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Swiss Federal Banking Commission

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Commissione federale delle banche
Swiss Federal Banking Commission

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1. IMF Financial Sector Assessment Program

The International Monetary Fund (IMF) carried out a Financial Sector Assessment Program (FSAP) in Switzerland in 2001,[1] the results of which were published in June 2002. The final report, known formally as the Financial Sector Stability Assessment (FSSA),[2] was presented to the IMF's Executive Board together with the report on the Article IV consultations,[3] which is also available to the public.

The FSSA comprises two parts. The first deals with the stability of the financial system and the preventive and risk management measures employed to preserve financial stability. The second assesses the extent to which Swiss regulatory measures comply with internationally recognized financial sector standards in the following areas: monetary and financial policy; supervision of the banking; insurance and securities sectors; payment and securities clearing systems; and the supervisory aspects of money laundering prevention.

The IMF's conclusion concerning the stability of the Swiss financial system is a positive one. The FSSA confirms that Switzerland has a well-developed and effective supervisory system and complies extensively with international standards for the supervision of banking, securities and markets. The same applies to the prevention of money laundering. The IMF does see some room for improvement, but its recommendations focus largely on areas that have already been identified by national task forces and expert commissions and addressed in the context of numerous regulatory initiatives:

- International banking supervision standards demand that a supervisory authority be independent in terms of its operations as well as its resources. The IMF acknowledges that the SFBC performs its supervisory activities independently, but points out that it is not financially independent. The commission of experts appointed by the Federal Council in December 2001 and headed by Prof. Ulrich Zimmerli is mandated to lay the foundations for a fully integrated financial market regulatory body that will be administratively and financially independent.[4]
- In its FSSA, the IMF supports Switzerland's efforts to integrate its banking and insurance supervision into a single financial market supervisory authority that will also be assigned additional responsibilities. It recommends, as an interim measure, creating a formal legal basis for cooperation between the SFBC and the Federal Office of Private Insurance as is currently practised primarily in the supervision of financial conglomerates. One measure serving this purpose is the complete revision of the Federal Law on Insurance Supervision, and the IMF would like to see the amendment process speeded up.

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[1] see Annual report / Key themes 2001, p9ff
[2] see http://www.imf.org/external/pubs/ft/scr/2002/cr02108.pdf
[3] see http://www.imf.org/external/pubs/ft/scr/2002/cr02108.pdf
[4] see Annual report / Key themes 2001, p5ff

- The IMF recommends reviewing the special status of Switzerland's cantonal banks. In order to ensure a level playing field with the other banks, the IMF thinks that the less stringent capital adequacy requirements applied to cantonal banks should be discontinued.
- The IMF attaches a great deal of importance to the issues connected with indirect supervision. Its FSSA expressly acknowledges that Switzerland's indirect supervisory system, with its dual approach involving the use of external auditors, has proven successful. Although most foreign supervisory bodies perform the audits of the banks themselves, the IMF deems the Swiss system adequate because it allows more resources to be mobilized for the supervisory process. However, it believes systematic quality control procedures and more frequent direct supervisory actions on the part of the SFBC are necessary. The IMF thus reiterates the conclusion and supports the recommendations of the commission of experts appointed by the SFBC under the leadership of Prof. Peter Nobel in February 2000 to address the topic of auditing.[5] Work has already begun on the implementation of these recommendations and the required changes in the law, the Banking Ordinance and the relevant circulars.[6]
- The IMF recommends reinforcing the supervisory framework by extending the SFBC's power to impose sanctions. At present, the SFBC can officially reprimand the financial intermediaries it supervises, demand the removal of directors or managers and, in serious cases, revoke their licences. Unlike its counterparts in other countries, however, it cannot impose administrative fines. The IMF also finds the SFBC's ability to impose sanctions on offenders for manipulation of markets inadequate, especially with regard to companies and persons not supervised by the SFBC. A credible supervisory system, says the IMF, has to be backed up by an appropriate catalogue of sanctions. Preliminary work on bolstering the SFBC's powers in this respect has already begun.[7]
- The IMF welcomes the planned change in the provisions covering the restructuring and liquidation of banks and the introduction of obligatory depositor protection.[8]
- The IMF sees weaknesses in the SFBC's collaboration with foreign market supervisory authorities. The International Organization of Securities Commissions (IOSCO) standards require information exchange for the effective enforcement of measures against securities offences and market abuses. However, the Swiss legislation governing cooperation between the SFBC and foreign securities supervisory bodies not only makes it difficult to exchange information rapidly, but also renders it completely impossible in certain circumstances. The SFBC worked intensively in 2002 to alter the wording of the law in question. A draft will be submitted to the Federal Department of Finance in early 2003.[9]

[5] see http://www.ebk.admin.ch/d/archiv/2001/neu6-01.pdf [German]
[6] see 6
[7] see 5
[8] see II/1.1.1
[9] see 3

2. Reform of financial market supervision

Current projects for regulatory legislation were continued, and new ones were added. In the course of this work the SFBC is becoming increasingly involved in regulatory efforts extending beyond its current remit covering the supervision of banks, securities dealers, stock exchanges and investment funds.

The commission of experts appointed by the Federal Council at the end of 2001 to create a financial market supervisory authority[10] – led by Prof. Ulrich Zimmerli and including the SFBC Chairman – concentrated on the organization of an integrated supervisory authority. The SFBC was concerned to ensure that these efforts not only defined how such an authority should be organized but also that its supervisory apparatus and powers to impose sanctions should be unified for all areas of supervision. On these issues it also delivered substantial proposals.[11]

In its proposal for a law on financial market supervision, the commission of experts proposes setting up a "Federal Financial Market Authority (FINMA)", which would take the form of a public-law institution with the status of an independent legal entity. This authority would take over the supervisory duties currently handled by the SFBC and the Federal Office of Private Insurance. According to the commission of experts, it could be decided at a later stage whether the new authority should be assigned further tasks, such as the supervision of asset managers or financial intermediaries under the Money Laundering Act. The Federal Financial Market Authority would have a Board of Directors – elected by the Federal Council – that would be responsible for determining its strategy, deciding on regulations and appointing an Executive Board, which it would also advise on issues of principle. Like the SFBC, the new authority would be financed entirely by fees and supervisory levies and would not be constrained by any directives from the Federal Council. It would be entitled to manage its own budget and would have its own personnel regulations. The authority itself would be supervised by the Federal Assembly.

At the SFBC's request, the commission of experts did not restrict itself solely to drafting a law for the organization of the authority, but also took into account a proposal by the SFBC for standardizing the supervisory apparatus in all areas. The actual rules of supervision, however, should remain separate and independent in order to be able to incorporate sector-specific requirements. This is in line with the recommendations made by the working group on financial market supervision headed by Prof. Jean-Baptiste Zufferey in 2000.[12]

The SFBC has submitted a proposal to the commission of experts that a set of guidelines be established for the use of external auditors. However, the new authority

[10] see http://www.efd.admin.ch/d/dok/medien/medienmitteilungen/2001/11/finanzmarkt.htm [German]
[11] see 6
[12] see http://www.efd.admin.ch/d/dok/berichte/2000/11/finanzmarkt.pdf [German and French]

should be free to fine-tune the details of these regulations in line with individual sectors and the complexity of the operations of the institutions it supervises. It is envisaged that the supervised institutions should have extensive obligations to report information to the new regulatory body FINMA. If a supervised institution breaches supervisory regulations, FINMA would be responsible for remedying the situation. This proposal takes up the idea of an investigator similar to that proposed in the draft of the bank insolvency law[13] instead of the current observer provided for in Art. 23^{quater} of the current Banking Act. This investigator would also be authorized to act in lieu of a supervised institution's directors or management. FINMA should be expressly empowered to audit the institutions it supervises itself, if this is deemed necessary. Finally, collaboration with other Swiss and foreign authorities should be regulated in a uniform manner, taking into account the changes in the area of administrative assistance envisaged by the SFBC.[14]

The commission of experts additionally adopted the SFBC's proposals on introducing administrative sanctions which the financial market authority would have power to impose.[15]

Supervision of asset managers

The commission of experts has not yet made any statement on the question of whether asset managers should also be subject to supervision by FINMA and, if so, what should be done about the remaining tasks of the Money Laundering Control Authority. It will address these issues in 2003. The SFBC believes the supervision of asset managers is not the most urgent consideration at present and care must be taken to ensure the new financial market authority is not overloaded with work right from the outset. It is much more important for those in charge of FINMA to concentrate on the existing core areas of supervision. Their efforts in this respect should not be jeopardized by the need to develop a supervisory system for parabanking, or non-bank financial activities. If necessary, that can be done at a later stage, when the Money Laundering Control Authority will also have a lot more experience in dealing with asset managers.

Supervision of financial conglomerates

The complete revision of the Insurance Supervision Act, which will create a formal legal basis for the supervision of conglomerates and corporate groups, encountered further delays. For one, Prof. Zimmerli's commission of experts came up with a number of changes, and for another, the Federal Office of Private Insurance decided to conduct a series of consultations with other offices. Ultimately, the question will be whether the amendments to the Insurance Supervision Act should be incorporated in the drafting of a law on financial market supervision.

[13] see II/1.1.1.1
[14] see 3
[15] see 5

Revision of the Investment Fund Act

At the SFBC's request, the Federal Department of Finance commissioned a group of experts in February 2002, headed by Prof. Peter Forstmoser, to draft a proposal for amendments to the Investment Fund Act. The SFBC was represented in this commission of experts, which published the results of their work at the start of 2003.[16] The SFBC proposes extending the scope of the current Investment Fund Act to include all collective investment vehicles. The amended Act should govern investment companies with fixed or variable capital and investment foundations, while the existing definition of funds for institutional investors should be expanded to cover "qualified investors" (high-net-worth individuals).

Administrative assistance and on-site inspections

Various rulings by the Federal Supreme Court prevented the SFBC, partially or completely, from providing administrative assistance to supervisory authorities in the US, Italy and Germany and threatened the provision of administrative assistance to other countries. The SFBC had given several warnings in recent years that this could happen. It therefore called publicly for an amendment to the provisions of the Stock Exchange Act regarding administrative assistance. In talks with bank representatives, the SFBC worked out a draft proposal for this amendment.[17]

Reform of bank auditing

The work begun by the SFBC in 2000 on reforming the way banks and securities dealers are audited was continued in greater depth.[18] The SFBC presented the interim findings of its own working group to Prof. Zimmerli's commission of experts, who integrated them into their draft.

Restructuring and liquidation of banks and depositor protection

In November 2002, the Federal Council brought a draft before parliament aimed at reforming the provisions of the banking law that apply to bankruptcy and restructuring of banks as well as to depositor protection.[19] This proposal had been delayed by discussions over the maximum amount that the banks, financing the deposit protection scheme, should guarantee their depositors.[20] The SFBC welcomes the procedural improvements put forward in the draft. However, to be given responsibility for decisions on restructurings and liquidations or for approving the self-regulation of depositor protection would constitute new and difficult tasks for the SFBC. For instance, in the future it will have to assess the prospects for successful restructuring in each case before deciding whether to revoke the licence of an insolvent bank or securities dealer. Any company illicitly involved in banking or securities trading without a licence will be liquidated rather than restructured.

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[16] see III/1.1
[17] see 3
[18] see II/3
[19] http://www.bk.admin.ch/ch/d/ff/2002/8060.pdf [German]
[20] see II/1.1.1

Insider trading

It is becoming increasingly clear, not only due to problems of dual criminal liability in the context of administrative assistance on securities transactions[21] but also in view of various high-profile cases within Switzerland,[22] that the current definition of insider trading in Art. 161 of the Swiss Penal Code is too narrow. The SFBC devoted considerable attention to this subject in its working group on securities crime, led by Hanspeter Uster (head of the Canton of Zug's justice department), and in particular when drafting its proposals for administrative sanctions.[23]

Regulation of payment and securities clearing systems

The Federal Council introduced a bill to parliament in June 2002 for a complete revision of the Banking Act.[24] The bill envisages changes in the capital adequacy and liquidity requirements applicable to banks that would have a material impact on their operations. Of particular importance for the SFBC, however, is the proposed supervision of payment and securities clearing systems and the creation of an explicit legal basis for comprehensive administrative assistance between itself, the Swiss National Bank and other Swiss financial market supervisory bodies.

Dormant assets

The public consultation procedure for the Federal Law on Dormant Assets was concluded at the end of September 2000. The concept of establishing a legal framework for this issue was supported by an overwhelming majority. The detailed proposals, however, were rejected, especially by those whom they would affect most – the banks. The latter wanted to see greater emphasis put on self-regulatory efforts, an area which has been substantially expanded since 1995. The main proposals rejected were those calling for the publication of dormant assets and the setting up of a state-run office to whom this information would be reported. Another controversial issue concerned who should profit from dormant assets and whether the scope of the new law should be extended to include areas which are not subject to supervision under specific laws.

As a result, the Federal Department of Finance commissioned a working group in July 2002, under the leadership of Prof. Luc Thévenoz, a member of the SFBC, to prepare a report together with a draft of the law by the end of 2003. The call for greater self-regulation will be incorporated in the forthcoming draft, provided the SFBC's audit of the banks' self-regulatory mechanisms shows that they meet its requirements. The SFBC expects the results of this focused audit of selected banks to be available in spring 2003. A special audit of systems conducted in 2002 yielded good results.

[21] see 3
[22] see Annual Report / Key themes 2001, p8
[23] see 5
[24] see FF 2002 6097 and Annual report / Key themes 2001, p8

Global custody

The Swiss Bankers Association submitted a draft law on securities safekeeping to the Federal Department of Finance in January 2003. The draft had been prepared by a working group commissioned by the Swiss Bankers Association and headed by Prof. Hans Caspar von der Crone, in which the SFBC was also represented.

The aim of this initiative is to improve the safety provided by law for securities and book-entry securities held in collective custody, which is of particular significance for securities settlement in the context of cross-border transactions and mergers. The SFBC supports the initiative and is committed to developing it further on the basis of this draft.

Coordination

Some of the above regulatory initiatives are closely interconnected. For instance, the draft law on financial market supervision may result in changes to certain provisions of the Investment Fund Act, which are in turn subject to the pending revision of that Act. There is therefore a pressing need for coordination and meaningful prioritization. Amendments to laws which are closely connected with one another could, for example, be bundled into legislative packages and their timing coordinated appropriately. As the authority charged with implementing such legislation, the SFBC will consult the bodies responsible for these matters as the occasion arises.

3. International administrative assistance and on-site inspections

Problems with the current rules on mutual administrative assistance

The rules on administrative assistance in relation to securities transactions are currently unsatisfactory in many respects:

- The requirements with regard to confidentiality cannot be met. The principle of confidentiality requires that the foreign authority requesting assistance be subject to official or professional secrecy. The Federal Supreme Court's ruling of 20 December 2001 in the Elsag Bailey case[25] stated that the US Securities and Exchange Commission (SEC) was not entitled to receive administrative assistance because its declared objective was to pursue public legal action in cases of suspected insider trading. This is not compatible with the confidentiality requirement.
- Long-arm principle in dealings of the requesting authority with other supervisory authorities: The SFBC must grant its approval before a foreign supervisory authority benefiting from administrative assistance can pass on any information to another supervisory authority in the same country. If the legal system in that country splits supervisory duties between more than one authority, a separate request for permission to pass on information must be submitted for each such authority.
- Long-arm principle in dealings of the requesting authority with criminal authorities: Before the SFBC can give approval for the requesting authority to pass information on to criminal authorities in the same country, the Federal Office of Justice must first ascertain that the rules on judicial assistance have been complied with and that dual criminal liability exists. Since the Federal Supreme Court defines insider trading narrowly as per Art. 161 of the Swiss Penal Code, the forwarding of information by the requesting foreign supervisory authority to criminal authorities of the same country will be prevented even in cases where inside knowledge has clearly been misused.
- The rules on passing on information can be especially problematic if a foreign supervisory authority is bound by its country's laws to bring criminal charges – immediately and without consulting the SFBC – where there are signs that a criminal act has been committed.
- Legal action by customers: If the information to be passed on concerns clients of securities dealers, the Administrative Procedure Act applies, giving the clients in question the right to complain before the Federal Supreme Court. The complaints procedure lasts between nine and twelve months. If a client's complaint is successful and the foreign authority submits a new request that meets the Federal Supreme Court's requirements better, the process starts again from scratch. Assuming the Federal Supreme Court rejects a second complaint by the client, it can therefore be three years before the SFBC is allowed to provide administrative assistance.
- Incompatibility with minimum international standards: The Swiss rules on administrative assistance fail to comply with minimum international standards, which are

[25] see ATF 2A.349/2001

primarily issued by international associations of supervisory bodies like the International Organization of Securities Commissions (IOSCO). Of particular interest in this respect is the multilateral Memorandum of Understanding (MOU) approved by IOSCO[26] in May 2002.[27] This agreement regulates cooperation and information exchange between securities exchange supervisory authorities worldwide.
In view of the problems outlined above, the SFBC is not currently in a position to fully comply with the requirements stated in IOSCO's multilateral memorandum of understanding. The long-arm principle by which the SFBC is required to give prior approval for information to be passed on from one foreign authority to another poses a major problem. A foreign authority receiving information on a securities crime must effectively be able to use that information in any administrative, civil or penal procedure or to forward it to another competent authority for this purpose.
However, any regulatory authority that wishes to sign the memorandum of understanding but is aware of inadequacies in its system, has the option of submitting to an application process on the understanding that it will undertake to rectify these inadequacies. It will only be allowed to sign once appropriate legal standards to remedy the deficiencies identified have been adopted internally and verified. The SFBC has decided to submit to this process.

The SFBC called for an amendment to the provisions on administrative assistance in the Stock Exchange Act in its 2001 Annual Report. Discussions with the Swiss Bankers Association have revealed that the SBA agrees with the Commission on the need for a revision. A working group prepared a draft of the changes to the law, containing the following main points:

- The confidentiality requirement will be eased, while the current rules on publicising proceedings and providing information on such proceedings to the public will generally be preserved. In particular, this will make it possible to share information with the US SEC again.
- The long-arm principle will be abolished in respect of bodies involved in regulating securities exchanges and dealers, albeit within the limits of the principle of speciality which restricts the use of information to the specific purpose it was provided for. The ban on forwarding information to criminal authorities will also be lifted – again within the limits of the speciality principle – in cases where assistance under the international guidelines on criminal matters and hence the current requirement for dual criminal liability is excluded.
- Outside the scope of the speciality principle, i.e. for purposes other than regulating securities exchanges and dealers, the current rules for passing on information will continue to apply. More specifically, passing on information for the purposes of taxation will continue to be prohibited.
- The administrative procedure for mutual assistance in client-related matters remains

[26] see http://www.iosco.org/mou/index.html
[27] see VII/1.2.2

unchanged. However, attempts will be made via statutory deadlines and other means to speed up the process.

- The rules on administrative assistance in the Banking Act and the Investment Fund Act will be adapted to match those in the Stock Exchange Act.

On-site inspections

Contrary to the previous year, no foreign authority made on-site inspections at the Swiss premises of foreign banking groups in 2002. Since Art. 23^{septies} of the Banking Act came into force on 1 October 1999, five foreign authorities have carried out on-site inspections at the premises of nine subsidiary banks, four branches and two non-bank financial companies. While the SFBC does not generally carry out on-site inspections of its own at foreign premises of Swiss institutions, it does demand that external auditors, who must attest that the companies they audit comply with prudence requirements at the group level, carry out such inspections. However, the SFBC's foreign counterparts do carry out their own inspections at Swiss branches and subsidiaries of banks that are under their supervision at the consolidated level.

The above legal provision is a compromise. It prevents direct access to information directly or indirectly relating to wealth management or investment activities for the account of clients (paragraph 4, "private banking carve-out"). In such cases, the SFBC itself must collect the required information and apply the Federal Administrative Procedure Act. What this means in practice is that the client must be informed and is able to make use of procedural rights including the right to be heard, the right to a formal decision and the right to appeal. Any foreign authority wishing to have access to information of this kind during an on-site inspection in Switzerland must thus return home, wait between nine and twelve months for the correct procedure to run its course before receiving information that could potentially raise additional questions. This method is neither practical nor defensible to foreign critics.

Furthermore, international standards on such matters are evolving rapidly. It is generally acknowledged that there is no real need to have access to data on individual clients in order to carry out system-level inspections, but the same cannot be said for operational or reputational risks or for the fight against terrorism and money laundering. The Basel Committee's October 2001 report[28] on "Customer due diligence for banks"[29] therefore expressly envisages the possibility, during on-site inspections by an authority from the bank's country of origin, of freely verifying the institution's compliance with policies and procedures in place to identify its clients by examining client files and conducting random account checks. Participants at the International Conference of Banking Supervisors in Cape Town in September 2002, which brought together representatives from almost 120 countries, committed themselves to supporting this report, stating that performing due diligence on clients was a matter of prudential responsibility, even for foreign units.

[28] see http://www.bis.org/publ/bcbs85.htm

[29] see Annual report / Key themes 2001, p18

The Swiss rules currently in force are too restrictive and, in addition to being in conflict with these standards, do not make much sense in a practical context. The only way to solve these problems is to amend the relevant legal provisions.

4. Impact of the bear market

The world's major stock markets saw a precipitous slide in share prices towards the middle of the year. This prompted the SFBC to carry out a situation analysis for the banks and securities dealers with the highest equity exposure. Its investigations revealed that, while the majority of these institutions were experiencing falling income, only a few of them were likely to suffer a net loss and there was no threat to capital adequacy overall. Although the bear market was in its second year in Switzerland and its third internationally, the banks and securities dealers had overall survived its impact well. This proves that market risks were sufficiently hedged or limited.

The insurance sector was hit particularly hard by the negative equity market trend. This was not without consequences for Credit Suisse Group. Winterthur Group's income from investments collapsed, and a massive diminution in portfolio values had to be charged to the income statement. In addition, the need to reduce the equity weighting in its investment portfolio resulted in substantial losses being realized.

The effects were much worse, however, for BZ Group. Plummeting share prices brought extensive losses on the group's various equity holdings, as a result of which BZ Group Holding was no longer able to honour its liabilities to a number of banks in full. It was therefore forced to sell its BZ Vision investment companies to Zurich Cantonal Bank and negotiate standstill agreements with several creditor banks. Nevertheless, the BZ Bank subsidiary was able to comply with all the applicable legal requirements by a comfortable margin at all times in spite of significant trading losses. BZ Bank will refocus on its core businesses of brokerage and wealth management, which is why its retail business (BZ Equity Account) was sold to AIG Private Bank.

Finally, the negative stock market environment also played a part in the SFBC's decision to revoke the licence of A&A Actienbank and its sister company, securities dealer SMS Securities Sigg Merkli Schrödel AG, and to liquidate the two. A&A Actienbank was unable to resolve a legacy of problems from the past, resulting, among other things, from equity trading losses in 2001. In addition, the poor state of the markets made it virtually impossible for either A&A Actienbank or SMS Securities to conduct its business operations at a profit.

As in 2001, the ongoing decline in share prices led to further consolidation among the online brokers. Three such companies either stopped trading or announced a merger with others in 2002.

Through their joint steering committee for system stability, the SFBC and the Swiss National Bank carried out regular situation assessments, exchanged the latest infor-

mation and opinions, evaluated aspects of systemic risk and proceeded with joint projects aimed at fine-tuning the supervisory and central bank apparatus. The SFBC continues to follow developments in the stock markets very closely and will take the necessary action in relation to individual banks and securities dealers if any further problems emerge.

5. SFBC sanctioning powers

The SFBC undertook an in-depth investigation into possible sanctioning powers for the supervision of institutions and markets and compiled a "Sanctions Report" containing its proposals for substantially bolstering its current system of sanctions. In its 2001 Annual Report, the SFBC stated that it needs sufficient powers in the form of comprehensive rights to information from all market participants and credible means of intervention with the possibility to impose sanctions.[30] The Sanctions Report was motivated by the general view that this was an urgent need as well as by experiences made in the Abacha case and findings from market supervisory activities.

The Abacha case exposed the SFBC's limited scope for intervention in its supervision of banking institutions.[31] If the SFBC determines that an institution is in breach of the conditions of its licence, it only has limited possibilities to react, and the means at its disposal are primarily aimed at restoring a state of compliance within the institution in question. The strictest sanction it can impose is to revoke an institution's licence, thus causing it to be liquidated. If individuals in positions of responsibility are guilty of serious misconduct, their removal from the company can be ordered. However, the only course of action open to the SFBC at present in cases of less serious infractions is to issue an official reprimand.

The same problem is apparent in the area of market supervision. Furthermore, the gap between financial intermediaries that are subject to regulation and those that are not is widening. The lack of sanctioning powers with regard to the latter group has certainly proven to be a problem. Moreover, of this, the criminal regulations currently in force are too narrowly defined. For example, it is not punishable to issue profit warnings, thereby exploiting inside knowledge of the fact that a particular company's earnings will be lower than forecast and below the market consensus. In such cases, only licensed institutions and their employees can be sanctioned.

With a view to solving this problem, the SFBC proposes introducing administrative sanctions that would significantly improve the supervision of institutions and markets. This extended catalogue of sanctions will be used by the planned Federal Financial Market Authority.[32] The SFBC's Sanctions Report was submitted in December 2002 to Prof. Zimmerli's commission of experts, who are working on a draft of the law for the new regulatory body.

The report's main proposals are as follows:

- The new regulatory body should have both financial and professional sanctions at its disposal.

[30] see Annual report / Key themes 2001, p6
[31] see Annual report / Key themes 2001, p14
[32] see 2

- In the case of institutional supervision, these sanctions should be imposable for serious breaches of duties described in the law, whereas in the case of market supervision they should be imposable for market abuses. The new regulatory body will need to clarify the offences which are subject to such sanctions via new regulations to be set out in the Stock Exchange Act.
- Financial sanctions and asset seizures should be imposable against companies in the context of institutional and market supervision. For natural persons, meanwhile, it should also be possible to prohibit such persons temporarily or permanently from engaging in licensed activities.
- The procedure should be essentially aligned with the Administrative Procedure Act, but expanded and reinforced by elements of federal criminal procedure rather than civil procedure, as is currently the case.
- The new FINMA should have a sanctions committee that is separate from its regulatory functions. This committee should employ a special sanctioning procedure that meets the requirements of the European Convention on Human Rights with regard to criminal procedures.
- Legal recourse against decisions by FINMA would be available under federal administration of justice procedures (administrative court appeal to the Federal Supreme Court or – after the justice reforms come into force – the Federal Administrative Court with the option of taking the appeal further to the Federal Supreme Court).
- The infractions punishable under administrative law and contained in current supervisory legislation should be reduced to a minimum and largely replaced by procedures for the pronouncement of administrative sanctions.
- Insider trading and share price manipulation should remain as criminal offences in the Swiss Penal Code, but their definitions should be expanded. However, they should only be referred to the criminal authorities competent in the jurisdiction of the exchange in very serious cases and at the request of FINMA. All other cases should be dealt with by FINMA via administrative sanctions.

These proposals will provide the Federal Financial Market Authority with more extensive sanctioning powers for the supervision of both institutions and markets. They permit the regulatory control of offences involving market abuse to be developed flexibly outside the constraints of criminal law. They also serve to considerably simplify the procedures involved. Furthermore, if FINMA is given sufficient resources to handle sanctions, market supervision could in future become a much less time-consuming process. The less significant offences under administrative law would be done away with and, where necessary, replaced by administrative sanctions. In addition, those concerned would be granted the same procedural guarantees as in the case of criminal procedures. Decisions in the first instance would be rendered by a specialist authority, making the sanctioning procedure transparent for the market and the general public and thus increasing the credibility and the effectiveness of the regulatory process.

As far as market supervision is concerned, it is essential for the rules to be enforced equally for all market participants, irrespective of whether they are employed by a company supervised by the new Federal Financial Market Authority or not. Moreover, only this model allows a standard catalogue of sanctions for the supervision of markets and institutions.

Shifting the punishment of market abuses from criminal to supervisory legislation is in no way detrimental to the credibility of the rules. On the contrary, this change would allow the acceleration of procedures and the uniform administration of justice by a specialist authority that offers transparency for the general public.

6. Audit reform

The SFBC is significantly dependent on the work of bank auditors in its supervision of banks and securities dealers. Having recognized that the existing rules do not take sufficient account of the changes underway in the accounting profession and in the environment in which auditing companies operate, it began an extensive reform of its auditing regulations in 2000. It appointed a commission of experts, headed by Prof. Peter Nobel, to look into the area of auditing.[33] This commission was asked to analyse and assess the current dual regulatory system and to formulate recommendations, which are now being implemented by a working group.[34]

After formulating the commission's recommendations into a first set of concrete draft laws, ordinances and circulars, the working group submitted an interim report with proposals for regulations on the tasks, functions and autonomy of audit companies and the supervision of complex financial conglomerates. The SFBC passed various of these draft legal provisions on to the commission of experts working under Prof. Ulrich Zimmerli to create an integrated financial market supervisory authority. The working group's final report is expected at the end of 2003.

In response to events that, among other things, exposed inadequacies in the way Swiss banks are audited,[35] the SFBC decided to implement two measures aimed at reinforcing/extending its supervisory activities. A new organizational unit is to be established within the SFBC to ensure stricter monitoring of audit companies. All banks and securities dealers, apart from the big banks, will be routinely and periodically subjected to a second audit performed by a company independent from their regular bank auditors. The big banks will be subjected to a more detailed audit at least once a year, the scope of which will be precisely defined. This in-depth audit should also be performed by the banks' bank auditors owing to the high complexity of the two banks concerned.

The SFBC has already started work on setting up the new unit for monitoring audit companies. The unit's tasks will include ensuring that audit companies meet the requirements for accreditation and comply with supervisory rules as well as the rules of their own profession. It will also handle the quality control of audit companies' organizational structures and mandate processing systems and analyse audit expenditure and fees. The unit's quality control activities will involve carrying out inspections at audit companies and performing random checks of their auditing activities at banks and securities dealers.

This new organizational unit has been set up in response to one of the recommendations made by the IMF following its Financial Sector Assessment Program.[36] In

[33] see http://www.ebk.admin.ch/d/archiv/2001/neu6-01.pdf [German]
[34] see Annual report / Key themes 2001, p7
[35] see II/2.3
[36] see 1

view of the trust the SFBC places in the judgements of the audit companies, the IMF considered that a quality control programme for monitoring and verifying their work was necessary.

In this connection, the self-regulation initiatives undertaken by the audit companies also deserve mention. In 2000, the Swiss Institute of Certified Accountants and Tax Consultants launched a project addressing the issue of external quality control. However, its implementation has been hindered by the fact that auditors are bound to secrecy under Art. 730 of the Swiss Code of Obligations and by the special secrecy obligation provided for in the Banking Act. The Swiss Institute of Certified Accountants and Tax Consultants turned to the SFBC and other federal authorities and supervisory bodies to help it find a way to introduce such external quality controls. Although the global audit industry is characterized by extensive self-regulation, recent international developments – the Sarbanes-Oxley Act of 2002 in the US,[37] for instance – have called the effectiveness of quality controls by professional organizations into question. As a result, there is increasing support for the idea of state-run monitoring bodies.

The periodic, routine checks envisaged by the SFBC are aimed at identifying, assessing and quantifying risks, performing a thorough check of areas such as credit administration and specific functions such as compliance and investigating the extent to which certain standards (e.g. guidelines on money laundering) are being adhered to. These second audits will be carried out in addition to the annual bank audit and are primarily intended to ensure a more intensive level of monitoring for banks and securities dealers. However, they could also serve as a second opinion in cases where there are doubts concerning the work of the bank auditors. The SFBC would determine the time frame and focus of the second audit in each case in accordance with the risk situation and current events.

Closer monitoring of audit companies has already been implemented, but it has not yet been possible to implement second audits because the necessary legal provisions are not in place at present. Since the second audits are supposed to be a matter of routine, the SFBC cannot simply use its authority to order special audits for this purpose. The second audits will therefore not be possible until the legislative reform package comes into force. Until then, the SFBC intends to make greater use of its special audit powers.

As regards self-regulation by auditors, guidelines on autonomy issued by the Swiss Institute of Certified Accountants and Tax Consultants came into force on 1 January 2002. These comprise seven principles based on the rules published by international professional organizations, in particular the International Federation of Accountants (IFAC) and the European Federation of Accountants (FEE). All bank auditors under the Banking Act and the Stock Exchange Act are members of the Swiss Institute of

[37] http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf

Certified Accountants and Tax Consultants and are thus subject to the Institute's regulations in addition to the requirement for independence stipulated in Swiss regulatory legislation.

7. Credit risk methodology

Credit risk and the management thereof play an important role for a large number of institutions. The SFBC keeps constant track of credit risk management issues, and the Basel Committee has developed regulations on the subject. The efforts currently underway to revise the Basel Capital Accord (Basel II) on capital adequacy for banks clearly suggest the need for further development and reinforcement of banks' risk management systems, regardless of whether internal capital adequacy rating methods are used in future or not. The SFBC must therefore regularly check that credit risk is subject to adequate, ongoing assessment and control by the institutions it supervises. To this end, the SFBC gave instructions to auditors in 2002 via its newsletters nos. 21 and 22.

More detailed checks on the assessment of credit risks and the calculation of provisioning requirements (SFBC newsletter no. 21)

The significant increase in value adjustments and provisions for loan loss risks observed at some banks recently[38] has led some to question the effectiveness of the banks' methods for evaluating credit risks and determining provisioning requirements, as well as the assessment of these methods by auditors. The SFBC responded in its newsletter no. 21 by calling for auditors to make statements regarding the adequacy of methods used to determine provisions and of the provisions themselves at banks whose core business is lending. It also requested confirmation that adequate methods are being used to value real estate and to calculate the values recorded for real estate used as loan collateral and for properties held for resale.

No fundamentally new findings arose from the responses received in respect of the 133 banks subjected to this detailed check. It would appear that almost all the banks apply their own individual methods for determining provisions. In addition to this method, several banks also use general provisions to cover deferred risks or less significant loss risks. The results nevertheless showed that certain ideas relating to default risk management were not being interpreted in the same way by all institutions. In terms of specific aspects such as the definitions of non-performing loans and real estate values, therefore, plans to introduce more precise versions of the SFBC's guidelines on financial statement reporting (RRV-SFBC) and other texts relating to self-regulation can be seen as justified.[39] They also provided an opportunity to discuss various points in greater detail during consultations with certain institutions and gave a broader and clearer insight into the credit risk management principles employed by the banks.

[38] see II/2.6.2

[39] see II/1.3.1 and II/1.4

More detailed checks on credit risk management (SFBC newsletter no. 22)

In order to complete the fairly specific information obtained in response to newsletter no. 21, the SFBC also decided to carry out a more detailed investigation into all aspects of bank auditing relating to credit risk management. The main aim of this investigation is to verify that the Basel Committee's recommendations (Principles for the Management of Credit Risk, published September 2000) are being implemented.[40] It will also make it possible to act on a recommendation made by the IMF following its Financial Sector Assessment Program (FSAP)[41] concerning the improvement of credit databases. In accordance with the SFBC's instructions in newsletter no. 22, auditors are to verify how well the institutions concerned perform in the various areas of credit risk management. Then, depending on this assessment, they are to concentrate on the weaknesses identified and the areas where there is room for improvement. Based on the Basel Committee's Principles for the Management of Credit Risk, the list of areas to be looked at includes the responsibility of managers for determining credit risk policy, procedures and tools for authorizing, managing and tracking loans – in particular internal rating systems – and credit management and controls. This in-depth check is intended to provide information that will allow the SFBC to ascertain the current situation at those institutions with lending as their core business and to assess the need for new regulations on credit risk management. The deadline for supplying the required information has been set for no later than the date on which the bank audit report for fiscal 2002 is submitted. The SFBC will therefore not be able to begin analysing the results until the second quarter of 2003.

The Banque Cantonale Vaudoise affair[42] brought to light a variety of significant weaknesses relating to fundamental aspects of credit risk management at BCV, for example the monitoring of risks by the bank's senior management, the internal organization of credit management and controls, and the procedures used to assess risks and determine provisions. The SFBC is also aware of the weaknesses inherent to the Swiss system of indirect supervision of banks and securities dealers, but it continues to support the system. It has therefore formulated changes aimed at reinforcing its supervisory apparatus (see 6). First of all, it intends to carry out more special audits of supervised institutions. Secondly, it has created a new unit devoted entirely to quality control of bank auditors. Finally, and more specifically, it carried out an analysis in 2002 which provided it with general information on the situation at the cantonal banks.[43]

Following the economic crisis in Switzerland in the early 1990s, which led to immense loan losses for the Swiss banks, the banks were forced to step up their credit risk management activities quite drastically. It is worth noting, however, that the banks could still improve the assessment of their credit risks. Consequently, compar-

[40] see http://www.bis.org/publ/bcbs75.pdf
[41] see 1
[42] see II/2.6.2
[43] see II/2.6.1

ing banks in terms of credit risk is a rather difficult task. Another problem arises from the fact that bank auditors have no universal standards to refer to when evaluating the results of their checks. The SFBC has thus looked into the question of whether more precise and restrictive regulations are needed for credit risk management.

The information received in response to newsletters nos. 21 and 22 will allow the SFBC to follow up this matter more effectively. In addition, at the request of the SFBC, the Swiss Institute of Accountants and Tax Consultants has revised its audit standards regarding the valuation of real estate loans. The Swiss Bankers Association has simultaneously been requested to draw up plans for updating its existing directives on granting and valuing loans with real estate as collateral, which date back to 1993.[44] Finally, the SFBC has already incorporated minimal rules concerning the valuation of doubtful loans and the establishment of appropriate value adjustments into its recent revision of the SFBC Guidelines on Accounting Procedures, and has created a formal definition of "best practice" with regard to valuing real estate provided as collateral.[45]

[44] see II/1.4
[45] see II/1.3.1