervised entities (ICP 6-10)</i></u></p> <ul style="list-style-type: none"> <li>• Consider explicit requirements for: (a) composite reinsurers to ensure proper segregation of life and nonlife risks so as to better safeguard the interests of cedants; and (b) reinsurers to seek the FOPI’s approval before they transfer all or any part of their insurance business so as to protect the interests of the policyholders of both the transferee and transferor.</li> </ul> <p><u><i>Ongoing supervision (ICP 11-17)</i></u></p> <ul style="list-style-type: none"> <li>• Build adequate regulatory resources and cost-effective systems and processes to: (a) enhance global market analysis; (b) conduct risk-focused on-site inspections; (c) enforce preventive and corrective measures; and (d) conduct group/conglomerate supervision.</li> <li>• Consider quarterly reports on selected key financial indicators, particularly on solvency and asset-liability management, to facilitate ongoing off-site surveillance and timely intervention.</li> </ul> <p><u><i>Prudential requirements (ICP 18-23)</i></u></p> <ul style="list-style-type: none"> <li>• Maintain the momentum in implementing the SST as planned.</li> </ul> <p><u><i>Markets and consumers (ICP 24-27)</i></u></p> <ul style="list-style-type: none"> <li>• Plan for the effective implementation of the IAIS standards on public disclosures so as to facilitate market discipline.</li> </ul>
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**d. Pensions regulation and supervision**

<b>Relevant FSAP Recommendations</b>	<ul style="list-style-type: none"> <li>• Upgrade the proposed supervisory framework by establishing a centralized body with supervisory responsibility.</li> <li>• Strengthen funding requirements by adopting a risk-based standard solvency test after an agreement on adequate coverage margins, and enhance the procedures in the case of underfunding.</li> <li>• Enhance standards on governance, structure of investments, and risk management.</li> </ul>
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