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# Switzerland: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Securities Regulation, Insurance Regulation, Payment Systems, and Monetary and Financial Policy Transparency

This Financial System Stability Assessment paper on **Switzerland** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **May 13, 2002.** The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Switzerland** or the Executive Board of the IMF.

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SWITZERLAND

# Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and the European I Departments

Approved by Stefan Ingves and Susan Schadler

May 13, 2002

- The Financial System Stability Assessment (FSSA) is based on work of an IMF mission that visited Switzerland as part of the Financial Sector Assessment Program (FSAP) from October 29 through November 12, 2001. The mission built upon the findings of an FSAP preparatory mission that took place from June 11 through June 15, 2001, and joint visits to supervisors of internationally active Swiss financial institutions in New York and London. Follow up discussions of the FSAP findings took place from February 29 through March 4 in the context of the 2002 Article IV consultations. The FSAP team was led by Hassanali Mehran and included Paul Hilbers, Peter Hayward, Marina Moretti, Maria Tramuttola (staff assistant), all from the Monetary and Exchange Affairs Department; Burkhard Drees (International Capital Markets Department); Anastassios Gagales (European I Department); Maike Luedersen (Legal Department); Kathleen O'Brien, Office of the Comptroller of the Currency, United States, and Stefan Spamer, Bundesbank, Germany (both banking supervision experts); Donald McIsaac, World Bank, and Johan Altersten, Finansinspektionen, Sweden (both insurance experts); James Dingle, Bank of Canada (payment systems expert); Nicoletta Giusto, Commissione Nazionale per le Società e la Borsa (CONSOB), Italy (securities regulation expert); and Victoria Saporta, Bank of England (stress testing expert). Mr. Cippà (Executive Director for Switzerland) attended the meetings during the first week of the main FSAP mission, and Mr. Zurbrügg (Advisor to Mr. Cippà) joined the mission during the second week.
- Overall, financial institutions in Switzerland are well capitalized, but the risks of the current environment should not be underestimated. The large internationally active banks have suffered from the recent asset market volatility and the global economic slowdown. The domestically-oriented banks are well-capitalized, but their lower level of underlying profitability makes them sensitive to the economic cycle: in general, the domestic banking system's efficiency would be enhanced by further consolidation and the creation of a level playing field. The large insurance sector has a good track record, but strains are emerging following the September 11 terrorist attacks and lower financial market returns. If lower returns persist, some institutions could face difficulties in meeting mandatory rates of return and payout ratios on pension assets; in a sustained low interest rate environment, more flexible formulae should be introduced.
- The lines of defense against potential financial sector problems appear to be functioning properly. Financial institutions have developed sophisticated risk management techniques. The supervisory system is effective and has been strengthened in recent years. More recently, financial sector surveillance and monitoring activities have started in the context of the Competence Center for Systemic Stability in the Swiss National Bank.
- This report is divided into two sections. The first section provides an overall stability assessment for the Swiss financial system. The second section reports on the observance of standards and codes on banking, securities and insurance supervision, payment systems, and transparency in monetary and financial policies, as inputs into the overall assessment.
- The main authors of this report are Paul Hilbers and Marina Moretti.

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Main Website of Swiss Financial System Regulatory Authorities

Federal Ministry of Finance .............................. http://www.efd.admin.ch

Federal Office of Private Insurance .............................. http://www.bpv.admin.ch

Federal Office for Social Insurance .............................. http://www.bsv.admin.ch

Swiss Federal Banking Commission .............................. http://www.ebk.admin.ch

Swiss National Bank .............................. http://www.snb.ch

## ACRONYMS

| | |
|---|---|
| AML | Anti-money laundering |
| BCP | Basel Core Principles for Effective Banking Supervision |
| CLS | Continuous Linked Settlement |
| CP | Core Principle |
| CPSS | Committee on Payment and Settlement Systems |
| CSG | Credit Suisse Group |
| ECB | European Central Bank |
| EU | European Union |
| FATF | Financial Action Task Force |
| FDF | Federal Department of Finance |
| FOPI | Federal Office of Private Insurance |
| FOSI | Federal Office for Social Insurance |
| FSA | Financial Services Authority (United Kingdom) |
| FSAP | Financial Sector Assessment Program |
| FSSA | Financial System Stability Assessment |
| FX | Foreign exchange |
| GAAP | Generally Accepted Accounting Principles |
| GNFS | Goods and nonfactor services |
| IAIS | International Association of Insurance Supervisors |
| IAS | International Accounting Standards |
| IOSCO | International Organization of Securities Commissions |
| LIBOR | London Interbank Offered Rate |
| MLCA | Money Laundering Control Authority |
| MLL | Money Laundering Law |
| MOU | Memorandum of Understanding |
| MROS | Money Laundering Reporting Office |
| NPL | Nonperforming loan |
| OTC | Over the counter |
| ROA | Return on assets |
| ROE | Returns on equity |
| SBA | Swiss Bankers Association |
| SEC | Securities and Exchange Commission (United States) |
| SFA | Swiss Funds Association |
| SFBC | Swiss Federal Banking Commission |
| SIC | Swiss Interbank Clearing |
| SIS | SegaInterSettle |
| SMI | Swiss Market Index |
| SNB | Swiss National Bank |
| SNMI | Swiss New Market Index |
| SOFFEX | Swiss Options and Financial Futures Exchange |
| SPI | Swiss Performance Index |
| SRO | Self-Regulatory Organization |
| SwF | Swiss Franc |
| SWX | Swiss Exchange |
| UBS | Union Bank of Switzerland |
| URB | Union of Raiffeisen Banks |
| VaR | Value-at-Risk |

## Section I—Staff Report On Financial Sector Issues

## I. Overall Stability Assessment

1. **The Swiss economy is well developed and prosperous, with the established, strong and reputable financial sector being one of its cornerstones**. Switzerland is a major international financial center that includes a number of the world's top financial institutions. The financial system is centered around these institutions, which are large in comparison to the size of the domestic financial markets. A substantial share of financial sector activities is international, which has implications for financial stability. On the one hand, the international orientation can be expected to function as a built-in shock absorber, since risks can be spread globally, while on the other hand it may create instability due to volatility abroad. The balance will be determined largely by the quality of risk management systems in financial institutions, the effectiveness of financial sector supervision and regulation, and the monitoring and surveillance of the stability of the system.

2. **All three "lines of defense" against financial sector problems—risk management, supervision, and surveillance—are well placed and functioning.** The Swiss financial institutions, drawing from their experiences during the domestic financial crisis in the early 1990s and the global markets turmoil of the late 1990s, have developed sophisticated risk management and early warning systems. At the same time, these institutions are operating under a well-developed and effective system of supervision. More recently, financial sector surveillance and monitoring activities have started in the context of the Competence Center for Systemic Stability in the SNB. Below, we will elaborate on these three important aspects of financial sector stability, with a focus on institutions, supervision, transparency and integrity, as well as provide some suggestions and recommendations for further work.

### A. Financial Institutions and Markets

3. **The financial sector is highly developed and diversified, and prospects and risks are different for each subsector.** The system consists of a small number of global players in banking and insurance, a large and diversified insurance sector, many pension funds, two dozen cantonal banks, regional financial institutions catering to the domestic market, a group of private banks that focus on wealthy individuals, foreign banks, and many nonbanks (including individuals) involved in asset management and financial advice. The activities and products of the institutions in these subsectors vary widely, from basic mortgage lending funded by local deposits to the offering of highly sophisticated products to foreign investors. These subsectors all have their specific strengths, vulnerabilities and risks.

4. **The major banks are profitable and well capitalized, and they have sophisticated risk management systems in place**—although large off-balance sheet exposures made it hard for staff to assess vulnerability to shocks from international financial markets. The first tier of the banking system consists of two very large institutions that dominate the Swiss market but are also large players in foreign markets. As a result, they are only partly

dependent on domestic developments and their main growth opportunities come from abroad, in particular from developments on international capital markets as these banks have become increasingly reliant on fees and commissions related to asset management and trading activities. These banks are clearly focused on risk management challenges in the current environment of substantial asset market volatility. Cost-cutting measures have recently been undertaken as fee-related income came under pressure. Particularly in the current challenging global markets environment, it is essential that internal control mechanisms are effective in aligning risk-taking incentives of business units with the overall attitudes toward risk of the complex institutions.

5. **The cantonal banks play a special role in the Swiss financial system.** These banks, which are fully or largely owned by the cantons, focus on the provision of financial services to clients in their home canton, while benefiting from preferential treatment in terms of capital requirements, taxation, and guarantees. In order to create a level playing field, staff recommends a phasing out of this preferential treatment.

6. **Some further consolidation among smaller players in the retail sector is likely.** A large number of relatively small financial institutions—particularly regional banks and Raiffeisen banks—operate in the domestic retail market, and their profitability and growth potential in this segment are limited. Necessary investments in new technology and the need to cut costs are likely to result in a further process of cooperation and consolidation.

7. **The private banking sector in Switzerland is well established and manages large amounts of assets for its wealthy clients.** This sector includes the private banking activities of the major Swiss banks, the foreign banks operating in Switzerland, and at the top end of the market the Swiss private banks. Professionalism, reliability, and client confidentiality have been the basis for private banking in Switzerland. Profitability in this sector has been high, although recently the private banking sector, which is an important provider of cross-border financial services, has been faced with increasing competition from onshore providers of financial products in the countries of Swiss banks' customers.

8. **Stress tests and scenario analyses, conducted by the SNB staff in collaboration with the mission, suggest that the main risk for the banking sector is likely to result from a deep and global economic recession.** The banking system's relatively high degree of capitalization and profitability reduces its sensitivity to sudden interest rate movements, credit risk, and real estate market developments. In particular, a repeat of the real estate crisis of the early 1990s seems unlikely under the current circumstances in light of the moderate price increases in recent years and relatively low loan-to-value ratios.

9. **The insurance sector in Switzerland is large and has a long history of strong performance.** The Swiss insurance and reinsurance industry includes a few of the world's main players. Institutions on average exceed the minimum statutory solvency requirements by a comfortable margin, and for the large companies the more stringent requirements for prime ratings by rating agencies are the real benchmark. The local insurance market seems practically saturated, and Swiss companies are looking abroad for growth opportunities, in

particular to the United States for expansion in their life business and to the emerging markets for non-life opportunities.

10. **The long-term impact of the September 11 terrorist attacks on the (re)insurance sector is not yet certain.** Insurance companies are affected in two opposite directions: pressure on the 2001 results due to sizeable claims, and expected improved results in subsequent years due to rising premiums and tightening terms and conditions after years of a soft market. The final settlement of claims resulting from the September 11 attacks is likely to take an extended period of time, and barring unforeseen developments it seems unlikely that this event will result in severe liquidity or long-term profitability problems.

11. **The Swiss private pension funds are generally well funded, but in the period ahead they may suffer from low interest rates.** Switzerland has a three-pillar pension system with large private pension funds, in part managed by insurance companies. Sustained low nominal rates of return on financial markets and longer life expectancy may result in a gap between the accumulated value of assets and the claims resulting from the pension schemes, in view of existing legally mandated pension parameters—notably, a benchmark 4 percent rate of return, and a 7.2 percent payout ratio at retirement. Revising such parameters should be considered.

12. **The Swiss securities markets, which are dominated by banks, are liquid, efficient, and have an increasing international orientation**. In 1998, Eurex, the German-Swiss electronic derivatives exchange, was established, and in early 2001 trading on virt-x, a London-based pan-European blue chip platform, with a sizeable Swiss Exchange (SWX) participation, took over trading in Swiss Market Index (SMI) stocks using the Swiss trading platform. These initiatives have enhanced market liquidity by facilitating market access for a wide range of institutions and have linked Swiss markets directly to the EU financial system. They also allow Switzerland, as a relatively small country, to retain a stake in financial markets that otherwise may migrate abroad as part of the general trend toward centralizing securities trading in only a few global financial centers.

## B. The Supervisory and Regulatory Framework

13. **The supervisory system is effective and has been strengthened in recent years.** The supervision of banks, securities markets, and insurance by the Swiss Federal Banking Commission (SFBC) and the Federal Office of Private Insurance (FOPI) has been strengthened in terms of quality and quantity, with a focus on large institutions and a more risk-based approach. In light of the large number of financial institutions and the relatively modest size of the two supervisory authorities, external auditors and self-regulatory bodies play a key role in the supervisory process. The SFBC is aware of the risks of outsourcing on-site work and takes a number of steps to check that the work done meets the standards required. Staff notes that this dualistic approach, which has served the system well, would benefit from a more formalized quality assurance program for supervising external auditors and an increase in joint on-site inspections. The SFBC has already taken steps in this direction.

Staff also favors a rapid adoption of the new law on insurance, which would bring the rules for insurance supervision in line with those in the European Union (EU).

14. **To further enhance the effectiveness of banking supervision, the supervisors would benefit from clearer enforcement powers.** In particular, staff recommends that the SFBC itself be given the authority to impose financial penalties and public sanctions. Moreover, it would be advisable to increase the frequency of special audits and on-site visits to banks in general, and to modernize the current liquidity regime.

15. **Staff carried out assessments of observance of the Basel Core Principles for Effective Banking Supervision (BCP), the International Association of Insurance Supervisors (IAIS) Insurance Supervisory Principles, the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation, the Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems, and the Code of Good Practices on Transparency in Monetary and Financial Policies.** It found that the authorities were in general fully or largely compliant with these financial sector standards and codes.

16. **The large and internationally active financial institutions represent special challenges for the supervisors, and require frequent contacts and exchanges of information with the host-country supervisors of Swiss financial institutions operating abroad.** These challenges include ensuring that risk management and internal control systems are applied properly across all levels of complex institutions. Staff welcomes the establishment of a special division within the SFBC that focuses on the two large banking groups, as well as the regular meetings between Swiss supervisors and the Federal Reserve in New York and the Financial Services Authority (FSA) in London; similar contacts with the U.S. Securities and Exchange Commission (SEC) would be useful as well, in light of the SEC's primary responsibility for the U.S. investment banking arms of the major Swiss banks, as well as contacts with appropriate foreign insurance supervisors.

17. **Staff supports further integration of banking and insurance supervision.** As in other European countries, a number of large financial institutions in Switzerland are involved in both banking and insurance. The advantages of "Bancassurance" are related to the efficiency gains in developing and providing a broad scope of financial services through one network. At the same time, risks can be transferred within large and complex financial institutions, driven in part by regulatory arbitrage. In such cases, close collaboration between banking and insurance supervisors is essential, and in this context staff welcomes the recent initiative of the two Swiss supervisors to work together in the supervision of conglomerates. The ability to share supervisory information between the SFBC and the FOPI is key to eliminating gaps in supervision of the conglomerates. The next steps on the road to integration could be a more formalized process of cooperation and an effort to bring the financial sector supervisors under the same ministerial responsibility. The position of the supervisors would also be enhanced by stronger budgetary independence. Staff supports the ongoing examination of the modalities for establishing a single supervisory authority, which should have financial as well as operational independence. If a single supervisory authority

were to be created, staff sees advantage in making such an authority also responsible for the supervision of pension funds in Switzerland.

18. **Staff recommends that all asset managers be brought within the overall prudential regulatory framework.** There is a large group of asset managers who provide financial services that are only regulated with regard to anti-money laundering (AML) issues. This may result in risks to the integrity of the system and consumer protection, and an uneven playing field. These activities should be supervised and regulated more generally by the existing prudential agencies, which should be provided with adequate resources to conduct this additional task. Furthermore, the unusual exception to the Banking Act of allowing nonfinancial companies to take deposits from employees should be withdrawn. This is currently being reviewed.

### C. Systemic Stability, Transparency, and Integrity

19. **The Swiss large-value payment and clearing system, which was one of the first in Europe to be based on real-time gross settlement, is well developed, efficient, and fully compliant with the CPSS Core Principles for Systemically Important Payment Systems.** The events of September 11 emphasized the importance of payment system support in times of crisis. Staff suggests that the Swiss National Bank (SNB) consider the option of a swap arrangement with the U.S. Federal Reserve in order to be able to provide U.S. dollar liquidity to Swiss institutions in cases of emergency. It also recommends careful analysis of the anticipated structural developments for the year 2002, including the establishment of a Continuous Linked Settlement (CLS) Bank for the settlement of foreign exchange (FX) transactions.

20. **Staff fully supports recent initiatives to develop a financial stability center in the SNB, which reflect the key importance of financial system stability for the Swiss economy**. The SNB's Competence Center for Systemic Stability, established in 2001, brings together the different functions in this area within the SNB. Regular assessments of financial sector soundness and developments help to identify vulnerabilities at an early stage. Staff welcomes the involvement of the SFBC in this initiative through its membership of the Steering Committee, which will contribute to a mutually beneficial exchange of knowledge and information. This is particularly important in order to be able to act rapidly when developments in financial markets require intervention, including through the provision of liquidity.

21. **The new monetary policy framework has enhanced the transparency of monetary policy.** Overall, transparency with respect to monetary and financial policies is in line with international standards. In 2000, after a quarter century of monetary targeting, the SNB switched to a new monetary policy framework based on its inflation forecast. The main elements are a clear definition of price stability, a three-year-ahead inflation forecast, and a target range for the three-month interest rate. In this context, staff supports the proposal for a revised central bank law. In particular, it welcomes the proposals for a more precise definition of monetary policy objectives, for broadening the SNB's tasks to facilitate the

operations of the cashless payment system, for modernizing the SNB's arsenal of monetary policy instruments, and for enhancing its capacity to collect data.

22. **Current initiatives to introduce special exit arrangements for banks and to strengthen deposit protection are welcome.** Proposed legislative changes, expected to be implemented over the next few years, will give the SFBC greater powers to intervene, restructure, and liquidate banks. In addition, as a way of broadening the safety net, deposit protection should, as has been proposed, become mandatory.

23. **Staff welcomes the recent guidelines on corporate governance** developed by the SWX and Economiesuisse. Although staff did not focus specifically on the issue of good governance, it wishes to emphasize the key importance of accountability and transparency for financial institutions and their clients, which will also help in avoiding reputational risks.

24. **The Swiss AML regime in the financial supervisory area is broadly in line with international best practice.** This is an important safeguard for the reputation of the Swiss financial system. Staff notes continued enhancements in the legal and institutional framework against money laundering, including the application of AML rules to nonbank financial intermediaries in recent years (see Annex I).

## II. Financial System Overview

25. Supported by its key strengths (including know-how, long-standing experience in asset management, and reputation), the Swiss financial sector performs a sizable international intermediation function within the global financial system, in part because it is one of the key players in the international private banking business. In 2000, international capital flows (other than direct investment) to and from Switzerland amounted to 53 percent and 56 percent of GDP, respectively. Most of these funds were channeled through financial institutions and were not directly invested in Swiss financial markets.

26. The financial industry makes up a large part of the Swiss economy. Financial services account for about 11 percent of GDP (more than twice as much as in the United States, France, or Germany). At end-2000, bank assets were equivalent to five times annual GDP; and banks held securities valued at SwF 3.7 trillion in client custody accounts, more than half of which are held on behalf of foreign clients. Swiss institutions are among the world leaders in private banking—with an estimated 30 percent of internationally invested private assets worldwide under management.[1] All told, at end-2000 the assets on banks' balance sheets, fiduciary assets held by banks off-balance-sheet, the assets held in client custody accounts, and the assets invested in investment funds totaled SwF 6.7 trillion (15 times annual Swiss GDP).

[1]See Swiss Bankers Association, *The Swiss Banking Sector* (Basel: September 2001).

## A. Institutions

27. A key feature of the Swiss banking system is its segmentation. There were 375 banks operating in Switzerland at end-2000, of which 225 were domestic banks, 127 foreign subsidiaries, and 23 foreign branches.[2] The banks operating in Switzerland can be classified into six segments.

- *The two large Swiss banks, UBS and Credit Suisse Group (CSG)*—These are large and complex financial institutions that operate globally, offer a broad range of products, and have significant on- and off-balance sheet risk exposures. UBS and CSG account for 63 percent of the global balance sheet of Swiss banks and ranked 6th and 10th in the world by market capitalization, respectively, in mid-2001.[3]

- *Cantonal banks*— These 24 banks are owned in part or in full by the cantons, which typically guarantee their liabilities. They account for 14 percent of global Swiss banking assets, and are heterogeneous in size and business activities. The smaller banks focus on domestic retail banking, primarily mortgage lending, while the larger ones are active in a wider range of activities, including securities trading.

- *Regional banks*—These 103 banks account for 3½ percent of global banking assets. Eighty-four of them are organized under a holding structure (the RBA holding), while some of the remaining ones are owned by the two large banks. They engage exclusively in domestic banking activities and serve mainly their local areas.

- *Raiffeisen banks*—These 536 credit cooperatives, which, together with their central umbrella (the Union of Raiffeisen Banks, URB) are counted as one bank, focus primarily on mortgages in rural areas, although recently they have been expanding into the main cities. Their share of banking assets is 3½ percent.

- *Private banks*—These banks engage primarily in portfolio management for high net worth individuals and, more recently, for institutional investors—a market worth over SwF 420 billion in 2000. The members of the Swiss Private Bankers Association are partnerships with unlimited liability. Other limited-liability domestic banks also engage in wealth management. The two groups represent about 4 percent of the balance sheet of Swiss banks, and about one quarter of the market for fiduciary assets.

- *Foreign banks*—The subsidiaries of foreign banks differ widely in size and activities. Most of them focus on private banking. With a 7½ percent share of total assets, they

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[2]By end-2001, the number of banks operating in Switzerland was 377. The state-owned Swiss Post Office is also a provider of payments services, with a payment system that parallels that of banks. It accepts customer deposits but is not allowed to extend loans.

[3]"Europeans Infiltrate the Ranks of the World's Biggest Banks," *Euromoney*, June 2001.

account for over 50 percent of fiduciary assets. Branches of foreign banks account for another 1 percent of assets, and 2 percent of fiduciary assets.[4]

28. Consolidation has changed considerably the structure of the Swiss banking system over the past 10 years. Domestic mergers and acquisitions have resulted in a banking sector with 40 percent fewer institutions than in 1990—from 625 to 375 banks—and one third fewer branches—from about 4,300 to about 2,900. Along with consolidation has come increased concentration, particularly as a result of the merger of Swiss Bank Corporation and Union Bank of Switzerland in 1998, although the presence of local banks (notably cantonal banks) remains strong.

29. Securities intermediaries comprise primarily securities dealers and investment funds.[5] The Swiss system is based on the universal bank model, and both the securities and the fund businesses are dominated by banks. In addition, there are a significant number of partially unregulated independent asset managers and investment advisors, who manage (but do not hold) assets on behalf of third parties.

30. Switzerland has an active investment fund business with more than 2,700 registered funds. Forty-eight Swiss fund management companies manage more than 400 domestic funds, while about 150 foreign representatives distribute 2,300 foreign funds. Total investment fund assets have almost doubled since 1996 to SwF 467.7 billion (115 percent of GDP) at end-2000.[6] More than two thirds of the assets are invested in foreign funds, which are in most cases established by Swiss financial institutions in Luxembourg and their products are then offered in Switzerland to residents and nonresidents.[7] The two large banking groups and the cantonal banks account for almost three-quarters of the market; UBS alone has a market share of almost 43 percent.

31. The Swiss insurance industry is highly developed. Total premiums collected in Switzerland by Swiss insurance companies for the year 2001 amounted to 8 percent of GDP for life insurance and 4 percent of GDP for property/casualty insurance. While in per capita terms insurance purchased by Swiss residents ranks among the highest in the world, 70 percent of business of Swiss insurance companies comes from abroad (Table 1). Both the Swiss life and non-life business are highly concentrated: in 2000 the five largest life insurers and the 10 largest property/casualty insurance companies, respectively, collected 75 percent of total premiums in each market segment.

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[4]The remaining banks have a combined share of 3 percent of Swiss banking assets.

[5]Securities dealers include not only market makers and client dealers (who trade securities in their own name for the account of clients), but also issuing houses and own-account dealers.

[6]According to data from the Swiss Funds Association (SFA).

[7]As of November 2001, 2,749 funds (42 of which hedge funds) were registered and approved in Switzerland, more than 80 percent of which were foreign funds.

Table 1. Premium Volume of Swiss Insurance Companies, 2001

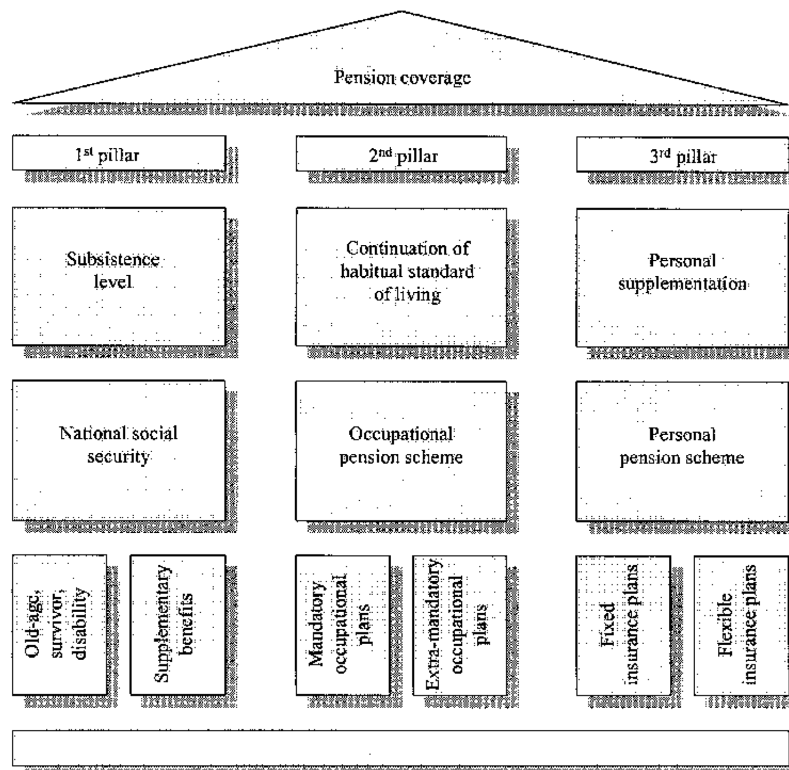
(In billions of Swiss francs)

| | Switzerland | European Union | Rest of World | Total |
|---|---|---|---|---|
| Life insurance | 32.0 | 19.8 | 3.2 | 55.8 |
| Non-life insurance | 16.3 | 28.9 | 24.8 | 70.0 |
| Reinsurance | 2.2 | 19.2 | 22.3 | 43.7 |
| Total | 51.3 | 67.9 | 50.3 | 169.5 |

Source: Swiss Insurance Association, 2002, Facts and Figures.

32. Switzerland has a large and highly developed three-pillar pension system (Figure 1). The unfunded public pillar is highly redistributive and offers nearly universal minimum pension coverage. The private, second pillar was introduced in 1985 and is employer-based, compulsory for dependent workers, and can be either defined-benefits or defined-contributions. The third (less important) pillar, which is voluntary, provides pensions to self-employed workers as well as supplementary coverage to dependent workers. The pension funds play a significant role in the financial system as collectors of personal savings and investors in the financial markets. In 2000, the 11,000 funds managed over SwF 500 billion.

Figure 1. The Swiss Pension System



## B. Markets

33. Financial markets in Switzerland are relatively deep and liquid. A strong investor base and the advanced trading technology for equities, bonds and warrants offered by the SWX, with integrated links to clearing and settlement systems, contribute to the attractiveness of Swiss capital markets. Switzerland's strong position in private banking is also a key factor in the development of its financial markets and investment fund business. At the core of the Swiss financial markets is a large international and domestic investor base with a strong preference for high-quality paper, particularly in the Swiss Franc (SwF) segment of the bond market. In fact, institutions and private investors in Switzerland hold in their portfolios about half of all Eurobonds outstanding. Moreover, the long tradition of a low interest rate environment has made the Swiss Franc an attractive issuing currency, supported by well-developed currency and interest-rate swap markets.

34. In the Swiss money market, activity has shifted from the unsecured interbank market to the repo market. This is a positive development since the repo market allows the transfer of liquidity between banks with negligible credit and market risk. The market has developed rapidly since 1998, after repos were exempted from stamp duty and replaced FX swaps as the main instrument of monetary policy.[8] Two features of the market are the high degree of automation and internationalization (German government paper and jumbo *Pfandbriefe* are accepted as collateral in SNB auctions, and 40 percent of transactions are concluded with foreign, mostly German, counterparties). Trading is carried out electronically on the Eurex platform; clearing and settlement occur on a trade-by-trade basis.

35. Although the domestic government bond market is relatively small—with outstanding bonds of SwF 81.4 billion (20 percent of GDP)[9]—the total stock of bonds issued in Switzerland exceeds 100 percent of GDP. Central mortgage bond institutions, banks and finance companies account for more than 40 percent of the domestic market segment. The long tradition of a low interest rate environment has made the Swiss franc an attractive issuing currency, supported by well developed currency and interest rate swap markets. The bulk of foreign bonds, which represent about 45 percent of the total market, are issued by banks and corporations; less than a fifth are issued by territorial government authorities and supranational institutions.

36. The SWX ranks 10$^{th}$ in the world by turnover in equities, with 2001 turnover close to SwF 1 trillion—more than double the turnover in 1996. Market capitalization of the Swiss Performance Index (SPI) was SwF 902.7 billion in March 2002 (equivalent to 2¼ times annual GDP). The SWX, one of the technologically most advanced exchanges, has exported its electronic trading platform. Since June 2001, the stocks in the Swiss blue chip index SMI

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[8]Outstanding repos amount to about SwF 35 billion, two thirds of which involve the SNB. The Swiss unsecured market volume is about SwF 45 billion.

[9]This includes issues of the federal government, the cantons, and the municipalities.

are traded exclusively in London on virt-x, the joint venture between the SWX and Tradepoint. The SWX is also one of the world's largest markets for warrants with almost 3500 warrants listed. Since 1998, all Swiss standardized derivatives are traded on Eurex, which was created by the merger of the Swiss Options and Financial Futures Exchange (SOFFEX) with the Deutsche Terminbörse (DTB). These international linkages tend to enhance market liquidity by facilitating market access for a wide range of institutions from various countries.

37. The Swiss FX market is very active and ranks sixth in the world based on turnover. Average daily turnover was about SwF 125 billion (30 percent of annual GDP) in April 2001, dominated by the U.S. dollar and, to a lesser extent, the euro. As in other countries, there has been a shift from spot to forward transactions, partly in connection with increasing attention to risk management. Major market participants are the large Swiss banks (60 percent of the market) and foreign banks (20 percent of the market). The market share of cantonal banks is small (7 percent) but rising, reflecting their increasing involvement in international transactions.

## C. Infrastructure

38. The Swiss Interbank Clearing (SIC) is unquestionably a systemically important payment system, both for Switzerland and for the global financial system. On an average day, electronic funds transfers of some SwF 180 billion are processed on a real-time, gross-settlement basis (equivalent to almost half of annual Swiss GDP). An analysis of the daily payment flows suggests that over half of this substantial activity results from Switzerland's position in the global economy and involves either FX transactions being settled between banks, or the associated commercial and business payments.

39. Each SIC transfer that passes the risk-control test of adequate balances in the sending participant's settlement account is immediately final. The SIC also supports the real-time, delivery-versus-payment, cash leg settlement procedures of the securities clearing mechanism operated by SegaInterSettle (SIS) AG. In addition it is used for the regular settlements generated by the derivatives exchange (Eurex), and the bulk settlement of retail-level noncash payments in Switzerland. The broad usage of the SIC is reflected in its list of participants. At the end of 2000, there were 302 participating members, of which 55 functioned on a remote basis, many of these being major foreign banks. Other types of applicants—domestic or foreign clearing institutions, for example—will usually gain access if their presence will "reduce systemic risk or enhance the significance of the Swiss financial center" in the global context.

40. Improvements to the regime for the exit of financial institutions, which is currently regulated under the general bankruptcy law, are under way. Amendments to the Banking Act were proposed by an expert committee in October 2000 to provide the SFBC with greater powers to intervene and liquidate banks. Administrators and liquidators would report to the SFBC, enabling the Commission to partly replace the existing courts, with a view to accelerating and increasing the certainty of the process. The proposal also suggested that the

SFBC be empowered to (i) appoint an "investigator" with powers to enter the bank and examine all its records, (ii) give directions to the management and directors of banks, (iii) suspend management, (iv) require specific activities regarded as high risk to be discontinued, (v) take measures to protect the interests of depositors, and (vi) establish a moratorium on payments as an alternative to revocation of the license and immediate liquidation. In the case of restructuring, the SFBC could appoint an administrator to develop a reorganization plan, or sell the whole, or parts, of the business, subject to the views of the creditors who would retain the power to move to immediate liquidation. In the case of liquidation, the SFBC would be able to initiate insolvency proceedings, and to order the early payment of claims of small depositors of up to SwF 5,000. Draft legislation is expected to be presented to Parliament in mid-2002.

41. Improvements to the depositor protection scheme, which is voluntary and administered by the SBA, have also been envisaged. The existing scheme pays up to SwF 30,000 to holders of personal accounts that are treated as preferred in bankruptcy. Some small depositors, however, are not protected, and there is the possibility of repayment delays. An expert committee, therefore, proposed a new scheme covering all (including foreign currency) deposits up to SwF 30,000. The scheme would not apply to deposits in foreign branches of Swiss banks, unlike the EU requirement. Membership would be compulsory and include branches and subsidiaries of foreign banks. Administration of the scheme, subject to the approval of the SFBC, would be the responsibility of the SBA, but the law would provide that if the SBA does not set up a satisfactory scheme, the government would do so. The legislative proposals are expected to be introduced and implemented in the next few years.

## D. Supervision

42. Financial system regulation and supervision in Switzerland is the responsibility of three main agencies: the SFBC with respect to banking and securities, the FOPI for insurance and reinsurance, and the FOSI for pension funds.

43. Although no supervisory agency has legal powers extending to financial conglomerates, the SFBC has established, through the courts, its right to conduct consolidated supervision of bank-led groups. Where such groups include insurance companies, the SFBC is responsible for the consolidated supervision of the group, while the insurance subsidiaries are the responsibility of the FOPI. Where an insurance-led group owns a bank, the FOPI acts as consolidated supervisor, with the SFBC responsible for the supervision of the banking and securities entities in the group. Administrative arrangements have been set up to coordinate the activities of the two agencies, although this process is still at a relatively early stage.

44. Swiss supervisory authorities do little on-site work and have traditionally relied extensively on the work of licensed external bank auditors, the so-called "dualistic system." At the supervised institutions' own expense, the external auditors are required to carry out a

number of specific tasks and to report annually on the institutions' compliance with prudential requirements.[10] Furthermore, the auditor sets appropriate deadlines for the institutions to take corrective action if necessary. Auditors are also under an obligation to inform the supervisor of any serious problem in the institution. The audit firms and their partners are approved by the supervisory authority and subject to a number of requirements, such as ensuring that conflicts of interest do not arise. The audit firm has to disclose to the SFBC all the consulting and other work it performs for the institution. The auditor can be removed, fined, or imprisoned for failing to perform duties to the supervisory authority. Although there is no routine quality assurance system, the supervisor can, and does, use 'special audits' by other firms as a check on the reliability of audit firms.[11]

45. The SFBC is the statutory authority for the supervision of banks and securities activities. The Commission consisted, at end 2001, of a full-time chairman and eight part-time members, all appointed by the Federal Council. The work of the Commission is carried out by a director and 115 staff. While the Commission's own staff is relatively modest, the staffing available to the audit firms is much more extensive and is located not only in Switzerland (in all the localities where banks have operations) but also in all the significant markets where supervised institutions have operations. The audit firms can, in addition to staff working full time on banks draw on their specialist expertise and indeed contract in other experts as and when needed. This gives the firms more flexibility than could be achieved by simply expanding the staff of the SFBC itself. The SBA acts as a self-regulatory authority. Its guidelines and circulars are developed in close cooperation with the SFBC, and, once approved and endorsed by the SFBC for proper business conduct, they become an integral part of banking regulation, and are thus binding on member as well as nonmember banks. The external auditors are then obliged to verify compliance.

46. In the last three years, the "dualistic system" of banking supervision has been supplemented by a more proactive regime to handle the two major internationally active banking groups, including a new department designed to undertake work for which auditors are less well equipped—such as the supervision of market risk; detailed supervision, off-site and on-site, by additional SFBC staff; and intensive cooperation with the major 'host' banking supervisors in the United States and the Unites Kingdom.[12] The Commission is aware of the risks of essentially outsourcing on-site work and therefore takes steps to ensure its reliability. Periodic assessments of audit firms are carried out and partners responsible for specific banks are also individually licensed. Where a firm or an individual is suspected of insufficient diligence, the SFBC has powers to, and does, appoint another firm to repeat the

[10]External auditors enjoy legal protection from personal liability when performing duties at the direction of the SFBC. Only the Swiss state can be held liable, and can have recourse against the special auditor if the latter acted with gross negligence or intent.

[11]The SFBC recently created a team responsible for supervising bank auditors.

[12]The SFBC has two to three trilateral meetings a year with the New York Federal Reserve and the U.K. FSA. Similar arrangements are being set up with other supervisory authorities.

work. Although this process appears to have worked well and deficiencies have been identified and rectified in time, it plans to formalize this quality assurance process.

47. The SFBC is responsible for licensing and supervising securities dealers, stock exchanges, and institutions similar to stock exchanges; it regulates disclosure of shareholdings in listed companies and take-over bids. Securities dealers, regardless of whether they are banks or nonbanks, need SFBC authorization. Two exceptions are own-account dealers and those who provide services exclusively to qualified institutional investors. Own-account dealers only require to be authorized if their annual turnover exceeds SwF 5 billion. Independent asset managers and investment advisors, who manage assets of third parties, are only regulated for AML purposes as long as they do not maintain clients' accounts.[13]

48. Supervisory functions are delegated to the exchanges, which function as self-regulatory organizations (SROs) and supervise members, trading, listing procedures, and ad hoc disclosure of shareholding. For example, the SWX, as an SRO, is responsible for regulating its members, subject to SFBC approval, and admitting participants to trading (who have to be licensed securities dealers); supervising price formation, and execution and settlement of transactions; and ensuring that the information necessary "to maintain a transparent market" is made public. The SWX is also responsible for enforcing listing rules and checking listing prospectuses.

49. Supervision of insurance companies is the responsibility of the FOPI. The FOPI has developed an approach to the supervisory process that groups its specialists into teams that supervise an assigned group of companies. The system appears to be effective. FOPI's "dualistic system" relies, in addition to auditors, on qualified actuaries to support life insurance companies' mathematical reserve estimates.

50. The registration and, consequently, the supervision of private pensions is an activity that is widely dispersed across the cantons of Switzerland. In principle, each "occupational pension foundation" is registered with the cantonal office where its headquarters are located and where the major part of the business of the employer is conducted. However, foundations serving employers who conduct business across the country (e.g., the transport industry pension foundation) or internationally, are registered with the FOSI. The law provides that the system of supervision be the same across the country. The system is a "reliance" model and each foundation is required to file key documents at regular intervals with its office of registration. The supervisors do not usually perform on-site inspections, but rely on external auditors and "pension experts" (mostly actuaries). These experts provide an annual report on the adequacy of the assets of the fund to meet obligations to members.

[13]This includes fit-and-proper tests for managers but excludes other prudential regulations.

# III. Macroeconomic Environment

## A. Recent Macroeconomic Developments

51. The pace of growth has cooled rapidly while inflation remains subdued. After a protracted stagnation in the 1990s, GDP growth gathered momentum in 1999–2000 bringing capacity utilization close to its historic average and reducing the unemployment rate to 1.7 percent (Table 2). However, the pace of growth dropped below potential in the first half of 2001 as external demand and investment weakened and activity stagnated in the second half of the year, reopening the output gap. Leading indicators, however, suggest that the slowdown may have bottomed. Meanwhile, headline and core inflation remain close to 1 percent and the, until recently, tight labor market has bolstered wage demands only moderately. The external current account surplus dipped to 10 percent of GDP in 2001, mainly reflecting a 2.5 percent of GDP drop in net investment income on Switzerland's large net foreign asset position (124 percent of GDP at end-2000).

52. Following a string of deficits in the 1990s that almost doubled public debt, fiscal policy at the federal level is now guided by the constitutional commitment to balance the budget. Cantons and communes have also been trying to reduce their indebtedness. Windfall revenues and the economic upswing led to a general government surplus of 2.4 percent of GDP in 2000. However, the surplus vanished in 2001 with the disappearance of one-off factors, the weakening of the economy, and the collapse of Swissair.

53. Monetary policy has responded flexibly to economic developments (Box 1). Amid evidence that the economy was growing at an unsustainable rate, the SNB raised its reference interest rate (three-month London Interbank Offered Rate (LIBOR)) to 3.5 percent in June 2000. The reference interest rate was kept unchanged until March 2001, when it was cut by a .25 percentage point, followed by another 1.5 percentage points since September (more aggressively than the European Central Bank (ECB)) on signs of a weakening external environment and benign inflation prospects, and in response to a safe haven related appreciation of the Swiss franc in the aftermath of the terrorist attacks. In early 2002, short-term interest rates were 1.5 percentage points below comparable euro-area rates and, in real terms, they were almost .5 percentage point below their average in the past quarter century. Long-term government bond yields have also declined to 3.5 percent. Despite its 4 percent nominal appreciation against the euro over the past year, the Swiss franc is still slightly weaker in real effective terms than it was prior to the advent of the euro.

54. Stock markets have displayed considerable volatility during the past two years in line with international developments. The New Market Index (SNMI) peaked in early-2000 and the blue-chip SMI in mid-2000, helped by a shift of investor sentiment from the "new economy" to large capitalization stocks. Although the SMI has rebounded by about 30 percent from its post-September 11 low, by end-April 2002 it was still some 20 percent below its peak, and the SNMI—following the fortunes of similar markets abroad—had dropped by 80 percent from its high. Despite modest gains in the past year, real estate prices remain 30–40 percent below their peak in the early 1990s.

## Table 2. Switzerland: Selected Economic Indicators, 1997–2001

Total population (end-2001): 7.2 million
GDP per capita (2001): $34,110

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| Real sector (percent change) | | | | | |
| GDP (percent change in 1990 prices) | 1.7 | 2.4 | 1.6 | 3.0 | 1.3 |
| GDP (in billions of SwF) | 371 | 380 | 389 | 404 | 417 |
| Exports of goods and nonfactor services | 8.4 | 5.4 | 5.2 | 10.0 | 1.0 |
| Imports of goods and nonfactor services | 6.1 | 8.3 | 7.5 | 8.5 | 0.0 |
| Consumer price index | 0.5 | 0.0 | 0.8 | 1.6 | 1.0 |
| Personal savings ratio (in percent) | 10.1 | 8.6 | 9.1 | 8.1 | 8.3 |
| Monetary and credit data (percent change in annual averages) | | | | | |
| Monetary base | 4.8 | 3.0 | 2.4 | 1.1 | 2.5 |
| Money (M1) | 10.1 | 8.0 | 8.6 | -1.9 | -0.2 |
| Broad money (M3) | 5.1 | 1.2 | 1.0 | -1.8 | 2.8 |
| Domestic credit | 1.1 | 0.5 | 3.2 | 1.7 | 1.7 |
| Three-month rate (period averages in percent) | 1.5 | 1.6 | 1.4 | 3.1 | 2.9 |
| Yield on government bonds (period averages in percent) | 3.5 | 2.9 | 2.9 | 3.8 | 3.3 |
| Spread of 3-month interest rate vs. Euro Area | -1.6 | -2.0 | -1.5 | -1.3 | -1.3 |
| Share prices of financial institutions (percent change, end of period) | 74.2 | 4.6 | 20.3 | 16.4 | -8.4 |
| New Market Index, SNMI (percent change, end of period) | ... | ... | ... | 28.3 | -57.9 |
| Overall stock market index, SMI (percent change, end of period) | 58.9 | 14.3 | 5.7 | 7.5 | -21.1 |
| Market capitalization (SPI, percent of GDP) | 226 | 249 | 279 | 311 | 200 |
| Public finances (in percent of GDP) | | | | | |
| Central government financial balance 1/ | -1.5 | 0.0 | -0.8 | 0.9 | -0.5 |
| General government financial balance 1/ | -2.4 | -0.4 | -0.2 | 2.4 | -0.3 |
| External sector (in billions of SwF, unless otherwise indicated) | | | | | |
| SwF per US$ (end of period) | 1.46 | 1.38 | 1.60 | 1.63 | 1.65 |
| SwF per Euro (period average) | 1.64 | 1.61 | 1.60 | 1.56 | 1.51 |
| Trade balance | -0.5 | -2.3 | -0.4 | -4.2 | -3.6 |
| Current account | 36.9 | 37.9 | 42.7 | 53.2 | 41.6 |
| (in percent of GDP) | 10.4 | 11.0 | 11.2 | 12.9 | 10.0 |
| Foreign direct investment (net) | -16.1 | -14.2 | -32.4 | -44.5 | -6.0 |
| Portfolio investment (net) | -15.5 | -6.7 | -61.5 | -19.9 | -75.4 |
| Official reserves (in billions of US$, end period) | 39.0 | 41.2 | 36.3 | 32.3 | 31.5 |
| Reserve cover (months of imports of GNFS) | 5.2 | 5.3 | 5.1 | 4.0 | 4.2 |
| Total external claims | 330.8 | 366.7 | 431.4 | 458.6 | ... |
| Total external debt | 245.6 | 271.5 | 334.5 | 393.8 | ... |
| Of which: General government debt | 0.2 | 0.2 | 0.2 | 0.2 | ... |
| External interest payments to exports (in percent) | 13.3 | 21.5 | 22.9 | 30.2 | 28.9 |

Sources: IMF, World Economic Outlook database; SNB; Swiss Institute for Business Cycle Research; and staff estimates.

1/ Including railway loans as expenditure.

## Box 1. The Monetary Policy Framework

After a quarter century of monetary targeting that kept average inflation at 3 percent, in 2000 the SNB switched to a new framework where monetary policy is set on the strength of an inflation forecast. Its main elements are:

- *A definition of price stability as headline CPI inflation of less than 2 percent.* Although a lower bound consistent with price stability is not defined, the SNB has made it clear that deflation will be prevented. To avoid destabilizing economic activity, the SNB refrains from fine-tuning inflation and can tolerate brief periods when headline inflation is outside the target range. The SNB strives to keep the *medium-term inflation forecast*, not headline inflation, within the price stability range.
- *The three-year-ahead inflation forecast.* This is a consensus forecast based on structural as well as VAR-type models, and on an analysis of the economic situation and the monetary aggregates, and approved by the SNB Board (which entails an institutional commitment to it). The forecast is announced twice annually. The three-year horizon reflects the estimated length of the monetary transmission mechanism in Switzerland.
- *A 100 basis points target range for the three-month Swiss franc LIBOR as the operational target.* The SNB does not control the three-month LIBOR directly but can steer it with its repo operations, which are typically conducted at much shorter maturities. The target range, as opposed to a point target, allows some flexibility to accommodate liquidity or exchange rate shocks without signaling a change in the monetary policy stance.

Despite similarities with inflation targeting, the current framework differs from it in two important respects: (i) the absence of an institutional commitment to price stability as the *overriding* objective of monetary policy; and (ii) considerable SNB independence in defining the range of price stability and conducting monetary policy when headline inflation lies outside this range. The planned revision of the SNB's mandate that would state "*The SNB conducts monetary policy in the overall interest of the country. It ensures price stability. In so doing, it takes account of developments in the economic cycle*" will strengthen the statutory commitment to price stability while allowing room for "disciplined discretion."

The system has worked well in the two years since its introduction. It has helped to focus the policy debate on maintaining medium-term price stability rather than on the interpretation of an unstable intermediate target (central bank money), ultimately making monetary policy more predictable. It has also helped to dispel misperceptions that the SNB had been targeting the franc/euro rate. Moreover, the switch from internal targets on bank reserves to a publicly announced interest rate target band has also enhanced the transparency of the SNB's operational procedures. There is, however, scope to improve transparency further by providing the public with more detail on the analytical underpinnings of the inflation forecast.

## B. Macroeconomic Sources of Risks to Financial Stability[14]

55. Substantial enterprise restructuring and fiscal consolidation in the 1990s have strengthened balance sheets of enterprises and have reduced Switzerland's vulnerability to macroeconomic shocks. The new constitutional amendment to balance the federal budget over the business cycle will reduce public debt in percent of GDP and increase the scope for the automatic stabilizers to operate; it will also allow greater flexibility in setting the policy mix. Moreover, the choice of the SNB to control inflation *over the medium term* rather than *headline* inflation (see Box 1) reduces the risk of policy-induced cycles. Nonetheless, the weakening macroeconomic environment could expose vulnerabilities in the enterprise sector that have escaped detection so far.

56. The Swiss economy has a strong international orientation. It features the fifth largest international currency in terms of turnover; it is populated by a disproportionately large (for its size) number of international enterprises (large banks and insurance companies have more employees and assets abroad than domestically); and it intermediates a large volume of international funds.[15] This international orientation has been a source of wealth but also of vulnerability to external financial shocks.

57. Having expanded rapidly their operations in the United States in the past few years, major Swiss financial institutions and multinationals have become increasingly more dependent on the outlook for the U.S. economy. Thus, a sharp deterioration of economic conditions in the United States could have implications for the quality of such exposures, and through spillover effects on the Swiss economy, on the quality of domestic assets as well.

58. The safe-haven qualities of Swiss financial assets make the franc vulnerable to sharp appreciation pressures during flight-to-quality episodes. There are some indications that safe haven related appreciation pressures have eased since the introduction of the euro as investors have a wider gamut of safe assets to choose from. Partly as a result, the volatility of the franc vis-à-vis the euro has been lower than the one vis-à-vis the Deutsche mark in earlier years. However, the risk of a sudden appreciation remains: in the aftermath of the September 11 terrorist attack, the franc appreciated 6 percent against the euro in one week, prompting an interest rate cut of ½ percentage which reversed half of the earlier appreciation.

59. Switzerland is an open economy with a large export-oriented sector (exports amount to almost 50 percent of GDP) and external shocks have a strong macroeconomic impact. The

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[14]See also Chapter IV on stress testing for an assessment of the relevance of the macro vulnerabilities and potential imbalances identified in this section for bank soundness.

[15]International intermediation in Switzerland is high in the sense that (i) foreign liabilities are high relative to foreign assets (excluding foreign exchange reserves), and (ii) the amounts intermediated are large in percent of GDP. The respective measures were 81 percent and 421 percent at end-2000 (SNB, Monthly Statistical Bulletin, Table M3).

economy is particularly vulnerable to business cycle conditions in the EU, the destination of 60 percent of Swiss exports, and the United States, which accounts for 12 percent of exports. Exchange rate gyrations have a strong impact on economic activity: a 10 percent nominal appreciation trims one percentage point off GDP according to the structural model of the SNB.

60. International financial markets currently face considerable uncertainty against the backdrop of a synchronized global economic slowdown. Since financial markets appear to price in a recovery in economic activity and earnings later in 2002, there is a risk that market expectations might be disappointed by the actual economic performance in the near term. A more subdued or delayed global recovery could lead to further asset price corrections and market volatility that could weaken the balance sheets of corporations, households, and particularly financial institutions.

61. A sharp correction in equity prices and increased volatility could affect the economy through a number of channels: exposures of financial institutions to equities and equity derivatives; loss of collateral values; declines in household wealth, including in the market value of pension schemes, which could depress consumption; and lower appetite for risk taking that could stall issuing activity, dry up enterprise liquidity and depress investment. Wealth effects on consumption are likely to be small owing to households' limited direct share ownership. The main channel is likely to be exposures of financial institutions and the impact would depend mostly on the adequacy of their risk management techniques.

## IV. Vulnerabilities and Soundness of the Financial System

### A. The Banking Sector

62. Overall, Swiss banks are characterized by good capitalization, asset quality, profitability, and liquidity (Table 3). As a system, they recovered well from the collapse in the property market and the recession in the early 1990s (Box 2), and from the losses suffered by the large banks during the Asian and Russian crises in the late 1990s. Helped by the improved macroeconomic condition of the second half of the 1990s, loan-loss provisioning and write-offs declined, and profitability improved, as measured by the return on assets (ROA), from 0.2 percent in 1996 to 0.9 percent in 2000 for the banking sector as a whole. Earnings performance was particularly good in the large banks and the Raiffeisen banks, followed by the regional banks and the cantonal banks. Regulatory capital levels increased from 10 percent at end-1995 to close to 13 percent at end-2000, before falling somewhat in 2001. Banks' liquidity position improved along with an increased reliance on sources other than customer deposits to finance credit. Overall, the system appears to be resilient to a variety of macroeconomic shocks and stress scenarios (Box 3). As noted above, however, significant differences remain both between segments and among institutions in each segment.

## Table 3. Switzerland: Banks' Financial Soundness Indicators, 1997–2001

(In percent, unless otherwise indicated)

| | Dec-97 | Dec-98 | Dec-99 | Dec-00 | Dec-01 |
|---|---|---|---|---|---|
| Capital adequacy | | | | | |
| Regulatory capital to risk-weighted assets | 10.7 | 11.4 | 11.4 | 12.8 | 11.8 |
| Tier 1 capital to risk-weighted assets | 6.5 | 7.2 | 7.9 | 9.2 | 12.0 |
| Capital (net worth) to assets | 4.6 | 4.1 | 4.2 | 5.5 | 5.2 |
| Asset quality | | | | | |
| Sectoral distribution of credit to total domestic credit | | | | | |
| Households | 54.1 | 55.6 | 56.1 | 57.2 | 58.1 |
| Mortgages | 47.7 | 49.5 | 49.8 | 50.4 | 52.0 |
| Primary sector | 1.0 | 0.9 | 0.9 | 0.8 | 0.8 |
| Secondary sector | 12.2 | 11.7 | 10.3 | 9.2 | 8.5 |
| Tertiary sector | 30.7 | 29.8 | 30.8 | 31.1 | 30.9 |
| Geographical distr. of claims to total external claims 1/ | | | | | |
| United States | 32.2 | 30.6 | 36.0 | 44.1 | 44.6 |
| United Kingdom | 20.0 | 36.5 | 25.5 | 22.3 | 19.2 |
| Japan | 9.1 | 8.9 | 7.5 | 6.6 | 6.7 |
| NPLs to gross loans | 6.2 | 5.2 | 4.6 | 3.8 | ... |
| Earnings and profitability | | | | | |
| ROA | 0.2 | 0.7 | 0.8 | 0.9 | ... |
| ROE | 5.0 | 17.1 | 18.8 | 18.2 | ... |
| Interest margin to gross income | 36.3 | 36.4 | 32.1 | 34.4 | ... |
| Trading and fee margin to gross income | 56.6 | 52.2 | 57.8 | 60.3 | ... |
| Personnel expenses to noninterest expenses | 46.2 | 47.9 | 52.4 | 50.8 | ... |
| Liquidity | | | | | |
| Liquid assets to total assets 2/ | 15.3 | 14.9 | 17.0 | 18.0 | 13.5 |
| Liquid assets to total short-term liabilities 2/ | 57.5 | 69.7 | 73.6 | 66.0 | 45.2 |
| Loans to customer deposits | 180.2 | 183.7 | 190.6 | 206.2 | ... |
| External exposure | | | | | |
| FX claims to total claims | 45.4 | 50.5 | 53.0 | 53.0 | 56.4 |
| FX loans to total loans | 23.6 | 27.4 | 23.8 | 31.6 | ... |
| FX assets to total assets | 50.3 | 56.3 | 58.2 | 56.1 | 58.3 |
| FX deposits to total deposits | 35.8 | 40.3 | 38.6 | 42.6 | 44.6 |

Sources: SNB; IMF, World Economic Outlook; figures for 2001 are preliminary.

1/ As of end-September 2001.
2/ Residual maturity of less than 30 days.

## Box 2. The Swiss Real Estate Crisis

In the 1980s, the Swiss real estate market boomed. Prices doubled, peaking in 1989 and remaining high until 1991, when they started to fall, until they rose again in 2000. The real estate crisis was part of a broader macroeconomic cycle. High macroeconomic growth in the 1980s was followed by recession in the 1990s, leading to high unemployment and impairing the health of the Swiss banking system.

The rise of real estate prices was reflected in the evolution of mortgages held by Swiss banks. The total amount of mortgages more than doubled in the 1980s, with mortgage growth even higher than that of real estate prices, reflecting the important role of the banking system in financing the real estate boom.

The most important factors that contributed to high mortgage financing are the following:

- Interest payment on mortgages and other forms of debt may be deducted from taxable income.
- Amortization is not mandatory for the majority of mortgages. Furthermore, Swiss banks at the time tolerated high lending limits. In the 1980s, 80 to 100 percent loan-to-value ratios were common.
- Historically, real and nominal mortgage rates have been very low in Switzerland. Until the late-1970s, this was partly explained by SNB interest rate controls on bank-issued medium-term notes and, indirectly, mortgage rates. In 1981 interest rate controls were abolished.
- Due to a shortage of land and high construction costs, real estate prices had risen at a rate of 10 percent per year on average since 1960 (see figure on the right, on the Swiss single-family home price index). This increase accelerated in the late 1980s. Swiss zoning laws further led to land shortages.

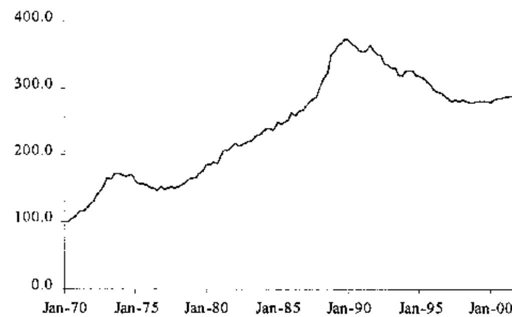


Figure: House price index, 1970-2001

*The banking crisis*

Banks ran into problems in 1991. On the asset side, the recession adversely affected the ability of bank customers to service their debts, and large sums had to be written off. On the liability side, banks lost deposits—as customers shifted to bond, equity and mutual fund investments—and started issuing medium-term notes and central mortgage bonds. The SFBC estimates that total losses incurred in 1991–96 amounted to SwF 42 billion, or nearly 8 percent of the total loan volume; the Raiffeisen banks, by contrast, only lost SwF 254 million, or less than 1 percent of total loan volume. At first sight, the large banks were the hardest hit, as they incurred about ¼ of total loan losses. However, due to their well-diversified portfolios, their profits were sufficient to cover these losses. By contrast, the regional and the cantonal banks suffered most.

In October 1991, the SFBC closed the Spar & Leihkasse Thun, a medium-size regional bank with assets of SwF 1.1 billion. This liquidation involved depositor losses and was followed by a regional banking crisis, resulting in merger or acquisition of nearly half of the 200 regional banks. In the event, the SFBC actively promoted a quick resolution of the crisis by taking four steps:

- Rapid closure of one insolvent bank. Since no bank was willing to take over the Spar & Leihkasse Thun, it was closed by the SFBC within two weeks.
- A task force on "banking structure" organized takeovers (especially by the large banks and the cantonal banks) for banks threatened by bankruptcy. The SFBC also cooperated with the Swiss Bankers Association (SBA) and the Swiss National Bank. About seven cases were settled through the task force.
- Banks that were likely to run into problems in the long run were encouraged to look for a stronger partner. As a result, about 20 banks merged.
- The SFBC helped to organize assistance through the Association of Regional Banks to cover loan losses.

The regional banking crisis was settled without financial assistance from the federal government. However, the cantonal banks of Berne, Solothurn, Geneva, and more recently Vaud had to resort to cantonal taxpayer money.

Source: Swiss authorities.

## Box 3. Summary of Results of Stress Testing and Scenario Analysis

The SNB, in consultation with staff, carried out a series of single risk factor exercises and scenario analyses.[1] The purpose of the exercise was to empirically test potential vulnerabilities in the Swiss banking system, based on global balance sheets. All analyses were carried out for each of three peer groups: large banking groups, cantonal banks, and regional banks. Due to data constraints, stress tests did not include Raiffeisen banks. These analyses are only estimates that need to be interpreted with great caution in light of their limitations and underlying assumptions.

Three main single risk factor tests were performed: (i) an increase in new provisioning and write-offs to levels experienced by the 5$^{th}$ worst affected percentile of banks within a peer group over the last decade accumulated over one and three years; (ii) a combination of a 30 percent drop in real estate prices with an 18 percent default rate in mortgage obligations over three years, and (iii) an interest rate shock resulting in an upward parallel shift in the yield curve by 200 basis points for (i) the Swiss franc only and (ii) all currencies.

The calibration of the joint mortgage default and real estate crash scenario was based on conservative adjustments to maximal variations in the relevant risk factors observed over the last decade. The calibration of the interest rate shock was in part judgmental and in part reflected the recommendations on the subject of the forthcoming new Basel Accord. In the case of the two credit risk tests, the shocks were directly reflected on banks' balance sheets, and the resulting losses compared with income and capital buffers. In the case of the third test, newly available bank-by-bank data on interest rate sensitivity of assets and liabilities were employed to assess the impact on the net present value of equity of each bank in the system.

The increase-in-provisioning exercise suggests that even if banks had to raise new provisions and write-off loans at levels seen by the worst affected banks in the early 1990s, none of the banks analyzed would have to use any part of their required regulatory capital. The default/real estate and interest rate in the banking book exercises point to similar conclusions, although an upward parallel shift in interest rates appears, on average, to benefit the regional banks mostly due to their greater reliance on long-term financing through mortgage-backed bonds and the fact that the majority of their mortgages are variable-rate ones.

Market risk stress tests were supplemented by looking at the results of the large banks' internal models, with a view to capturing trading book and off-balance sheet exposures to changes in interest rates, exchange rates, and equity prices. Model results showed resilience to interest rate and FX shocks, although the large banks would be somewhat vulnerable to a further drop in global equity prices. However, large off-balance sheet exposures made it hard to fully assess vulnerability to shocks from international financial markets.

In addition to single risk factor tests, the impact of developments in the Swiss and world economy on new credit and interest rate risk was considered under two scenarios: (i) a world recession,[2] resulting in a decline in Swiss GDP growth to 1.5 percent in 2001, -2.3 percent in 2002, -0.5 percent in 2003, and 2.8 percent in 2004, and (ii) a nominal effective appreciation of the Swiss franc of 10 percent, effected through an appreciation of the franc vis-à-vis the euro and an appreciation of the euro vis-à-vis the dollar in end-2002.

The analysis was performed by simulating the response of macroeconomic variables to the two scenarios using the SNB structural macro-model. The impact of changes in these variables relative to a benchmark (a mild recession) scenario on interest rates risk (in the banking book) and provisioning levels was assessed, in the latter case by using a reduced form regression of new provisioning levels on four economic variables. The results suggest, as expected, that a world recession could lead to substantial credit- and interest rate-related losses, with the former being more significant than the latter. As a result, significant parts of banks' excess capital would be depleted over a three-year period, but required regulatory capital of the large and cantonal banks would remain intact. As expected, banks would face greater pressure in the event of the significantly more severe combined shock scenario. Even in these extreme circumstances, however, the large banks and the cantonal banks would have sufficient capital to withstand the shock without having to use any part of their required capital. This is not the case for the regional banks due to their relatively greater sensitivity to interest rate risk, although no allowance was made for income from continuing operations and behavioral responses.

[1] Staff wishes to express its appreciation to its counterparts in the SNB and SFBC for their efforts in preparing the data and carrying out this analysis in cooperation with mission members.

[2] World activity drops from a trend of 3.5 percent to .8 percent in the first year, -1.6 in the second, and to 3.1 in the third.

63. A natural starting point for analyzing the implications of the activities of Swiss banks for the stability of the financial system is an evaluation of its structural characteristics. With its two-tiered nature, the question arises whether this structure constitutes a stabilizing element for the domestic Swiss financial system, or whether it has the potential of being destabilizing. Four factors will likely determine the nature of potential stability implications: (i) the diversification effects based on the correlations between the different business lines and market activities; (ii) the size of the institutions' capital base relative to potential losses; (iii) the quality of their risk management systems; and (iv) the vigilance of financial supervision. To what extent disturbances in global markets may affect the Swiss financial system also hinges on how the large institutions would respond to global market distress, for instance, by reallocating capital or altering their risk appetite and business strategies.

**The two large banking groups—Credit Suisse and UBS**

64. CSG and UBS benefited from the favorable developments in global markets in the past few years. After experiencing losses in 1996 (SwF 2.7 billion) and in 1997 (SwF 0.7 billion) in the aftermath of the Swiss real estate and the East Asian crises, profitability improved despite setbacks in 1998 related to Long-Term Capital Management (LTCM) and the Russian default. In 2000, UBS and CSG had returns on equity (ROE) of 21.5 percent and 17.7 percent, respectively.

65. Despite the considerable strengths of CSG and UBS, their international presence and the shift toward financial markets activities inherently carry risks and link the Swiss financial system increasingly closely to conditions in international markets. Global asset price shocks could therefore pose significant risks to the financial health of the large banks. These risks could arise not only directly from asset price drops but also as a result of a potential decline in securities turnover, underwriting, and merger and acquisition activity. These risks have been evident in recent months as fee and commission revenues have come under substantial pressure and cost-cutting measures have only been partly effective in bringing the cost base in line with lower revenues. As a result, profitability deteriorated sharply in 2001 against the backdrop of a challenging global capital market environment and worldwide recession. Despite cost cutting efforts, particularly in investment banking and capital market operations, CSG and UBS saw their net profits decline by 73 percent (to SwF 1.6 billion) and 36 percent (to SwF 5.0 billion), respectively, in 2001 relative to 2000.[16] Capital adequacy, however, remained at comfortable levels. Stress tests indicate that the large banks could be vulnerable to a deep world recession stress scenario (see Box 3).[17] An extreme recession, coupled with a Swiss franc appreciation, could lead to substantial losses and consequential decline in capital. However, the banks would continue to meet SFBC's minimum capital requirements.

[16] See www.credit-suisse.com and www.ubs.com.

[17] The staff's stress testing exercise did not evaluate off-balance sheet positions. These, however, are regularly monitored by banks and supervisors.

66. The close interdependence among global financial players and their operational complexity, which grows with the importance of market-sensitive activities (such as over-the-counter (OTC) derivatives), complicates an external assessment of risk exposures. Although the risk management systems of theses institutions are state-of-the-art, and accounting and disclosure standards are mostly based on U.S. and U.K. rules, inherent limitations imply a significant element of residual uncertainty, in particular—but not exclusively—with regard to off-balance sheet exposures.[18] Even with the best systems unexpected risks could remain undetected. Failure to adequately identify and manage any of these risks may result not only in financial loss but also in loss of reputation—a key asset of Swiss banks.

67. Like many other large global banking organizations, CSG and UBS also face the challenge of deciding to what extent it is prudent to use their considerable balance sheet resources to support and attract investment banking business, for example, through bridge loans and back-up credit facilities. Recently, both UBS and CSG have adopted business strategies to strengthen their onshore private banking activities to compensate for the declining trend in offshore banking from which they have traditionally benefited.[19] But these strategies are also fraught with risks in the harsher competitive environment for private banking, particularly when costly acquisitions are needed to establish an onshore presence (notably in the EU).

68. The international diversification of the large banking groups may constitute a shock absorber for the Swiss system. Their diversified international and market activities could offset domestic disturbances to the extent that they are less than perfectly correlated with domestic activities, and their large capital base (relative to the size of the domestic system) could provide a cushion against domestic shocks. For example, the large banks were able to weather the real estate crises of the early 1990s better than the cantonal and regional banks, despite incurring three quarters of total loan losses (see Box 2). Furthermore, their large trading books can, in principle, be adjusted quickly to market conditions, and the assets of the large banks (notably in their investment banking units) tend to be more liquid and marketable than standard banking assets, suggesting that liquidity problems originating in Switzerland may be less of a concern.

69. On the other hand, the large banks could spread global turbulence to Switzerland. Turbulence in international financial markets is typically associated with higher correlation in asset prices and markets, which decreases global diversification benefits. For example, losses on global markets could prompt the institutions to rebalance their portfolios in ways that might adversely affect the supply of lending and other banking services within

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[18]For example, both groups have to file Form 20-F with the U.S. SEC, and present consolidated balance sheet and income statements based on U.S. GAAP.

[19]At end-2000, UBS, the largest asset manager in the world, and CSG had assets under management of SwF 2.5 trillion and SwF 1.4 trillion, respectively.

Switzerland. Moreover, the two large banks are closely integrated into the interdependent web among large global financial institutions. These global players are not only linked through direct interbank exposures and OTC market counterparty exposures, but also through trading, clearing, and settlement relationships and as a result of correlated exposures in their trading portfolios. A shock that would threaten one of the large Swiss institutions (or both at the same time) could create major dislocations. The risk of international shocks being transferred to the Swiss banking system may be magnified by the large banks' major involvement in the daily settlement of FX transactions. Given the complexity of the large institutions and the sophistication of their market operations, the large banks are also exposed to potential operational problems emanating from events outside Switzerland.

70. Ultimately, whether the large banks will be able to act as shock absorbers and whether the other banks will likely withstand domestic shocks on their own will depend on the strength of three lines of defense: the quality of their risk management and corporate governance (Box 4), effective regulation and supervision, and overall systemic stability surveillance and considerations, including actions by the SNB as lender-of-last-resort.

**Other banks**

71. The relatively strong market position of cantonal banks has been helped by exemption from corporate taxes, lower minimum capital requirements (7 instead of 8 percent), and cantonal guarantees to all, or some, of the banks' liabilities. However, profitability has been below average, in part because of their local focus and obligations to their local communities, and in part as a result of remaining asset quality problems in some cantonal banks—making them vulnerable to further credit risk shocks (see Box 3). Moreover, selected cantonal banks have been losing deposits to Raiffeisen banks,[20] and since 1999 have substantially increased their borrowing in the interbank market (Figure 2), making their liability base more volatile.[21] While cantonal banks remain a vital element of the Swiss strategy to ensure sufficiently diverse local financial markets, creating a level playing field for these institutions by phasing out their privileges would strengthen incentives for efficient management and prudent risk behavior.

72. Some cantonal banks still suffer from the effects of the Swiss real estate crisis, and, unlike for private sector banks, there is little scope for mergers. While it may well be possible for cantonal governments to sell their ownership stakes to other banks, or to liquidate banks, experience shows that they will find it unpopular to reduce their bank ownership.[22]

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[20]Cantonal banks' customer deposits cover about 40 percent of loans, down from 47 percent in 1997. Mortgage and other bonds have covered on average 32 percent of credit. Net interbank borrowing covered over 5 percent of credit, up from net interbank lending in 1997.

[21]The SNB and SFBC have launched a project to monitor the interbank market more closely.

[22]Privatization proposals put forward in recent years have been rejected by the electorate.

## Box 4. Risk Management at Swiss Banks

The lessons from the domestic crisis in the early 1990s led most Swiss banks to improve risk management techniques. While the smaller banks focused on mortgage books, the large Swiss banks—further spurred by the Asian and Russian crises in 1997–98—developed sophisticated risk management systems across business units.

Improvements in the risk management of mortgage books were largely achieved by lowering loan-to-value (LTV) ratios and gradually improving the credit quality distribution of borrowers. Increasingly, internal rating systems that assess borrower credit quality have been used for this purpose.

The large banking groups use similar risk management practices. For instance, large banks—and even a few of the smaller banks—apply Value-at-Risk (VaR) techniques to assess market risks in their trading books under normal market conditions. A number of supplementary tools are used to assess exposure limits.[1] These include, among others, limits based on maximum value VaRs over prescribed historical periods, limits designed to prevent single borrower, sectoral, regional and country concentrations, and 'stress loss' limits. Banks use single risk factor tests and scenario analyses to assess 'stress losses' in both their trading and banking books. Various single risk factor tests are run across different exposure classes and need not be economically consistent with one another.[2] One of the large banks also employs a number of standardized macroeconomic scenarios where economic imbalances or external shocks lead to internally consistent changes in risk factors.

Banks' use of stress tests and scenario analysis varies. The minority of institutions interviewed by the mission use them to set exposure limits for certain asset classes and to adjust their portfolios. The majority uses them mostly as 'thinking tools' and to communicate to management potential vulnerabilities in a transparent way: they do not—at least not automatically—adjust their portfolios in response to stress test results, unless these results suggest that there is a plausible likelihood that solvency could be threatened.[3]

There are also a number of important risks that banks are aware of but—given the current state of the art—are difficult or impossible to quantify. Primary examples are operational and reputational risk, which are particularly important for Swiss institutions that have enjoyed traditionally an excellent reputation for professionalism and discretion around the world. A series of operational failures threatening the reputation of one or more Swiss institutions, for instance by casting doubt on the integrity of staff and the adequacy of internal processes, could have serious consequences for Switzerland's reputation as a safe banking center. Spurred in part by recommendations in the proposed new Basel Accord, a number of banks are expending efforts on trying to quantify operational risks. Risk quantification, however, even if it were technically feasible, is not the same as risk management. The most effective way to manage operational risk, as one of the banks pointed out, is to set-up internal controls and the right incentive structures for staff—for instance, by remunerating personnel on the basis of risk-adjusted, rather than unadjusted, contributions to profitability.

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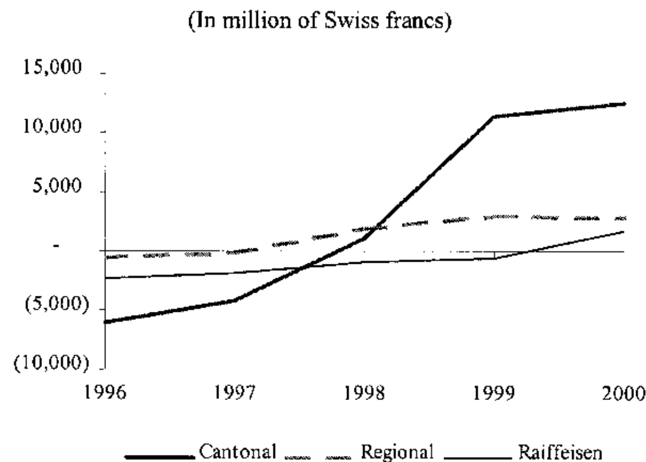
[1] VaR techniques are commonly associated with the measurements of market risk, while VaR-based "economic risk capital" techniques are used to capture credit risk.

[2] For instance, the loss associated with a "stress" appreciation of the Swiss franc could be considered for one risk class, alongside the loss associated with a "stress" tightening of Swiss franc interest rates for another.

[3] The underlying assumption is that banks can easily rebalance their portfolios in response to changes in the environment. Notably, however, situations might arise where the simultaneous unwinding of similar exposures across large banks can potentially lead to liquidity squeezes and more difficult—or costly—rebalancing of positions.

Figure 2. Banks' Net Interbank Borrowing

(In million of Swiss francs)




73. The main challenges for regional and Raiffeisen banks are related to the need to achieve economies of scale, and to reduce portfolio concentration in mortgages (ranging from 65 percent for regional banks to 76 percent for Raiffeisen banks), which makes them vulnerable to a downturn in the real estate market. Both regional and Raiffeisen banks are monitoring their real estate exposures closely, and in response to the banking crisis of the early-1990s, have adopted more conservative credit policies. While asset quality for Raiffeisen banks is currently good, stress tests show that regional banks remain exposed to a drop in real estate prices—partly due to lending at higher loan-to-value (LTV) ratios—and would be affected significantly by a deep economic recession (see Box 3).

74. Concentration pressures in the smaller bank segments have been visible for some time. Yet these pressures face obstacles because small banks are traditionally community-based and highly independent. Nonetheless, most small banks have been organizing themselves around umbrella organizations that centrally provide high-fixed-cost infrastructure such as information technology (including for e-banking) and risk management. Cost-cutting through mergers, however, is likely to remain a priority.

75. Growth in the domestic private banking segment has been fuelled by a sustained flow of nonresidents' funds, facilitated by the comparative advantages enjoyed by Swiss banks in terms of professionalism, reliability, and client confidentiality.[23] Private banks derive two-

[23]The Swiss professional secrecy requirements are based on the concept of confidentiality in contractual relations and privacy protection rules (Article 47 of the Federal Law on Banks and Savings Banks and Article 43 of the Federal Law on Stock Exchanges and Trading in Securities). Violations of professional secrecy are sanctioned by imprisonment or fine. However, professional secrecy does not apply if information must be provided to the authorities and courts as specified by law, such as in the case of anti-money laundering.

thirds of their income from fees, and have above average profitability and operational efficiency—14 percent of global earnings of Swiss banks in 2000. Their share of the private banking market (as roughly proxied by off-balance sheet fiduciary transactions) is 23 percent. Recently, the Swiss private banking sector has been faced with increasing competition from foreign onshore financial services providers, which underscores the importance of maintaining its professional reputation.

76. Foreign banks have been mostly involved in the private banking business, where, as already noted, they hold a significant market share. They benefit to a certain extent from the Swiss banking reputation and business image, while not representing by themselves a significant source of instability for the Swiss banking system.

77. The great importance of the large banks for the stability of the Swiss system as a whole suggests that the authorities could develop further tools and processes to assess their vulnerability to a greater range of risks from a systemic viewpoint. The complexity of the large banks' businesses and their substantial activities overseas, however, imply that it would not be easy to perform comprehensive stability analysis. One possible way ahead is to utilize for systemic surveillance purposes information on stress tests run by individual banks that is already available to the SFBC.[24] An additional tool would be to ask banks to run standardized stress tests, on an ad hoc basis. Depending on the type of vulnerability the authorities are interested in validating, these standardized tests could be run not only for the large banks but also for sub-samples of the smaller ones. Although the results would not be strictly comparable—given that different banks may use different asset pricing methods—these exercises could give an indication of vulnerabilities across the system.

## B. Securities Markets and Nonbank Financial Intermediaries

### Securities markets and intermediaries

78. Financial markets in Switzerland are relatively deep and liquid. Market capitalization of the Swiss stock market, equivalent to more than 200 percent of annual GDP, is large by international standards, and the repo market is highly liquid because the SNB uses repos as its primary monetary policy instrument and adjusts liquidity daily. The trend toward repo transactions in the money market has, moreover, reduced the counterparty credit exposures among financial institutions. Another attractive feature of the Swiss money, equity, bond, and warrants markets is the effective and reliable market infrastructure, which includes fully integrated electronic trading, clearing and settlement systems in some market segments.

79. The close cooperation between the SWX and FXs, such as the 1998 merger that formed Eurex (a derivatives exchange) and the recent joint venture that created virt-x (a securities exchange), has enhanced market liquidity. In particular, it has reduced cross-border clearing and settlement costs and, more generally, has facilitated market access for foreign

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[24] The SFBC is already in the process of collecting these data in a more systematic way.

institutions. It has yielded the added benefit of directly linking key Swiss financial markets to the EU financial system. Foreign joint ventures also allow Switzerland to retain a stake in financial markets that otherwise may migrate abroad as part of the general trend toward centralizing securities trading in only a few global financial centers. Exchanges such as Eurex and virt-x, which span different jurisdictions, can, however, create complex coordination tasks for supervisors to ensure seamless supervision and effective market surveillance.

80. In the past few years, equity funds and "allocation funds" have rapidly gained market share in the investment fund industry. Nonetheless, systemic risks for the Swiss financial sector stemming from the investment fund industry are relatively small for two reasons. First, investment funds are maturity-balanced and claims on the funds, of course, vary with the value of the underlying assets. Therefore liquidity problems and solvency pressures do not arise in case of asset price declines. Second, as explained above, the bulk of investment funds sold in Switzerland are managed by entities located abroad, mostly in Luxembourg.

**Insurance and reinsurance**

81. Some Swiss companies rank among the major suppliers of insurance throughout Europe—either directly or through subsidiary members of a number of conglomerate groups. For some of these organizations, fully one-half of their premiums come from outside Switzerland. The management of Swiss insurance companies shares the belief that there remains little opportunity for growth in the domestic insurance market. In the area of non-life insurance, they generally speak of a "saturated" market. Growth potential in the life insurance area is also regarded as limited although there may still be some opportunities for growth from the pension business. With this as background, companies have been exploring the opportunity for selling policies in other countries and have been expanding their operations through acquisition abroad. The United States is regarded as an area with potential for further development for Swiss companies by means of acquisition.

82. The insurance industry in Switzerland has a long history of strong performance. There has not been an insurance company failure in over 100 years, and large companies appear to have focused on risk management practices. Switzerland has adopted and mandated EU solvency standards. Companies appear to manage their affairs so as to exceed minimum statutory solvency requirements by a comfortable margin. Large companies are very sensitive to rating agency assessments, which are often more demanding than statutory requirements. Statistics provided by the FOPI indicate that the net worth of Swiss life insurance companies stood at 12.0 percent of premiums at the end of the year 2000, as compared to 6.7 percent at the end of 1995. For non-life insurance, net worth amounted to 48.2 percent of premiums at the end of 2000, little changed from the level at the end of 1995. These are relatively high ratios when compared to other countries; something closer to 35 percent may be more common for non-life insurance in other Organization for Economic Cooperation and Development countries, for example. Thus Swiss companies can be said to be well capitalized.

83. Events of the recent past and in particular the September 11 terrorist attacks in the United States have presented important challenges for the insurance industry worldwide. In general, most Swiss insurance companies do not expect to suffer major losses from the property and liability claims that will arise from the incident, although Swiss Reinsurance Company will bear heavy claims due to its role as one of the world's largest reinsurance companies.

84. Of greater relevance for the financial health of insurance companies has been the fall in values of securities that had preceded and was briefly aggravated at the time of the attacks. Companies have seen important reductions in the value of their security portfolios, which will translate in losses once portfolios are marked to market. Major Swiss companies had previously introduced risk management techniques to assess their capacity to absorb potential shocks with an impact similar to that of the terrorist attacks and of the fall in asset values. The process involves the development of internal capital requirements that each company will maintain. These internal requirements usually exceed those mandated by the statutory solvency rules.

85. The participation in the second pillar of the pension system is a major activity for the life insurance industry. Over SwF 100 billion of pension assets are managed by the life industry. This portfolio can be a source of stress in the near future because of declining asset values. By virtue of the pension legislation, companies must credit 4 percent interest to the funds that they hold on behalf of the individual clients each year. In many cases, this guarantee exceeds the current rate of investment earnings on the supporting assets and companies may be faced with special requirements for reserve strengthening or additional capital.

**Pensions**

86. While overall the Swiss pension system compares positively with most other systems around the world, some weaknesses remain. Investment performance by pension funds has been an issue for some time. In the second half of the 1990s, Swiss pension fund returns were low by international comparison, due to conservative investment policies and asset valuation rules that discouraged investments in equities. Nonetheless, in a bullish investment environment, overall funds easily surpassed the legally mandated 4 percent minimum rate of return. However, in the current environment, pension funds (and insurance companies managing those funds) will find it difficult to meet the minimum rate. Despite the lack of official statistics,[25] there is some evidence that returns in 2000–2001 were barely positive.

87. The viability of some pension funds may also by threatened by the high fixed annuity conversion factor (7.2 percent), which has remained unchanged since 1985 despite considerable fluctuations in interest rates and a gradual increase in longevity. Legal

[25]The Federal Office of Statistics, with the assistance of the FOSI, collects pension statistics every two years, and publishes them with a two-year delay; the last year available is 2000.

amendments are currently being discussed to lower the conversion factor while retaining the amount of pension benefits.

88. Vulnerabilities in the system are also evidenced by the increasing recourse to the Guarantee Fund—an insurance fund established as a foundation and supervised by the FOSI. The Guarantee Fund, which is financed by fees charged to covered pension funds, insures losses related to financial difficulties by employers (the vast majority of claims) as well as insolvency by the foundations themselves.[26] The law grants the Guarantee Fund flexibility in raising fees in response to an increase in claims, and this faculty has been used in recent years to ensure the solvency of the Fund.

89. Pension plans are organized through special purpose legal entities ("foundations"). Among the characteristics of the pension foundations is the equal representation of workers and employers in the governing board. In the case of a pension foundation serving several employers, for example, the governing board would have representatives from the workers as well as the management of each of the participating firms. It is important to note that the foundation is a legal entity entirely separate from the employer.

## C. Financial System Infrastructure

**Payment and securities settlement systems**

90. The SIC observes all of the nine applicable Core Principles for Systemically Important Payment Systems. The SNB fulfills all three of the applicable central bank responsibilities relevant for the payment system broadly defined. No vulnerabilities within the SIC system itself have been identified, and indeed the system achieves the principal reason for which it was designed, namely the substantial reduction of systemic risk in the interbank payment mechanism. If it should prove vulnerable in the future, it is most likely that the vulnerability will stem from how the SIC fits into the global arrangements for large-value transfers.

91. Both the interbank payment system and the securities clearing and settlement structures in Switzerland are thus sound. One area that merits caution is the FX settlement, where the average daily volume is substantial and where Swiss banks rely directly, or indirectly via correspondents, on the soundness of major U.S. payment mechanisms and their participating banks. The experience of September 11—when the settlements in the United States of dollar transfers to and from a Swiss bank failed,[27] creating a same-day dollar liquidity shortage for that bank—indicates the sort of contingencies that could arise from operational failures in the future. These risks need to be examined carefully, particularly since the major global banks plan to move to CLS for most FX transactions during the

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[26]Cases of insolvency by pension foundations have been rare, but are usually more significant in terms of outlays by the Guarantee Fund.

[27]The Swiss bank's clearing bank in New York suffered damage during the attacks.

second half of 2002. Settlement problems similar to those of September 11 could threaten the necessary settlement sequences of CLS. Contingency management arrangements have been put in place and the future arrangements are being studied by the SNB with a view to ensuring that they will not pose a systemic threat to the Swiss payment system and institutions.

**Crisis management and safety nets**

92. Current initiatives to introduce special exit arrangements for banks and securities firms, and to strengthen deposit protection, are welcome. Proposed legislative changes, expected to be implemented over the next few years, will give the SFBC greater powers to intervene, restructure, and liquidate banks. In addition, as a way of broadening the safety net, deposit protection should, as has been proposed, become mandatory.

93. The SNB provides a standing credit facility (a Lombard facility) to financial institutions facing unforeseen liquidity shortages. Within this facility, high-quality collateral must be pre-pledged. Currently, collateral arrangements are fairly restrictive, but proposed revisions to the SNB law would provide additional flexibility for eligible collateral, which would no longer be specified in the law.

94. A further need could arise if one of the major financial groups were to experience FX liquidity problems. In response to the dollar settlement failure in New York on September 11 (see above), sizeable dollar shortages at one Swiss bank were addressed through liquidity assistance from the New York Federal Reserve. On that occasion, the Bank of England and the ECB, but not the SNB, established on a temporary basis 30-day swap arrangements with the Federal Reserve.[28] The SNB was not approached for dollar liquidity and, therefore, felt no need on this occasion to set up a swap facility. The SNB is now taking steps to be in a position to swiftly activate a swap arrangement.

## D. Supervisory Issues

95. Recently, an expert committee on financial market supervision proposed reforms of the supervisory structure. The committee's report (known as the Zufferey Report, after its Chairman) recommended in particular that, in the light of the growth of financial conglomerates, the SFBC and the FOPI be merged, and that all asset managers and brokers be supervised (see below). The government appointed a new expert commission in November 2001 with responsibilities for drafting legislation on the creation of a unified supervisory authority. This process could take up to two years. Although integration involves costs in terms of distracting the agencies' management from their current tasks, a single supervisory authority would have several advantages, for example by improving consolidated supervision of conglomerates, and by strengthening supervisory resources, budgetary autonomy, and supervisory authority in the face of very large and powerful financial

[28]The SNB had such an arrangement until it was terminated three years ago.

institutions. In several countries the mandate of the unified regulator also includes private pension funds. Such a course could well be appropriate in Switzerland.

96. Whether or not a single supervisory authority is established, it is important that supervisors have full operational and budgetary independence, and are fully accountable. Supervisory agencies should be able to recruit and retain sufficient numbers of competent staff, which would be aided if they could offer a more generous compensation and not be subject to the restrictions on compensation applied to the regular public service. At present it is possible to hire "experts" at higher salaries, subject to special approval. However, it would be preferable if the general compensation structure recognized the special competencies required by professional staff of supervisory agencies.

**Banking**

97. A working group chaired by Professor Nobel has recently examined the "dualistic" supervisory system. It noted that the authorities' policy of making the most effective use of available resources (in banks' internal audit departments, external audit firms, and the SFBC) is clearly the most practical way of proceeding—a view shared by staff. The group recommended that the present system be retained, but that the work be more closely defined by the SFBC and aligned with bank risks and business activities of the banks. A second group is now revising the regulations, and final proposals are due in 2002–03. Along with the recommendations in the Nobel report, staff supports a more formal quality assurance program—to strengthen the existing informal quality assurance mechanisms and other safeguards (see Chapter II.D), and to ensure consistent performance by external auditors. The more routine use of "special audits" and on-site visits not only to the two large banking groups might also enhance the SFBC's effectiveness.

98. The Swissair collapse has revealed a particular gap in the supervisory framework. While banks have the exclusive right to take deposits, the Banking Act does permit exceptions. This facility has been used to allow nonfinancial companies to accept deposits on their own balance sheet from employees and retired employees. The recent collapse of Swissair with employee deposits of SwF 110 million has demonstrated the danger of this loophole. The loophole should be closed.[29]

99. The assessment of the SFBC's compliance with the Basel Core Principles (BCP) found that Switzerland is compliant with the BCP. The most significant observations in the assessment are as follows:

- The dualistic system, as enhanced for the two major groups, has proven an effective means of mobilizing far more extensive resources, both at home and abroad. However, the advent of the new Basel Capital Accord will demand additional resources. Further expansion of the SFBC's staff to enable it to respond more rapidly

[29]Legal arrangements allowing these firms to accept deposits are currently being reviewed.

to developments in supervised institutions and be less dependent on annual audit reports would be desirable.

- The SFBC has always had considerable operational independence, but it is, as a government agency, subject to central government budgetary control despite the fact that its costs are covered entirely by fees charged to the institutions under its supervision. Budgetary independence would be recommendable.

- While the SFBC has available significant sanctions, these do not include the ability to levy financial penalties and, more importantly, to impose sanctions publicly. Extension of the sanctioning power of the SFBC to give it explicit powers to name offenders, together with the direct imposition of financial penalties, would be desirable.

**Securities**

100. Exchanges that span different jurisdictions, such as Eurex and virt-x, can create complex coordination tasks for supervisors. Cross-border joint ventures must therefore be carefully structured in such a way that trading activities are seamlessly supervised and market surveillance is complete regardless of the home country of the exchange participants and the listing authority for the financial instruments.

101. The Swiss securities regulations are largely in compliance with the IOSCO Objectives and Principles of Securities Regulation. However, there are a few areas, where the implementation appears to be incomplete. The legislative framework, particularly on the budgetary independence and staffing of the regulator, enforcement powers, and cooperation with domestic or foreign counterparts, needs strengthening to be fully in line with IOSCO standards. Moreover, as already mentioned, some areas of the securities industry, for example asset managers and the primary market, should be covered under SFBC jurisdiction.

- Rules on domestic and cross-border cooperation and exchange of confidential information are not fully in line with international standards. At the domestic level, the law does not cover information exchange between agencies, although this is envisaged in current draft legislation. At the international level, the IOSCO Principles require that administrative cooperation should be permitted without restrictions, including the communication of confidential information about customers' accounts. Swiss law, however, sets certain conditions. Notably, the SFBC can share confidential information about a client's account with foreign regulators; if the client does not consent, the client may request a formal decision by the SFBC, which can be appealed to the Supreme Court. In criminal procedures, dual criminality requirements have to be met.

- Some regulations on conduct of business rules could be strengthened. Disclosure to clients of conflict of interest should be provided ex ante rather than ex post (once the transaction has been executed). The legislative framework on issuers could be

improved by strengthening the role of the regulator in requiring compliance with international accounting principles and rules on corporate governance.

- Supervision of investment firms could include examination of sales and business conduct; in-house supervisory staff may be more appropriate than external auditors for such inspections. Moreover, the direct sanctioning power of the SFBC could be extended by permitting a wider range of sanctions.

**Insurance**

102. In the review of compliance with the IAIS Core Principles, the FOPI was found to be observant or broadly observant of most principles.

- The insurance legislation is somewhat out of date and a revision is pending. The existing legislation does not deal with modern corporate governance ideas nor does it provide for any special authorities in the area of internal controls. The supervisor should have the authority to require proper measures to be taken by the company in this regard. The FOPI should also develop guidelines and standards for the promotion of best practices in the areas of internal controls and corporate governance.

- The supervisor lacks desired powers in relation to the control of changes in ownership and the application of fit and proper tests to owners and managers.

- Experience in other jurisdictions shows that it is important that market participants follow certain codes of conduct. The supervisor may want to issue general guidance on areas to be covered by ethical codes, for instance information to policy holders, treatment of customers, conflicts of interest, advice to customers, and similar issues, while the industry drafts more detailed guidelines for specific lines of business. Future plans will provide the FOPI with licensing responsibility for insurance agents, which should foster proper market conduct.

- Under existing rules, the FOPI is not authorized to share confidential information about supervised companies without the permission of the company itself. Thus, the FOPI is restricted in its ability to negotiate MOUs about the exchange of information with insurance supervisors in other jurisdictions, or with other Swiss financial supervisors. Reforms in these areas are desirable—both domestically, in view of the existence of complex bank-insurance conglomerates, and internationally, given the increasing expansion of Swiss insurance companies abroad. If Switzerland proceeds to integrate banking and insurance supervision (as discussed above), the exchange of information between banking and insurance supervisors should be facilitated.

- The FOPI should enhance its consumer protection activities and the monitoring of market conduct of insurance companies and intermediaries.

103. Under the leadership of the FOPI and with considerable collaboration from the trade association, new draft insurance legislation has been prepared. Changes proposed in the draft legislation would address some of the issues raised in the assessment of observance of Core Principles (CP). For example, it appears that the FOPI would be formally authorized to conduct fit and proper reviews of owners and managers when a license application is filed and when company management changes. The draft legislation would also enable agreements on information sharing with other financial sector supervisors. The adoption of the new draft insurance law should be accelerated.

104. The present draft legislation, however, does not require the FOPI's prior approval of changes in ownership of a company. Modern principles of corporate governance, including the designation of responsibilities of the board of directors for key policies, such as the investment policy and the risk management policy, are not reflected in the current draft.

**Pensions**

105. The system of pension funds oversight could be strengthened if supervision were assigned to a central office. This would ensure uniform standards. Moreover, as already mentioned, if the supervisory offices for banking and insurance were to be integrated, serious consideration should be given to also include pension supervision in that same office, due to the significant overlap between insurance and pensions.

106. The legislation stipulates a prudent management approach to investment of pension fund assets. Since a substantial portion of the assets of foundations are lodged with life insurance companies, the supervisory authorities for private insurance and private pensions have developed identical requirements for the proportionate composition of asset portfolios. Pension foundations may now invest up to 20 percent of their assets abroad.

107. Foundations may also lend or otherwise invest up to 20 percent of their assets with the employer who launched the foundation. These investments must be supported by an appropriate guarantees or collateral. One consequence of a foundation's authority to lend money to the employer is the risk that the bankruptcy of the employer could well result in losses for the foundation. Such losses would be covered by the insurance scheme for private pension foundations. Since losses have emerged in some cases, consideration should be given to disallowing this practice or at least to sharply curtailing it.

## ANTI-MONEY LAUNDERING ISSUES

### Legislative and institutional framework

108. The focus of the Swiss authorities on AML measures in the financial sector intensified in the 1990s. Money laundering and the failure to exercise due diligence in determining the beneficial owner in financial transactions became criminal offenses in 1990. The scope of predicate crimes for money laundering has recently been extended to include corruption both in Switzerland and abroad.

109. The legislative framework was significantly enhanced with the adoption of the Federal Law on the Prevention of Money Laundering in the Financial Sector (MLL), which entered into force in 1998. The law provides for the establishment of the Money Laundering Control Authority (MLCA), the Money Laundering Reporting Office (MROS), and SROs for financial intermediaries. For the banking and securities sector, more detailed provisions are set out in the SFBC 1998 Circular on the Guidelines Concerning the Combating and Prevention of Money Laundering, and in the SBA Agreement on the Swiss Banks' Code of Conduct with Regard to the Exercise of Due Diligence (Due Diligence Agreement), originally introduced in 1977 and revised, most recently, in 1998. For the insurance sector, the 1999 Ordinance of the FOPI on the Prevention of Money Laundering provides detailed rules.

110. The MLL applies to all financial intermediaries. Explicitly excluded from the scope of the MLL are tax-exempt occupational pension plans and persons providing services exclusively to such entities, and intermediaries that provide services exclusively to banks, investment fund managers, insurance companies, or securities dealers. The MLL specifies due diligence requirements, in particular the obligation to verify the identity of the contracting party prior to commencing business. In specified circumstances, the beneficial owner must be established, notably when there is doubt that the contracting party is the beneficial owner, the contracting party is a domiciliary company, or a significant cash transaction is undertaken. The MLL also provides for a reporting obligation for suspicious transactions. A financial intermediary who knows or has reasonable grounds to suspect that assets in a transaction are related to a criminal offense, constitute the proceeds of a crime, or are controlled by a criminal organization must notify the MROS without delay and block access to the funds, without informing the customer of such reporting and of the freezing of the assets.

111. The MLCA, established in 1998, reports to the Federal Finance Administration, part of the Federal Department of Finance. Its main function is to authorize and supervise under the MLL SROs and financial intermediaries that are not members of an SRO. The MLCA may request all information needed to perform its functions and may perform, either directly or through an audit firm, on-site inspections. The MROS, also established in 1998, reports to the Federal Office of Police, part of the Federal Department of Justice and Police. It serves as financial intelligence unit—evaluates suspicious transaction reports and investigates cases. If the MROS suspects that a criminal offense has been committed, or that assets constitute the proceeds of a crime or are at the disposal of a criminal organization, it shall report the suspicion to the competent criminal prosecution authorities. The MROS has discretion to advise a financial intermediary of the referral of a case to the criminal prosecution authorities.

112. The MLL provides for the establishment of SROs for prudentially unsupervised financial intermediaries. An SRO and its rules and regulations must be approved by the MLCA. The SRO assumes responsibility for supervising its members' compliance with AML measures. As of end-February 2002, 12 SROs had been approved, with a total membership reaching almost 6,000 financial intermediaries. Financial intermediaries not subject to prudential supervision and not members of an SRO must be authorized for money laundering purposes by the MLCA and are directly supervised by the MLCA. By end April 2002, the MLCA had granted 40 authorizations, and close to 300 applications were being processed.

**Assessment of the adequacy of the AML regime and practices**

113. The AML regime and practices on the prevention and detection of money laundering were assessed in the area of banking, insurance, and securities in accordance with the August 2001 draft AML Methodology Document (SM/01/258). Overall, staff found the Swiss AML regime in the financial supervisory area broadly in line with international best practice. It noted continued enhancements in the relevant legal and institutional framework against money laundering, including the application of AML rules to nonbank financial intermediaries in recent years. This has brought a large number of financial intermediaries, otherwise not subject to prudential supervision, under the scope of supervision for AML purposes.

114. Staff found the Swiss AML regime and practices in the banking supervisory area to be adequate and in line with the principles assessed under the AML Methodology Document. The MLL requires banks to comply with due diligence obligations. These include 'know your customer' rules that are enshrined in the SBA's Due Diligence Agreement. The agreement requires that customers be identified before a relationship is established or a large cash transaction is undertaken. Banks are required to have procedures in place so that any relationship with a customer who could be a 'politically exposed person' is the responsibility of a senior bank manager; suspicions must be reported to the MROS and access to the funds blocked. Bank secrecy is lifted for criminal investigations into money laundering, as for example in the Abacha case.[30]

115. The SFBC guidelines, which are enforceable, require banks to have the necessary operating procedures and training arrangements to enable them to comply with the legal obligations described above. Internal auditors are required to ensure that these arrangements operate satisfactorily. External auditors check for compliance with the law and SFBC circulars as part of their annual audit, and are required to report to the SFBC any noncompliance in this regard. Banks are expected to keep records of all suspicious transactions and investigations for up to five years. Banks must apply these rules in their Swiss offices as well as branches and subsidiaries abroad. The two large Swiss banks were part of a group of eleven international banks that developed and agreed to principles on global guidance for sound business conduct in international private banking (the *Wolfsberg Anti-Money Laundering Principles*).

[30]The SFBC released in 2000 a report on the "Abacha Funds at Swiss Banks," which investigates adherence of 19 banks in Switzerland to AML requirements.

116. The SFBC has a variety of powers available to enforce these requirements. It can reprimand the bank, make rulings to the extent to which management and directors meet 'fit and proper' requirements, require closure of noncompliant foreign offices or take stronger administrative action if necessary. Management and directors may be suspended and individuals may be liable to criminal prosecution. As a last resort, the SFBC may revoke the bank's license. The SBA also enforces the Due Diligence Agreement and has the authority to impose fines on its members for any contravention.

117. In the securities sector, broker-dealers are subject to the same identification and record keeping requirements applicable to banks. Individual asset managers, although not subject to full prudential supervision, do fall under the MLL and are subject to fit-and-proper tests, and must identify customers and report suspicious transactions. However, as securities regulators in charge of monitoring market integrity and prosecuting market abuse can play an important role in counteracting money laundering activities, the absence of full prudential supervision may create a potential vulnerability.

118. Overall, there is some room for further strengthening the supervisory role of the securities regulator regarding AML measures, including through strengthened cooperation with foreign regulators. Swiss law sets certain conditions on the provision of information on customer accounts. Notably, the SFBC can share confidential information about a client's account with foreign regulators; if the client does not consent, the client may request a formal decision by the SFBC, which can be appealed to the Supreme Court. In criminal procedures, dual criminality requirements have to be met.

119. For insurance, the AML regime and practices are broadly in line with the principles. The MLL defines intermediaries to include "...insurance institutions which underwrite life assurance directly or offer and distribute units in investment funds...." The FOPI has issued an ordinance to all life insurance companies outlining expectations with respect to AML efforts and has also distributed blank forms for reporting, including a prescribed form for reporting suspicious transactions. An SRO, formed to promote best practices and to assist in monitoring of compliance with the requirements of the MLL, has also issued a formal set of by-laws governing its application. The rules apply at present to life insurance companies but a number of non-life companies have voluntarily joined the SRO. The FOPI is considering extending the system to embrace all types of insurance companies.

120. Each life insurance company is to appoint a compliance officer—usually at the senior management level—with responsibilities for reporting transactions and also for organizing training programs for staff. Suspicious transactions are to be reported directly to the MROS by the compliance officer as soon as they are identified. A summary of all transactions reviewed during each calendar year is forwarded to the SRO, which in turn makes an annual report to the FOPI of its activities including a summary of these company reports. Practices related to internal controls and corporate governance are partly observed, and it is recommended that the FOPI develop guidelines and standards for the promotion of best practices by insurance companies in this area. It is also advisable that supervisory personnel or external auditors undertake more frequent on-site inspections of records maintained for AML purposes.

## SECTION II—OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains summary assessments of adherence to the major international standards and codes applicable to the financial sector. The assessments have helped to identify the extent to which the regulatory and supervisory frameworks have been adequate to address the potential risks in the financial system. They have also provided a source of priority areas for ongoing legislative revision, and recommendations for improved financial regulation and supervision in various areas.

Detailed assessments of standards were undertaken based on a collegial peer review process as part of the FSAP by Peter Hayward (IMF), Kathleen O'Brien (Office of the Comptroller of the Currency, United States), and Stefan Spamer (Bundesbank, Germany) for the *Basel Core Principles for Effective Banking Supervision*; Nicoletta Giusto (Commissione Nazionale per le Società e la Borsa (CONSOB), Italy) for the *IOSCO Objectives and Principles of Securities Regulation*; Donald McIsaac (World Bank) and Johan Altersten (Finansinspektionen, Sweden) for the *IAIS Insurance Core Principles*, James Dingle (Bank of Canada) on the *Core Principles for Systemically Important Payment Systems*, and Anastassios Gagales, Maike Luedersen, Marina Moretti (all IMF), and the sectoral experts on the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies*.

The Swiss authorities were requested to complete self-assessment questionnaires for each standard or code in advance of the mission. The questionnaires and self-assessments were made available to the peer group of experts in advance of the mission. During the mission, the responses to the questionnaire and self-assessments of compliance with the standards and principles were clarified and checked through subsequent discussion with the authorities and market participants in critical areas.

The Swiss systems of regulation and supervision are in general fully or largely compliant with international financial sector standards and codes. There remains room for further improvement, however, in a few areas. In particular, the assessments identified some weaknesses related to the power and independence of the regulators. The assessments of banking supervision, securities regulation, and insurance supervision, all identified the lack of budgetary independence, and weak information sharing arrangements among domestic agencies, as lacunae that could become sources of vulnerability in a stressful market environment. Some gaps also appear to remain in the institutional coverage of the regulatory framework, notably with regard to some individual asset managers, which are only regulated for AML purposes, and to nonfinancial companies, whose power to take deposits from employees should be withdrawn.

The Swiss authorities were largely aware of the areas where measures would be required to achieve full compliance with financial sector standards and codes. They indicated that in many instances the assessments helped foster the internal debate and generate momentum for reform. A number of revisions to the legislative framework are currently being prepared that will help to further improve the overall level of compliance.

# I. Basel Core Principles for Effective Banking Supervision

121. This section provides summary findings from the assessment of the BCP. The assessment is based on a review of documents made available in advance of the mission, and meetings with representatives of the SFBC, host country supervisors in the United States and United Kingdom, bankers, bankers' association representatives, and accountants.

122. The authorities' responses to the IMF questionnaire by the Swiss authorities, detailed information available on the SFBC's Internet website and the websites of the Swiss Bankers' Association (SBA), the Federal Department of Finance (FDF), KPMG Switzerland, and the two large Swiss banks, facilitated the initial drafting of this report. Key sources of information included the *Federal Law on Banks and Savings Banks* of November 8, 1934 (Banking Act), as amended through April 22, 1999, the Ordinance of the Swiss Federal Council on Banks and Savings Banks of May 17, 1972 (Banking Ordinance), as amended through October 4, 1999, other ordinances and SFBC Circulars and Guidelines, Codes, Conventions, and Agreements issued by the SBA. Implementing Swiss regulations, SFBC administrative notices and statutory instruments, audit and accounting guidelines, and the SFBC's Guidelines on *Financial Statement Reporting Requirements,* which provide instructions/guidance for periodic financial and prudential reports, were incorporated into the assessment process.

## A. Institutional and Macroprudential Setting

123. Switzerland has a highly developed, well-diversified, and overall robust financial system, which plays an important role in the domestic as well as the global economy. Banking is one of the prime industries in the Swiss economy in terms of employment and value added. In the last decade, bank activities have undergone change with reduction in bank savings accounts, increased investment funds, initiation of mortgage-backed securities, increased global custody, fiduciary business, derivatives and investment counseling, and asset management business. Swiss banks offer global consultancy services, primarily in private banking, which include tax, pension plan and inheritance counseling.

124. There were 375 banks licensed in Switzerland at end-2000. The two largest banks account for about 60 percent of total Swiss bank assets and deposits and dominate the banking system. The assessment tailored the principles to the Swiss market. Switzerland has a relatively unique banking sector, with a high market concentration by the two largest domestic banks, and a relatively low level of complex bank activities conducted in most other banks, which are primarily involved with mortgage banking activities or private banking and asset management.

125. The authority and responsibility of the SFBC in bank licensing and supervision are explicitly set out in the Banking Act and various ordinances, circulars and guidelines. All credit institutions are subject to supervision and regulation by the SFBC. The SFBC is not responsible for the supervision of insurance companies, insurance intermediaries, investment advisors, and industrial deposit-taking entities. Recent recommendations by an expert

working group include merging banking and securities, and insurance supervision into a single financial services supervisory authority.

## B. General Preconditions for Effective Banking Supervision

126. The SFBC and Swiss Government have achieved a high degree of implementation of the recommendations of the Basel Committee's reports. As a member of the Basle Committee, the Joint Forum, and several other international standards and principles-setting bodies, the SFBC participates in setting the standards for financial sector supervision and actively strives to implement them. Although not a member of the EU, Switzerland has incorporated many of the EU directives into its ordinances, guidelines and supervisory practices. Swiss legislation, SFBC ordinances and circulars, and/or SBA guidelines and circulars cover all the BCPs. Although the Banking Act is relatively general in some areas, the SFBC's implementation of the Banking Act through regulations and guidance to external auditors in their examination mandate reflects effective supervision.

127. The SFBC recently enhanced its supervisory process by establishing a separate Large Bank Supervision unit to oversee the two large Swiss banks, UBS and the CSG. The SFBC has also created a unit staffed with highly skilled staff for the assessment and validation of bank risk models. These two new units, focused primarily on the two large banks, have somewhat altered the traditional Swiss "indirect" supervision model. The changes allow the SFBC to better coordinate its supervisory activities for the two large banks with external auditors, bank management and foreign host supervisors. This approach shifts limited supervisory resources to the financial sector's greatest risk—the largest banks. The risk-based supervisory approach more fully integrates the SFBC's off-site analysis of these banks' prudential returns with the bank examinations performed by SFBC-licensed and approved external auditors. The new approach includes quarterly management meetings with the two institutions, semi-annual trilateral meetings between the SFBC and U.K. and U.S. supervisors, and annual trilateral meetings between the bank, its external auditor, and the SFBC.

128. The overall assessment of the peer review team is that Switzerland is in general fully compliant with the BCP, and in two cases (budgetary independence and banking activities not subject to SFBC supervision) largely compliant. Both cases are discussed in more detail in the summary assessment that follows. The SFBC relies heavily on the dualistic system of supervision whereby the on-site examinations are outsourced by the SFBC to approved and licensed external auditors. The supervisory process is enhanced by the self-regulatory activities of the industry via the SBA, which, together with the SFBC, issues guidance to the industry. This approach has generally been effective.

129. The SFBC will continue to be challenged by innovative licensing proposals (such as internet banks) and requests for approval of new business activities and increasingly complex investment products, the same issues being faced by supervisors in other financially developed countries. As banks expand or enter new businesses, supervisors need to remain vigilant in order to minimize potential problems in the industry. This may include a more

formalized system of supervision with more explicit supervisory directives incorporated into the Banking Act.

130. The SFBC is responding to recent regulatory initiatives put forth by various expert commissions and working groups to enhance the supervisory process.

- In December 1998, an expert commission on "Financial Market Supervision," chaired by Professor Zufferey, was created to analyze the strengths and weaknesses of the system of financial services supervision in Switzerland. In November 2000, the expert commission issued a report (the "Zufferey Report") recommending, among other things, that banking, securities, and insurance supervision be merged. Subsequent to the Fund mission, in November 2001, the Federal Council instituted another expert commission chaired by Prof. Zimmerli to put forward a legislative proposal for the creation of a unified financial supervisory authority.

- In May 1999, an expert commission was created to review the existing systems of bank reorganization and liquidation, and deposit insurance. In October 2000, the commission submitted its findings in a report along with a proposal for an amendment to the Banking Act to include specific bank exit rules, and the creation of a mandatory deposit insurance system.

- In February 2000, a working group, chaired by Professor Nobel, was created to analyze the dualistic concept of supervision. The group published its recommendations in December 2000. In March 2001, another working group on "Auditing and Supervision of Banks" was established to follow up on those recommendations, including strengthening safeguards in the use of external auditors.

- In December 2001, a parliamentary initiative asking to review the legal arrangements allowing nonfinancial companies to accept employee deposits was accepted.

131. While the team was aware of the work of the various commissions and working groups, the assessment of the BCPs was done based on the laws, policies and procedures in effect as of the start of the mission. This BCP assessment arrived at many of the same conclusions as those of the commissions and working groups and supports the various groups' recommendations.

## C. Summary Assessment

132. **Preconditions for effective banking supervision (CP 1):** The basic legal framework is contained in the Banking Act, Rules, Regulations and circulars issued pursuant to the Banking Act. These provide powers for the SFBC to supervise credit institutions, and permit the exchange of information with the FOPI. There appears to be a lack of administrative independence with regard to the SFBC's budget, which is incorporated into the Finance Ministry's budget. The SFBC has historically operated at minimal supervisory staff levels but the three-tier supervisory process—internal controls, external audit, and supervision—has

so far limited the need for more staff. Additional staff, however, may be needed following implementation of the pending revised Basel Capital Accord. Moreover, turnover is high at 18 percent and as the SFBC begins to get more directly involved in on-site supervision of the largest two banks, turnover needs to be addressed (possibly through compensation and work-life issues).

133. **Licensing and Structure (CPs 2–5):** The Banking Act defines clearly the term "Bank" and the permissible activities. In implementing the Banking Act, the Federal Council granted exceptions to nonfinancial companies, which can accept employee deposits for reinvestment into the firm without being considered as a bank and be subject to SFBC supervision. This exception, in place since 1994, premised on the strength of Swiss companies and presumed depositor protection. The recent Swissair collapse, however, including over SwF 100 million in employee deposits, highlighted the inherent risks of such nonregulated deposits.

134. In the licensing process, the applicant has to inform the SFBC about all relevant information (strategic and operational plan, fitness and propriety of management, suitability of shareholders, and similar data). Under the Banking Act the SFBC has the authority to grant authorization for acquisitions or increases of qualifying holdings. Investments in companies that are not credit institutions, financial institutions, or ancillary banking undertakings, are restricted to 15 percent of the net own funds per nonfinancial company, up to a total of 60 percent of the net own funds.

135. **Prudential regulation and requirements (CPs 6–15):** Swiss prudential requirements are sound but there are some deficiencies. Rules and regulation regarding capital adequacy conform to the Capital Accord of the Basel Committee and are similar to the EU Directives on Solvency and Own Funds. In general, SFBC's requirements are more conservative than the Basel Accord and EU directives, except for the risk weightings on commercial real estate loans. Cantonal banks, which benefit from a liability guarantee from their canton, are allowed a capital discount of 12.5 percent of the requirements. Such a discount does not seem necessary and provides the cantonal banks with a competitive advantage.

136. Credit standards, including lending to affiliates and large exposures, are consistent with the BCP. Information on asset quality and provisions in the monthly and quarterly prudential reports, however, is limited. Moreover, banks are not required to disclose in their annual published reports a breakdown of asset quality by categories, nor other asset quality indicators (such as past due, renegotiated, classified or nonaccrual loans). The external auditors assess the adequacy of provisions and reserves during their annual bank examination and audit and ensure that the methodology used to determine the provision amount is justifiable. If the allocation is insufficient, the auditor will require corrective action and notify the SFBC. Traditionally good earnings and strong capital support the current approach. In order to better monitor the banking system, the SFBC should consider requiring more detailed reporting of asset quality information. A consistent standard for reporting such information should be established.

137. Banks are required to have an internal audit function as well as an approved and licensed external auditor. The SFBC requires every licensed bank in Switzerland to have an internal audit function. If the entity is a subsidiary of a multinational conglomerate, the internal audit function can be outsourced to the audit department of the group. The purpose is to ensure adequate monitoring of internal controls. As part of the external auditor's exam, the adequacy of internal controls and internal audit are also assessed.

138. The SFBC is, as part of the Swiss delegation, an active member of the Financial Action Task Force (FATF) and has issued Circular 98/1 Guidelines concerning the Combating and Prevention of Money Laundering implementing the Swiss Money Laundering Law. Switzerland has signed and ratified the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime of 1990. The FATF-IX Annual Report for 1997–1998 gives Switzerland high marks on its efforts to combat money laundering, including the recent passage of a new Money Laundering Law (MLL). An assessment of the AML regime in the financial supervisory area was conducted as part of the FSAP and found the framework for banking supervision adequate and in line with international best practices in the AML area. The two large Swiss banks were part of a group of eleven international banks that developed and agreed to principles on global guidance for sound business conduct in international private banking (the *Wolfsberg Anti-Money Laundering Principles*).

139. **Methods of ongoing supervision (CPs 16–20):** The supervisory function is effected through a combination of both off-site monitoring and limited on-site monitoring carried out in general by the bank's external auditors. In the case of the assessment of market risk models, a recently created specialized unit of the SFBC carries out on-site inspections. Additionally, the SFBC holds quarterly meetings with the two large Swiss banking groups. Bank information is verified and validated by external auditors who conduct bank audits that include not only annual financial statement certification but also compliance reviews of the various laws, ordinances, SBA guidelines, SFBC circulars, and other safety and soundness reviews as directed by the SFBC. The external auditors must submit an auditing report to the bank's management and the SFBC, in addition to promptly notifying the SFBC of any material violations of law or other implementing regulations and guidance. In this context, the SFBC issued a circular on the content of auditing reports that guides auditors in their on-site inspections of the books and records of credit institutions regarding asset quality, large exposures, liquidity, corporate governance and internal controls, etc. The SFBC uses a risk-based method for prioritizing inspections, which allows flexibility in the event a higher risk entity is identified through off-site analysis. The SFBC also collects monthly, quarterly and annual returns, and contacts the banks periodically during their off-site monitoring when deviations from established trends are noted. SFBC representatives meet with senior management quarterly for the large banks and at least every three years for other banks to discuss current financial data, planned new business activities, and emerging issues. The SFBC (i) ensures that Swiss banks have adequate procedures for monitoring and controlling their activities worldwide; (ii) obtains information on the condition of all Swiss banks and their subsidiaries and offices through regular examination reports, audit reports, or otherwise; (iii) obtains information on the dealings with and relationship between Swiss banks and their

affiliates, both foreign and domestic; (iv) receives from the banks financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the banks' financial condition on a worldwide consolidated basis; and (v) evaluates prudential standards, such as capital adequacy and risk exposures, on a worldwide basis. These are signs of comprehensive consolidated supervision.

140. **Information requirements (CP 21):** Reporting requirements are based on the Banking Act, the Banking Ordinance, and the respective Guidelines of the SFBC. Swiss accounting standards are comparable to International Accounting Standards (IAS) and U.S. Generally Accepted Accounting Principles (GAAP); any differences are detailed in banks' annual reports. The annual reports of credit institutions must be audited by an external auditor, in accordance with international auditing standards, and standards for communication with external auditors are high. The external auditor's responsibility encompasses participation in setting corrective action plans and timeframes for remedial action. A formal process is not in place for the SFBC to assess the quality of work of the external auditors.[31] Auditing firms must be approved and licensed by the SFBC in order to audit banks. In addition, the SFBC has the power to remove and replace an external auditor and withdraw the firm and auditor's SFBC license.

141. **Formal powers of supervisors (CP 22):** The Banking Act empowers the SFBC to issue the decisions necessary to restore rightful conditions, remove abuses, and develop a practice of corrective action and early intervention. The Act provides a range of remedial actions, including the withdrawal of the bank's license. Any measure imposed by the SFBC supersedes differing resolutions of the bank's shareholders. There is no mechanism for the automatic imposition of administrative or penal sanctions, as under Swiss law such sanctions require the conduct of legal proceedings. The proposed amendment to the Banking Act will codify the SFBC's current practices and will explicitly empower the SFBC, for instance, (i) to suspend or dismiss managers or directors if bank solvency is under threat; (ii) alter, reduce or terminate any activity that poses excessive risk, or restrict an institution's business activities; or (iii) impose temporary management and reorganization measures. The SFBC has no explicit legal basis for publicly disclosing enforcement actions naming institutions and individuals involved.

142. **Cross-border banking (CPs 23–25):** The Banking Act provides the SFBC with all means to supervise credit institutions on a consolidated basis. The SFBC may request information and documents from foreign banks and financial supervisory authorities and has the authority to undertake direct inspections in foreign establishments of banks—which the SFBC plans to do in the future. Consideration should be given to formalizing current informal information sharing arrangements with foreign supervisors in countries where Swiss banks have significant operations. Such arrangements would facilitate on-site visits, which are planned for the future and also expected to increase after implementation of the new Basel Capital Accord. Current informal arrangements, however, have not impaired the

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[31] The SFBC recently created a dedicated team responsible for supervising bank auditors.

SFBC's ability to practice consolidated supervision, including on-site inspections if necessary.

Table 4. Recommended Action Plan—BCP

| Reference Principle | Recommended Action |
| --- | --- |
| CP 1.2. Independence | The SFBC should have full budgetary independence, based on the law. |
| CP 1.6. Information sharing | The SFBC should consider formalizing the exchange of information and on-site visits e.g. through the conclusion of MOUs or the exchange of letters. |
| CP 2. Permissible Activities | An exception in the Banking Act (Art. 1 par. 2) permits nonbank employer-sponsored deposit-taking entities that are not licensed or regulated as financial institutions. This poses a risk to the system and should be eliminated. |
| CP 6. Capital Adequacy | The 12.5 percent capital reduction for cantonal banks should be eliminated on competition grounds. |
| CP 7. Credit Policies | Insufficient data is collected by the SFBC regarding renegotiated, past due, and internally classified credits. Such information, along with provisions, charge-offs, and recoveries, would be useful in monitoring asset quality trends in the banking system. |
| CP 13. Other Risks | Gap reports are not filed as part of the prudential reporting process and the current supervisory system for monitoring liquidity as part of off-site supervision is under review. The SFBC should continue investigating ways to improve its liquidity monitoring to align it with the Basel Committee's paper on managing liquidity in banking organizations. |
| CP 16. On-Site and Off-Site Supervision | Additional detailed data should be obtained (e.g., on asset quality), and an early warning system should be developed. Consideration should be given to setting up a more detailed large bank risk profile using off-site data and information from trilateral meetings with foreign supervisors, insurance supervisors, management and external auditors. |
| CP 17. Bank Management Contact | Consideration should be given to implementing a process with all Swiss banks whereby SFBC staff meets with management annually, possibly in conjunction with completion of the annual external audit and receipt of the long form report. |
| CP 19. Validation of Supervisory Information | A formal quality assurance program for supervising and verifying the work of the external auditors has to be developed and implemented. Such a program seems necessary given the reliance placed on the external auditors. |
| CP 20. Consolidated Supervision | A proposed amendment of the Banking Act, the Stock Exchange and Securities Trading Act, and the Insurance Supervision Act provides for a more comprehensive set of legal rules for the supervision of groups of banks and/or securities dealers as well as financial conglomerates. These amendments will be welcome. Further development of a strategy for supervision of insurance activities of Swiss conglomerates in major markets is recommended. |
| CP 22. Remedial Measures | The SFBC should have the authority to impose direct civil monetary penalties on banks or directors or managers and to publish enforcement activities. The proposed amendment to the Banking Act should cover both. An additional area where the SFBC should have, clear legal enforcement authority is in their right to publish the identities of banks and individuals involved in money laundering activities and to impose monetary penalties for noncompliance with the MLL. |
| CP 24. Host Country Supervision | Informal arrangements have not impaired the SFBC's ability to practice consolidated supervision in the past, including on-site inspections if necessary. The expected higher frequency of on-site inspections to be carried out by the SFBC would be facilitated if this process were formalized through the conclusion of MOUs. |

***Authorities' response***

143. In general, the Swiss authorities agreed with the main findings and the recommendations, in particular CP 1.2 (budgetary independence) and CP 2 (deposit taking entities). Most comments of the SFBC were included in the assessment. The main area in which the mission team identified a need for improvement and where agreement with the Swiss authorities was not fully reached is detailed below.

- CP 1.6/24: The SFBC shares the conviction that it is important to establish a relationship with other primary supervisors. As mentioned earlier, the existence of a formal co-operation arrangement with a foreign regulator is not a prerequisite for the exchange of information under Swiss law. While the existence of such arrangements may be useful in some cases, the SFBC finds that in the absence of such arrangements co-operation can be as efficient and oftentimes more flexible. There are no legal or other obstacles for the SFBC to enter into formal co-operation arrangements with a foreign counterpart. Should a foreign regulator, with whom the SFBC maintains close working relations, wish to formalize this process the SFBC does not raise any objections.

## II. IOSCO Objectives and Principles of Securities Regulation

144. This section provides summary findings from the assessment of implementation of the IOSCO Objectives and Principles of Securities Regulation. Meetings were held with staff of the Swiss National Bank (SNB), the SFBC, the SWX, the Swiss Funds Association (SFA), as well as several private sector firms. The assessment contained in this report is based on these discussions, on the responses to questionnaires sent to the SFBC, and on the analysis of relevant laws, regulations, administrative policies and other written information provided during the meetings.

### A. Institutional and Macroprudential Setting

145. Two securities markets have been authorized by the SFBC, namely the SWX and Eurex Zürich AG. The SWX is a joint-stock company with 77 Swiss and 28 foreign participants. The SWX operates various market segments, including—in addition to the traditional Swiss equities segment—the SWX New Market, the SWX Local Caps, exchange-traded funds, warrants, Swiss franc and foreign currency bonds issued in Switzerland, and Eurobonds. A few exchange-traded funds are also traded on the exchange. The trading of the stocks represented in the Swiss blue-chip index SMI has been transferred to virt-x, although the SWX has maintained the listing competence for these stocks. The SWX has a 50 percent ownership stake in Eurex, the Swiss-German derivatives exchange (the largest in the world) that was created in 1998 by the merger of the SOFFEX with the Deutsche Terminbörse (DTB). The SWX and Deutsche Börse together own Eurex Zürich AG, of which Eurex Frankfurt AG is a fully owned subsidiary. Almost 430 participants from 16 countries are admitted to trade on Eurex; 141 remote members have been authorized via the Swiss entry point.

146. Turnover in equities in the SWX was SwF 968.1 billion in 2001 (slightly down from SwF 1.0 trillion in 2000, the 10th highest in the world). Market capitalization of the SPI was SwF 859.6 billion in 2001 (equivalent to two times GDP). Since June 2001, the stocks represented in the Swiss blue chip index (SMI) are being traded exclusively on virt-x—the new pan-European blue chip exchange in London, which is a joint venture between the SWX and Tradepoint. The SWX is also one of the largest markets for warrants in the world with almost 3,500 warrants listed.

147. Securities intermediaries comprise primarily securities dealers and investment funds.[32] Since the Swiss system is based on the universal bank model, both the securities and the fund businesses are dominated by banks. Switzerland has an active investment fund business with more than 2,700 registered funds, including 30 real estate funds. The 445 domestic funds are managed by 48 Swiss fund management companies. The total assets with investment funds have almost doubled since 1996 to SwF 467.7 billion (115 percent of GDP) at end-2000. More than two-thirds of the assets are invested in foreign funds, which are in most cases established by Swiss financial institutions in Luxembourg and their products are then offered in Switzerland to residents and nonresidents.[33]

148. Supervision and regulation of the securities market are entrusted to the SFBC, in accordance with the 1995 Law on Stock Exchange and Securities Trading (as subsequently amended) and the 1994 Law on Investment Funds. The SFBC is responsible for licensing and supervising securities dealers and stock exchanges; it regulates disclosure of shareholdings in listed companies and takeover bids. Supervisory functions are also delegated to the exchanges, which function as SROs and supervise trading, exchange members and listing procedures.

149. The SWX, as an SRO, is responsible for regulating its members and admitting participants to trading (who have to be licensed securities dealers); supervising price formation, execution and settlement of transactions; and ensuring that the information necessary "to maintain a transparent market" is made public. The SWX is also responsible for enforcing listing rules and checking listing prospectuses.

## B. Summary Assessment

150. **The Regulator (Principles 1–5):** The SFBC is responsible for the supervision of securities dealers, investment funds, stock exchanges, the disclosure of significant participations, and public takeover bids. The jurisdiction of the SFBC, however, does not include the regulation of (i) primary markets; (ii) asset managers or investment advisors who

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[32]Securities dealers include not only market makers and client dealers (who trade in their own name for the account of clients), but also issuing houses and own account dealers.

[33]As of November 2001, more than 80 percent of funds registered in Switzerland were foreign. Swiss fund providers account for 30 percent of the fund market in Luxembourg.

manage the assets of third parties only on the basis of powers of attorney; and (iii) closed-end funds. A commission of experts has recently been given the mandate to draft an oversight regime for asset managers. The SWX is responsible for regulating listed companies and supervising the market to detect market abuse practices. In case of suspicion, the SWX must inform the SFBC, which, in turn, can order the necessary investigations.

151. Before adopting new policies or new regulations, the SFBC consults extensively with the market. Some draft regulations are proposed by professional associations, such as the SBA and the SFA. If the SFBC approves the proposed regulation and endorses the proposed text, it makes the regulations binding.

152. The SFBC does not supervise securities firms, investment funds, and exchanges directly. Instead, it relies on external auditors to perform front-line supervision. Although the SFBC may issue supervisory orders requiring supervised entities to end violations or other irregularities; can suspend all legal transactions and payments from (or to) a securities dealer; and can withdraw the license of a supervised firm, the range of sanctions available to the regulator seems to be limited. The SFBC is working on a draft proposal that would broaden the set of available sanctions. Generally, a more active involvement of the SFBC in direct supervision (including direct on-site inspections, and reviews of external auditors and their operations) would be advisable.

153. Although the SFBC is funded through fees paid by supervised entities, its budget is part of the Federal budget and thus must be approved by the Swiss Parliament. Concerns have emerged about the ability to retain skilled staff and reduce turnover. Furthermore, resources allocated to supervisory tasks could seem inadequate given the size of the supervised securities and banking industry in Switzerland.

154. **Self-Regulatory Organizations (Principles 6–7):** Formally only securities exchanges can be SROs. Presently, the SFBC has authorized the SWX and Eurex Zürich AG as SROs. The SWX is a nonprofit organization established as an association;[34] it is part of the SWX Group, which includes participation in Eurex (derivatives exchange); EEX (European Energy Exchange); virt-x; STOXX (a joint venture that offers indexes based on industry groups) and EXFEED (financial data).

155. Rules issued by the exchanges must be approved by the SFBC. The exchanges are responsible for (i) regulating their members and admitting participants to trading (who have to be licensed broker dealers); (ii) enforcing listing rules; (iii) supervising price formation, execution and settlement of transactions; and (iv) ensuring that the information necessary "to maintain a transparent market" is made public.

[34]In April 2002 the General Meeting of the SWX Swiss Exchange decided to convert the Association into a joint-stock company named SWX Swiss Exchange. All the members of the former Association have joined a new association (Association SWX Swiss Exchange) that took over the shares of the SWX Swiss Exchange.

156. **Enforcement (Principles 8–10):** The SFBC can carry out on-site investigations, but in practice, the front-line supervision—both routine supervision and special examinations—is performed by external auditors. Auditors must inspect supervised entities at least once a year and may perform interim audits if necessary. External auditors also play a role in examining licensing applications. The SFBC has the powers to order supervised entities to end breaches of securities legislation, and, in case of noncompliance, it could disclose relevant facts to the public. The legislative framework, however, does not clarify in detail which investigative powers are available to the SFBC concerning individuals and entities that are not subject to licensing requirements or obliged by law to report to the SFBC.

157. The range of sanctions available to the SFBC include (i) withdrawing the license from securities dealers, stock exchanges, and investment funds; (ii) imposing trading restrictions on securities dealers; (iii) ordering the suspension of payments by (or due to) a securities dealer when creditors (or debtors) may be damaged; (iv) appointing an observer if a securities dealer's or investment management company's governing body proves incapable of properly performing its functions; and (v) withdrawing the recognition of external auditors. Insider dealing and market manipulation are punished as criminal offences. Besides making referrals to criminal authorities, the SFBC can also sanction regulated persons or entities involved in insider dealing or market manipulation under administrative law.

158. The powers conferred to the SFBC, including the range of available sanctions, could be strengthened. The SFBC is working on a draft proposal aimed at broadening and strengthening the sanctions that can be imposed directly by the SFBC, including the power to impose monetary penalties. Because the SFBC relies heavily on the front-line supervision by external auditors, it should have formal surveillance powers over external auditors. The Expert Commission on Bank Auditing has issued recommendations on the use of auditors. It emphasized the need for a more direct involvement of the SFBC in the examination process and recommended a quality assurance program for the external auditors. The SFBC is in the process of drafting guidelines on market conduct.

159. The SWX, as an SRO, supervises trading in the market, including monitoring for insider dealing or price manipulation. It, however, is not entitled to obtain information on securities dealers' clients (i.e., those who ordered the execution of the relevant transactions). Violations discovered by the SWX must be notified to the SFBC, which can initiate the required investigations. The SWX enforces its rules directly, including by fining its members or listed companies.

160. **Cooperation (Principles 11–13):** The exchange of supervisory information, and the cooperation and mutual assistance (both domestic and cross-border) is regulated by law. The banking law, for example, provides for cooperation between the SFBC and the SNB. Though not directly regulated, cooperation with insurance and/or pension funds regulators takes place in the supervision of financial conglomerates.

161. Exchange of information with foreign regulators is also governed by the law, which distinguishes two cases: (i) confidential information concerning supervised entities, and

(ii) confidential information on clients of Swiss intermediaries (banks, securities dealers, and funds). In the case of confidential information concerning supervised entities, the information can be transmitted only if the foreign supervisor (i) uses the information only for the direct supervision; (ii) is bound by confidentiality rules; and (iii) does not, without the prior consent of the SFBC, forward the information to other supervisory agencies. Special agreements have been signed with foreign regulators that supervise exchange alliances, such as virt-x and Eurex. The regulator may communicate information on supervised entities and clients of securities dealers in the context of a criminal procedure only if the alleged conduct is also illegal under Swiss criminal law (dual criminality).

162. The SFBC can share confidential information about a client's account with foreign regulators; if the client does not consent, the client may request a formal decision by the SFBC, which can be appealed to the Supreme Court. In criminal procedures, dual criminality requirements have to be met. The SFBC has publicly recognized that the Swiss law does not allow adequate cooperation with respect to the sharing of customer-related data with foreign securities regulators and has announced plans to submit an amendment proposal to the Federal Department of Finance.

163. **Issuers (Principles 14–16):** The primary market is not subject to supervision; in particular the SFBC's (or the SRO's) powers do not extend to issuers that do not subsequently list on an exchange. The SFBC does not, for example, have the power to verify that the information published is accurate, and that all material information is disclosed; there is no oversight of offering procedures.

164. The listing admission process falls within the jurisdiction of the SWX. Listing rules, which according to SFBC staff are in line with the European Listing Directives, provide for initial, ongoing, and ad hoc disclosure requirements. While issuers of securities admitted to trading on the SWX must publish annual reports, issuers in the SWX New Market segment have to provide quarterly reports.

165. Shareholder rights are regulated under ordinary company law. Preferential voting rights can be granted to certain categories of shares and there are no corporate governance rules on minority shareholder rights. The Admission Board of the SWX recently adopted a corporate governance directive, which focuses on disclosure matters and proper conduct by board members, but does not include rules on minority shareholder rights and the collecting and exercising of proxies.

166. The SFBC is not responsible for ensuring the quality of accounting or auditing standards, which are set by professional bodies. Swiss accounting standards are detailed in the Swiss Accounting and Reporting Recommendations, which are issued by the Commission for Accounting and Reporting Recommendations, an independent foundation. Under existing listing rules, the SWX—depending on the market segment—accepts financial statements drafted according to Swiss standards, IAS, U.S. GAAP as well as home-country standards of foreign companies. Auditors do not need to be approved or licensed except if they audit banks or securities dealers. However, auditors of listed companies must possess

professional qualifications as defined by federal regulation and have to be registered with the SWX.

167. **Collective Investment Schemes (Principles 17–20):** The Investment Funds Act of 1994, which is consistent with the EU Directive on Undertakings for Collective Investments in Transferable Securities (UCITS),[35] establishes requirements for collective investment schemes in the form of the open-ended contractual type. Generally, closed-end funds, which are not covered by the law, are not subject to prudential supervision. However, closed-end funds that are listed are subject to the relevant listing rules.

168. The supervision model for investment funds follows the same approach as for banks and securities dealers. External auditors examine compliance with the regulatory standards and check the authorization requirements. A Code of Conduct has been issued by the SFA, and has been endorsed by the SFBC. Fund management companies have to publish prospectuses for each of their funds. The prospectus (and the subsequent amendments) must be submitted to the regulator. Assets must be valued at their market value. To ensure uniform valuations, the SFA has issued guidelines for the calculation of net asset values, which have been endorsed by the SFBC. Funds may stipulate special valuation rules for exceptional circumstances such as market closings, restrictions on foreign currency transactions, or extraordinary high volumes of redemptions.

169. **Market Intermediaries (Principles 21–24):** Swiss law distinguishes five categories of securities traders: (i) dealers who trade for their own account (with gross turnover that exceeds SwF 5 billion per year); (ii) issuing houses, which offer securities on the primary market; (iii) institutions that deal in derivatives; (iv) market makers, which trade on their own account and quote prices to the public for certain securities; and (v) dealers that trade on behalf of nonprofessional customers. All securities traders, including banks, must obtain a license from the SFBC. A securities dealer license is also required to trade directly on stock exchanges in Switzerland or abroad.

170. Individual portfolio management is not considered a regulated activity as long as the asset manager does not maintain accounts or securities deposits on behalf of customers. Asset managers who do not hold customer funds directly are only subject to AML regulation. There also seems to be a regulatory gap for dealers who trade on their own account (below the threshold of SwF 5 billion) or dealers who provide services only to qualified professional investors. As mentioned above, an expert commission is currently drafting legislation for prudential oversight for asset managers and investment advisors.

171. All supervised intermediaries are subject to capital requirements based on credit and market risk (similar to bank capital adequacy requirements). Swiss regulations also mandate

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[35] The EU Directive on UCITS (85/611/EC) has recently been amended by Council Directives 2001/107/EC and 2001/108/EC of January 21, 2002. These changes are not reflected in current Swiss legislation.

a certain internal organization, including Chinese walls. Customer assets have to held separately from the firm's assets. Winding down procedures for supervised institutions are regulated mostly by general bankruptcy law. A new draft bill is under consideration that would introduce more specific rules for regulating the failures of financial intermediaries (banks, securities dealers). The AML law stipulates rules on identifying customers and, if required, the beneficial owners.

172. Securities dealers must follow conduct of business rules. But customer suitability tests are not required, and there are no rules for the disclosure of potential conflicts of interest (rules only include ex post disclosure). Conduct of business rules, therefore, could be supplemented by SFBC instructions to ensure a higher degree of investor protection (especially in the area of suitability tests and the disclosure of conflict of interest). The conduct of business rules could also include rules aimed at ensuring market integrity.

173. **Secondary Markets (Principles 25–30):** The SFBC is responsible for the licensing of exchanges. It has authorized the SWX and Eurex Zürich AG—both are SROs. Once authorized, an exchange is responsible for supervising compliance with its own rules, which have to be approved by SFBC. It can admit members to trading if they are licensed by the SFBC as securities dealers. Foreign dealers may be admitted to trading on Swiss exchanges if (i) the responsible foreign regulator does not object, (ii) the foreign dealers are properly supervised, and (iii) the foreign regulator is in a position to offer administrative assistance. The SFBC does not monitor securities exchanges directly, but through external auditors, who have to report annually.

174. Swiss law, including criminal law, prohibits market manipulation and other unfair trading practices. Responsibility for prosecution lies with competent criminal authorities. Guidelines of the SBA forbid certain practices such as front running. The SFBC is working on a circular on conduct of business rules for market integrity. The Supervisory Department of the exchange monitors the market continuously and reports relevant findings to the SFBC. There are no specific rules for the supervision of large exposures of market participants and their clients. Securities lending transactions are not restricted; short selling is permitted.

175. The SWX operates various market segments for small caps and fast growing equities (New Market); investment funds; corporate and government bonds, including Eurobonds and warrants. The SWX has a fully electronic order-driven trading system. Orders are matched based on price-time-priority criteria. Although Swiss blue chips (in the SMI segment) are traded exclusively on virt-x, the SWX is the listing authority. Securities dealers admitted to trading on the SWX are automatically admitted to trade on virt-x. Special arrangements are also in place for the supervision of Eurex in close cooperation between the Swiss and the German market surveillance departments. Exchange of confidential information is subject to the relevant rules on administrative assistance (see above).

176. Trades on the SWX are settled via SIS, which is authorized as a bank, an also acts as a central security depository (CSD). The SWX settles trades on a T+3 basis. SIS provides for a simultaneous, final, irrevocable delivery-versus-payment real time gross settlement for

Swiss franc transactions. Cross-border securities transactions are settled through custodians in the corresponding countries. The Eurex Clearing House is supervised as part of the exchange authorization process, while the German competent authorities supervise all other aspects related to Eurex clearing.

Table 5. Recommended Action Plan—IOSCO Objectives and Principles

| Reference Principle | Recommended Action |
| --- | --- |
| Principles Relating to the Regulator (CP 1–5) | Securities regulation should be updated to include all types of securities transactions and securities intermediaries, including primary markets and all asset managers. Modalities for removal of board members could be clearly spelled out in the law. Rules on incompatibilities with other professional activities could be improved. Full budgetary independence should be granted to the SFBC, and an increase in its staff resources would be justified. |
| Principles of Self-Regulation (CP 6–7) | A more proactive role for the SFBC in supervising SROs is desirable. The role performed by certain trade associations in regulation and supervision could be formalized. |
| Principles for the Enforcement of Securities Regulation (CP 8–10) | Enforcement powers of the SFBC could be strengthened. In particular, it would be desirable to increase direct supervision, formalize the examination process and quality assurance for external auditors, and increase the range of available sanctions. |
| Principles for Cooperation in Regulation (CP 11–13) | Efforts by the SFBC to strengthen cooperation with foreign regulators are welcome. |
| Principles for Issuers (CP 14–16) | There is room to improve protection for minority shareholders and strengthen accounting and auditing regulations to ensure comparability of financial information. It would also be advisable to introduce proper supervision and sanctioning of auditors of listed companies. |
| Principles for Collective Investment Schemes (CP 17–20) | Improvements are possible in the area of asset valuation, where a more direct involvement of the regulator could be envisaged. |
| Principles for Market Intermediaries (CP 21–24) | Supervision of market intermediaries could be strengthened by supervising dealers that trade on their own account but whose business volume falls below the official threshold, and those that provide services only to qualified professional investors. Rules on disclosure of conflict of interest before conducting the transaction could be provided. |
| Principles for the Secondary Market (CP 25–30) | The supervisory role of the SFBC with regard to secondary markets could be strengthened. Proper supervision of international exchanges requires full ability to provide information; see recommendation under Principles 11 to 13. |

***Authorities' response***

177. In general, the authorities agreed with the key findings and with most of the recommendations. They agreed that budgetary independence of the SFBC could be strengthened, but viewed full prudential regulation of asset managers and investment advisors who do not manage funds in their name on behalf of clients, and small firms that trade on their own account, as unnecessary. They supported the recommendation for

additional sanction powers as useful but not strictly necessary. The SFBC noted that in its view, prudential supervision of firms who trade on their own account below the threshold of SwF 5 billion is not required from the perspective of investor protection nor from that of financial system stability. On the need for a more proactive role in supervising SROs and primary and secondary markets the authorities noted that the SFBC in most cases has the authority, if needed, to directly supervise SROs, securities dealers, and markets. They did not consider direct responsibility of the SFBC with respect to accounting and auditing standards as necessary, since the SFBC's approval of SWX listing rules, which prescribe acceptable accounting and auditing standards, provides the regulator with indirect competence in this area.

## III. Insurance Core Principles

178. This section provides summary findings from the assessment of observance of the International Association of Insurance Supervisors (IAIS) Core Principles, and to suggest areas where further development may be appropriate. The assessment was based on a review of the legal framework, and extensive discussions with the supervisory authorities and market participants. It focused mainly on the supervisory work of the FOPI under the Ministry of Justice and Police.

179. The supervisory staff of the FOPI cooperated extensively in the assessment, by providing answers to an extensive questionnaire, preparing a self-assessment against IAIS Core Principles, and making themselves available to meet with mission members at every opportunity. The assessment was also greatly aided by the extensive program of publications produced by the Office, both on paper and in electronic (CD) form.

180. This assessment was based on the Core Principles Methodology Document that was adopted by the IAIS at its annual meeting in October 2000. Consideration was also given to the Principles on Capital Adequacy and Solvency. The principles are supported by extensive criteria that are particularly helpful in preparing this type of assessment. For the work in Switzerland, emphasis was placed on those criteria classified as "essential" with references to the additional criteria, where relevant.

### A. Institutional and Macroprudential Setting

181. The following two tables provide statistics that are widely quoted as indicative of the development of an insurance market. The first table provides information on insurance premiums per capita for 2000 (in U.S. dollars), often referred to as "premium density."

| | Total business | Non-life business | Life business |
|---|---|---|---|
| Switzerland | 4,154 | 1,571 | 2,583 |
| Japan | 3,973 | 808 | 3,165 |
| United Kingdom | 3,759 | 730 | 3,029 |
| USA | 3,152 | 1,541 | 1,611 |
| Ireland | 2,552 | 664 | 1,888 |
| Netherlands | 2,290 | 933 | 1,357 |

Source: SIGMA/Swiss Re, *World Insurance in 2000.* Social security contributions are excluded.

182. Another widely quoted statistic is the ratio of premiums to GDP, referred to as "insurance penetration." The following table shows the 2000 statistics for the five countries with the highest percentage ratios. As these two tables indicate, Swiss residents are among the world leaders in the purchase of insurance.

| | Total business | Non-life business | Life business |
|---|---|---|---|
| South Africa | 16.86 | 2.83 | 14.04 |
| United Kingdom | 15.78 | 3.07 | 12.71 |
| South Korea | 13.05 | 3.16 | 9.89 |
| Switzerland | 12.42 | 4.70 | 7.72 |
| Japan | 10.92 | 2.22 | 8.70 |

Source: SIGMA/Swiss Re, *World Insurance in 2000.*

183. Swiss companies have not confined themselves to operations in Switzerland and some of them rank among the large suppliers of insurance throughout Europe—either directly or through subsidiary members of a number of conglomerate groups. For some of these organizations, one-half of their premiums comes from outside Switzerland.

184. Management of Swiss insurance companies shares the belief that there remains little opportunity for growth in the domestic insurance market. In the area of non-life insurance, they speak of a "saturated" market. Growth potential in the life insurance area is also regarded as limited although there may still be some opportunities for growth from the pension business. With this picture in mind, companies have been exploring the opportunity for selling policies in other countries and have been expanding their operations through acquisition in other countries. The United States is regarded by some as an area with a clear potential for further growth.

185. Business in member countries of the EU is an important target for Swiss companies. When the local trade association quotes statistics on the business volumes of its member countries, it points out that the companies garner more business outside the country than they do in Switzerland. As noted previously, this statistic relates to the total revenues of a group of

companies, some of which are foreign subsidiaries that do not report their business activities to the Swiss authorities.

## B. General Preconditions for Effective Insurance Supervision

186. Swiss legislation is not very specific on obligations and powers of the supervisory authority. This gives quite extended supervisory powers to the Minister of Justice and Police, who is formally responsible for decisions in this area. In practice, however, decision-making is delegated to the FOPI's managing board. This implies that the range and quality of supervision to a large extent depends on the composition of the Board.

187. The overall impression is that to a significant degree, supervision in Switzerland is based on a trustful relationship between the insurance industry and the supervisor. Insurance companies readily inform the authority about any change in plans, or other changes, while the authority regularly consults with the insurance industry in preparing new regulations.

188. There are some shortcomings in the present supervisory model. One is in the area of changes in control of management or ownership. The FOPI does not give its approval of changes in ownership or carry out fit and proper assessments of major owners or management, since the present legislation does not give the authority those powers.

189. A critical feature to be submitted with an application for license is the "Business Plan." This document contains a description of the manner in which the company intends to conduct its business and fixes the parameters of the pricing for insurance contracts, the computation for the technical provisions in support of those contracts; and the reinsurance treaty arrangements that the company will, or has, negotiated. The important feature is that this plan remains in force for as long as the company is licensed and the company will be expected to seek approval of the authorities for any amendment to the plan, even in such matters as changes to the parameters used to set premium rates for life and health insurance.

190. An area of concern is that relating to insurance intermediaries. There is presently no legislation in Switzerland that applies to insurance brokers, nor is there a code of conduct regarding sale of insurance products by tied agents or others. Market conduct and consumer protection issues found in the CPs relate, in many ways, to the conduct of insurance intermediaries.

191. Another issue of concern is the lack of requirements on internal control systems in insurance companies. Insurance legislation does not cover the duties of the Board of Directors nor the General Manager in this area. The FOPI has no legal basis to establish appropriate rules and has not issued any guidance. The legislation that to some extent covers internal controls and management is the general corporation legislation.

192. A new draft law is to be submitted to the Parliament shortly. The expectation is that it will become effective in 2003. The new law will encompass the areas that are not covered by the Acts mentioned above. It will also cover the areas of changes in control and ownership and

insurance intermediaries. Under the new law, Swiss insurance legislation will, in essential areas, be aligned with EU requirements.

193. The supervisory authority benefits from the presence of a competent audit profession. Accounting for insurance companies follows the rules and directives set down for member companies of the EU.

194. There are four important financial conglomerates in Switzerland and in two cases, Swiss Reinsurance and Zurich Financial Services, the conglomerate groups are headed by insurance companies. Through the efforts and cooperation of the FOPI, the management of these conglomerates, and the banking supervisor, special memoranda of understanding have been negotiated, to provide for a coordinated approach to supervision and monitoring of the financial activities of the groups, and to the effective exchange of information between supervisory bodies.

## C. Summary Assessment

195. In general, the assessors noted that the insurance supervisory system has functioned well. Information systems operated within the FOPI enable the supervisor to collect, process and maintain a database of information regarding all licensed companies that is impressive.

196. The inspection staff is divided into teams, with each team being assigned a portfolio of companies to monitor. Portfolios are rotated from time to time. Individual specialists within the group of inspectors (such as actuaries and lawyers) are also given functional responsibilities and they supply these services across all the teams. In this way the supervisor gets maximum leverage out of the manpower available. The system could be enhanced if the resources of the office were increased, thus permitting the hiring of additional staff.

197. The process will be made more effective and the scope of the work of supervision enhanced if all companies were obliged to work to a higher standard with respect to internal controls and if best practices in insurance company corporate governance were to be mandated and implemented.

198. The changes in legislation that are contemplated will provide the supervisor with control over changes in ownership and this is more in keeping with best practices followed in the EU and other developed markets.

Table 6. Recommended Action Plan—IAIS Core Principles

| Reference Principle | Recommended Action |
| --- | --- |
| Organization of an Insurance Supervisor<br>CP 1 | Of a total staff of 55, the professional members of the FOPI dedicated to supervision number 35. The FOPI is anxious to increase staff in order to augment its supervisory capacity. It would be preferable if the general program of compensation recognized the special competencies required by all FOPI professional staff.<br>The existing legislation is not very specific regarding the powers of the supervisor. The proposed new legislation is expected to make these powers more specific. |
| Licensing and Changes in Control<br>CPs 2–3 | Fit and proper assessments are essential for the licensing process. This is not presently carried out in Switzerland (except for licensing of foreign insurance companies.). Fit and proper issues are covered in the Draft Bill that will be submitted to the Government shortly. The present law does not contain specific provisions relating to the assessment of owners and managers.<br>Changes in control do not need to be approved, and the FOPI does not conduct assessments of managers or owners. As a principle, changes in control should be subject to the same scrutiny as the issuance of a new license. The supervisor should be empowered to block the transfer. |
| Corporate Governance and Internal Controls<br>CPs 4–5 | The insurance legislation does not give directions regarding corporate governance. Since the FOPI has not provided formal guidance, no standards have been set in this area (except from the general provisions in the corporate legislation). International best practices for insurance companies would suggest that there be special duties specified for Boards of Directors in areas such as setting investment policy, risk management policy and the establishment and monitoring of a system of internal controls. The issue of formal guidelines in this respect would be an appropriate step for the supervisory authorities. |
| Prudential Rules<br>CPs 6–10 | Investment controls will be improved and greater risk management achieved once effective internal control procedures are in place. New draft legislation will go beyond what is required by EU legislation and require consolidated supervision of insurance groups. |
| Market Conduct<br>CP 11 | In relation to consumer protection, it is essential that all who are involved in selling insurance products comply with some kind of ethical code.<br>The FOPI could issue guidelines regarding codes of conduct and also suggesting that companies establish claims resolution procedures. |
| Monitoring, Inspection, and Sanctions<br>CPs 12–14 | It would be desirable that the FOPI be given the resources to increase the frequency of on-site inspections since it is important that on-site inspections are carried out on a regular basis, in order to verify reported prudential information and to make observations regarding the operations of insurance companies. |
| Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality<br>CPs 15–17 | The FOPI should continue and expand its practice of entering into MOUs with insurance supervisors in other jurisdictions (such as the one already in place with Liechtenstein) and also with supervisors of other types of financial institutions. |

***Authorities' response to the assessment***

199. The FOPI broadly agreed with this assessment, which it considered to be comprehensive, balanced, and constructive. At the same time, it wished to emphasize that most of the recommendations contained therein are being addressed in the proposed new legislation on insurance supervision.

## IV. CPSS Core Principles for Systemically Important Payment Systems

200. This section reviews the degree of compliance of the SIC with the relevant international standards, and includes recommendations on anticipated structural developments. The assessment was conducted based on information provided by the Swiss National Bank (SNB) in the form of the answers to the questionnaire with regard to payment and securities clearing and settlement infrastructure, relevant sections of the current Federal Law on the SNB, the 2001 "experts" draft of the new SNB Law, the SIC Users Manual, the SIC Rules and Regulations, and the October 8, 2001 draft of the Self-Assessment of the Core Principles for Systemically Important Payment Systems prepared by the SNB. These sources were supplemented by discussions held with officials of the SNB, the chief executive officer of SIC AG—the principal computer-service corporation operating the SIC on behalf of the central bank—a senior official of SIS AG, Switzerland's central securities depository and securities settlement system, as well as individuals regularly using SIC at the two largest banks (UBS and Credit Suisse).

### A. Institutional Setting

201. The SIC is unquestionably a systemically important payment system, both for Switzerland and for the global financial system. On an average day, electronic funds transfers of some SwF 180 billion are processed on a real-time, gross-settlement basis (equivalent to almost half of annual Swiss GDP). An analysis of the daily payment flows suggests that over half of this substantial activity results from Switzerland's position in the global economy and involves either FX transactions being settled between banks, or the associated commercial and business payments.

202. Each SIC transfer that passes the risk-control test of adequate balances in the sending participant's settlement account is immediately final. The SIC also supports the real-time, delivery-versus-payment, cash leg settlement procedures of the securities clearing mechanism operated by SIS. In addition it is used for the regular settlements generated by the derivatives exchange (Eurex), and the bulk settlement of retail-level noncash payments in Switzerland. The broad usage of the SIC is reflected in its list of participants. At the end of 2000, there were 302 participating members, of which 55 functioned on a remote basis, many of these being major foreign banks. Other types of applicants—domestic or foreign clearing institutions, for example—will usually gain access if their presence will "reduce systemic risk or enhance the significance of the Swiss financial center" in the global context.

## B. Summary Assessment

203. The SIC observes all of the nine applicable Core Principles for Systemically Important Payment Systems. The Swiss National Bank fulfills all three of the applicable central bank responsibilities relevant for the payment system broadly defined. No vulnerabilities within the SIC system itself have been identified, and indeed the system achieves the principal reason for which it was designed, namely the substantial reduction of systemic risk in the interbank payment mechanism. If it should prove vulnerable in the future, it is most likely that the vulnerability will stem from how the SIC fits into the global arrangements for large-value transfers.

204. **Legal foundation (CP I)**. The legal basis of the SIC is well-founded, being based on Article 2 of the Law on the National Bank and the various contracts put in place in order for the central bank to establish the operational arrangements for the system. The Civil Code and/or the Code of Obligations govern the creation and perfecting of security interests in a manner that has proved both sufficient and flexible. Accounting records produced by electronic means have the same evidentiary value as books and documents in written form.

205. **Understanding and management of risks (CPs II–III).** The rules and procedures of the SIC reflect the fact that it is a real-time gross-settlement system. Each settled transfer is final. Consequently it is not risky for a participant to experience a substantial bilateral gain vis-à-vis another institution. Information regarding the amount of each transfer that is not yet settled, but temporarily held in the sending bank's waiting queue, is automatically provided to the receiving bank, a situation that facilitates intra-day liquidity management. Because the SIC calculates each bank's position on a real-time, payment by payment basis, automatically prevents day-light overdrafts, and uses accounts at the central bank as the settlement asset, no credit risk arises in the system for the participants.

206. **Settlement (CPs IV–VI)**. The SIC provides prompt final settlement during the day. Any transfer that is not immediately and finally settled is held in a waiting queue, and will be finally settled as soon as the sending bank's multilateral position rises to a level equal to or greater than the transfer held in the queue. The assets used for settlement purposes in the SIC are effectively claims on the Swiss National Bank.

207. **Security and operational reliability, and contingency arrangements (CP VII).** Continuous efforts are made to further strengthen the security package of the SIC, despite the fact that operations have not been hampered by fraud or attack in over fifteen years. A security package with state-of-the-art authentication and encryption devices was implemented in 1999. The SIC is highly reliable. Once a year an accounting firm performs a security and operations audit of the system; to date these audits have not identified any major shortcomings. Contingency arrangements, including internal and external emergency committees, exist and are tested regularly.

208. **Efficiency and practicality of the system (CP VIII).** The users of the SIC are the central bank, all banks operating in Switzerland whether domestic or foreign, many

broker/dealers, and a number of clearing and settlement mechanisms processing transactions in a variety of financial products. These constituencies benefit from the immediate finality of SIC transfers in terms of minimizing payment-related risks in their particular contexts. The participants' fees for payment transfers are comparable to those observed in other national real time gross settlement (RTGS) systems. The efficiency with which the SIC provides services to its users is partially a result of the fact that, before major development projects are undertaken, a business case is investigated. Over time, the supporting private corporation for the SIC (i.e., SIC AG) has been profitable.

209. **Criteria for participation (CP IX).** The access criteria for the SIC, which are published in descriptive articles on the central bank's website, indicate that the system is among the most open in the world. Access to the SIC depends primarily on the granting of a settlement account at the SNB. The central bank is obligated to open such an account for any Swiss bank or broker/dealer that requests access. In the cases of other Swiss financial institutions, and both Swiss and foreign clearing and settlement organizations, the SNB will open the necessary settlement account if it judges that such a development would either reduce systemic risk, or be of positive significance for Switzerland as a financial center. Participants of the SIC wishing to operate on a remote access basis, that is, by means of computer/communications linkage from outside the country, must meet additional requirements relating to adequate supervision (in the case of banks and broker/dealers), and the "reachability" of personnel capable of expressing themselves clearly in English, French or German and accessible during normal business hours in Central European Time.

210. **Governance of the payment system (CP X).** The governance structure of the SIC involves two major components: the SNB which concentrates on the broad policy questions of payment system design; and the SIC AG, which is a technical services corporation handling the operational structure under a contract with the SNB. The central bank is represented on the Board of SIC AG by the Director of the Informatics and General Processing Division of Department III. The contractual agreement between the SNB and SIC AG covers the following topics: the cost recovery objective; the structure of fees paid by participating institutions; the allocation of liability including sanctions; and the monthly reporting responsibility of the service provider. In addition the SNB has access to all internal and external audits conducted at SIC AG, it can carry out on-site inspections, and it can require the replacement of incompetent staff. Two sections of the SNB (each staffed by five persons) are directly involved with the operations and evolution of the SIC. The first manages the daily cycle of SIC operations, determining any changes to the usual start and stop sequences, manages the settlement accounts of the participants, and is in a position to effect payments for an institution that is unable to do so itself for technical reasons. The second section deals with policy and oversight issues, bearing in mind both systemic risk and the daily implementation of monetary policy. These governance arrangements of the SIC function well.

211. **Central Bank responsibilities in applying the CPs.** The payment system objectives of the central bank in Switzerland derive from the Law on the National Bank that specifies the "facilitation" of payment transactions as one of its three major responsibilities. In this

context its primary objectives are "efficiency" and "safety." The SNB uses a market-based approach in pursuing the first objective, encouraging market forces to play their role in developing, operating and enhancing payment-system infrastructure. The central bank focuses on the one systemically important system, the SIC, in its pursuit of the second objective. It is proactive in the oversight of the SIC, maintaining an on-going professional and contractually governed relationship with SIC AG. The SNB oversees the SIC in a variety of ways. The contracts between the central bank and the service-providing corporation delineate clearly the rights and responsibilities of each party. The SNB meets regularly with the Federal Banking Commission to ensure an adequate exchange of information on the development and operation of the various payment mechanisms in Switzerland. The SNB maintains bilateral relationships with numerous central banks as well as other authorities and organizations having an interest in payment system matters.

Table 7. Recommended Action Plan—CPSS Core Principles

| Reference principle | Recommended action |
| --- | --- |
| Security and operational reliability, and contingency arrangements | |
| *CP VII* | ▪ The SNB should analyze developments that are either planned or anticipated to occur during 2002, examining the contingency procedures of the SIC and the extraordinary liquidity sources of relevant currencies in plausible situations involving interruptions of operations in both the traditional and in the new (continuous linked) arrangements for FX settlements.<br>▪ The SNB should continue to prepare for operational problems related to violent acts.<br>▪ The SNB should consider hiring an accounting firm of its own choice to conduct occasional operations and security audits of the SIC. |
| Central Bank responsibilities in applying the CPs | |
| *Responsibilities A-D* | The SIC should continue its interaction with the Deutsche Bundesbank with respect to the evolution of the euroSIC, in a manner consistent with the Lamfalussy Principles of Co-operative Central Bank Oversight of Cross-Border Netting and Settlement Systems. |

***Authorities' response***

212. The staff of the SNB has begun the recommended examination of the structural developments anticipated in 2002, and has investigated the steps necessary to establish an inter-central bank swap arrangement that could provide U.S. dollar liquidity if needed. The suggestions made with respect to operational reliability and additional security audits have been viewed positively.

# V. IMF Code of Good Practices on Transparency in Monetary and Financial Policies

213. In Switzerland, the responsibilities and institutional arrangements for monetary and financial policies and for the regulation, supervision and oversight of the financial and payment system, including markets and institutions, are shared by several agencies. Within this framework, there is a high degree of observance of the Code of Good Practices on Transparency in Monetary and Financial Policies, although practices vary across the range of agencies as well as across different functions in each institution. The more specific findings in the area of transparency of Monetary and Financial Policies are discussed below.

214. The assessment of transparency practices covers the following institutions: (i) the Swiss National Bank (SNB), for its responsibility over monetary policy, the payment system, the market for its own securities, and the FX market; (ii) the SFBC, which is responsible for supervision and oversight of banking institutions and the securities markets; (iii) the FOPI for insurance companies oversight; and (iv) the Federal Office of Social Insurance (FOSI) for the supervision of pension funds. The assessment contained in this report is based on discussions with staff of these institutions and of the Federal Department of Finance (FDF), on responses to questionnaires sent to the authorities, and on an analysis of relevant laws, the proposed revisions to existing laws, regulations, administrative policies, and other information provided during the meetings.

215. Monetary and financial policies in Switzerland are generally highly transparent. The high level of transparency reflects the fact that rules are mostly codified (in legislation and regulations) and thus are on the public record.

## A. Transparency of Monetary Policies

### Main Findings—Summary

#### *Clarity of roles, responsibilities, and objectives of financial agencies*

216. In 2000, the SNB replaced monetary targeting with a new framework that sets monetary policy on the strength of the inflation forecast over a three-year horizon with an explicit objective of keeping medium-term inflation below 2 percent, but positive. The legislation currently in effect is vague about the objectives of monetary policy (the central bank should pursue a credit and monetary policy serving the interests of the country as a whole). In practice, however, the ultimate objective of monetary policy has always been interpreted by the SNB as maintaining price stability and, in fact, inflation averaged 3 percent in 1973–99 the lowest among industrial countries; and responsibility for determining and implementing monetary policy is vested with the SNB's Governing Board.

217. The objectives of monetary policy will be more precisely defined in the revised SNB Law and will correspond closer to the way monetary policy has actually been practiced. The proposed revisions will stipulate clearly that the SNB shall ensure price stability. In doing so it shall take account of business cycle developments. The revisions will also address a range

of issues, such as the structure and organization of the SNB, supervision of the payments system, the collection of statistical data, the determination and distribution of profits of the SNB, and information requirements. A draft SNB Law, incorporating comments made during the public consultation process, is expected to be submitted to parliament in mid-2002 and the new law is anticipated to take effect not before 2004.

218. Switzerland maintains a flexible exchange rate regime. Foreign exchange policy is conducted by the SNB and subject to the same rules as monetary policy in general. However, the SNB retains the option to offset undesirable exchange rate developments, should it become necessary. While rules on the institutional responsibility for choosing the exchange rate regime are not specified in law, it is understood that this is a shared responsibility of the SNB and the Federal Council and it may require legislative action by parliament.

219. The independence of the SNB, which is enshrined in the constitution and will be stated explicitly in the proposed revised SNB Law, precludes an institutional relationship between monetary and fiscal operations. At the same time the SNB, based on a strict interpretation of its statute, limits its advances to the government to the level of government deposits with it; and abstains from the primary market for government securities other than in an agency function. The revised SNB Law will codify this practice by explicitly prohibiting any lending to the government (other than intra-day overdrafts against sufficient collateral). The participation of the SNB in the secondary market for government securities has been small and related primarily to monetary policy operations.

***Open process for formulating and reporting of monetary policy decisions***

220. The monetary policy process is well structured and open: monetary policy decisions are taken by the Governing Board at a quarterly meeting where a broad assessment of the economic situation is made. The decisions are communicated in the "Monetary Policy Assessment" which presents the motivations underpinning the policy decision. Twice a year the "Monetary Policy Assessment" is complemented by a formal update of the inflation forecast and the underlying assumptions. The Governing Board meets weekly and can change the monetary policy stance at any meeting. If the policy is changed outside the regular quarterly cycle, a press communiqué is immediately issued. Liquidity is managed with short-term repo operations and the market is guided with the announcement of a target range for the three-month Swiss franc LIBOR.

221. The current process of formulating and reporting on monetary policies has been successful in focusing the policy debate on price stability and guiding expectations in the money market, and has helped to dispel earlier public misperceptions that the SNB had been targeting the franc/euro exchange rate. There are, however, some minor nontransparencies. Minutes of the Governing Board are not released, as the SNB considers that this could lead to less open discussions at the meetings. The SNB has refrained from revising its published inflation forecast outside the regular semi-annual cycle, and the criteria used to select counterparties for FX and reserve management transactions are not publicly disclosed.

***Public availability of information on monetary policy***

222. Switzerland meets the specifications for the coverage, periodicity, and timeliness of the IMF Special Data Dissemination Standards, and for the dissemination of advance release calendars. The financial accounts of the SNB, including aggregate information on market transactions, are disclosed on a timely and pre-announced schedule. The SNB uses various channels to disseminate information to the public, including an annual report, quarterly and monthly bulletins, periodic announcements, research papers, and speeches by members of its governing board; these publications are also posted on the SNB website.

223. Two areas where improvements in the provision of information would be desirable are emergency support to banks and claims on government. First, there are no lender-of-last-resort provisions in the SNB Law. As the SNB can only provide secure loans, emergency financial support to banks is reported in SNB's regular statement together with other Lombard advances or repo transactions; it is not identified separately. The SNB avoids commitment for liquidity support to prevent moral hazard. Second, information regarding claims on government is published only annually.

***Accountability and assurances of integrity by the central bank***

224. The provisions in the law on SNB's accountability are limited in that the SNB is only required to consult with the Federal Council before any major monetary policy decision; but there are no penalties for underperformance or nonobservance. In practice, however, the SNB meets regularly with the Federal Council and the Federal Finance Ministry and appears once a year before the Economic Committee of parliament to explain the conduct of monetary policy and describe the performance in maintaining price stability. The proposed revision of the SNB Law distinguishes between *accountability* vis-à-vis the Federal Council, and *sharing of information* with the competent parliamentary committees and the public. It also introduces formally the requirement that the SNB publishes a quarterly report on economic and monetary developments. Two issues related to the Governing Board not addressed in the draft law are: first, specific criteria for determining whether a person no longer fulfils the conditions for exercising the duties as Governing Board member and, second, the requirement that Governing Board members be "fit and proper."

225. As an independent public law institution, established as a listed joint-stock company, the SNB is required to have its annual report examined by an auditing committee, based on the findings of independent external auditors and the internal audit. The annual report has to be approved by the federal government prior to its presentation to the annual general meeting of shareholders; although the proposed revised law does not require the publication of the annual report, this derives indirectly from the listing rules of the SWX. The annual report provides a breakdown of claims on and liabilities to the government, and includes an income statement with information on salaries, premises and office-related expenses.

226. The SNB has internal governance procedures to control activities in the institution and ensure the integrity of its operations. However, it does not disclose publicly these

procedures or measures to address conflict of interest, thereby not achieving full observance under the Code. The SNB Law provides legal protection for its staff in the conduct of official duties. With respect to civil liability, the law provides that third parties may assert a claim against the Confederation, but not the officer itself.

### Recommended Action Plan and Authorities' Response

Table 8. Recommended Action Plan—Monetary Policy Transparency

| Reference Practice | Recommended Action |
| --- | --- |
| I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy | It is recommended that the revised SNB law contain a provision explicitly requiring the publication of the annual report.<br>It would be advisable to be more specific regarding the criteria to be applied to determine that a person no longer fulfills the conditions for exercising the duties as SNB's Governing Board member. |
| II. Open Process for Formulating and Reporting Monetary Policy Decisions | It is recommended that principles for selecting counterparties in FX transactions with the SNB be disclosed. |
| III. Public Availability of Information on Monetary Policy | It is desirable that the SNB discloses in its 10-day statements information on claims on general government.<br>It would be advisable to establish internal rules for disclosing emergency liquidity support to banks. |
| IV. Accountability and Assurances of Integrity by the Central Bank | In the context of corporate governance, it would be advisable to publish information on the integrity of operations, such as measures to address conflicts of interest, and internal audit procedures. |

***Authorities' response***

227. The SNB agreed with the assessment, noting that the majority of practices were observed and the proposed SNB Law would strengthen the legal support of the transparency and the accountability efforts already undertaken by the SNB. On the recommendations, the SNB noted that those on the publication of the annual report and on the fitness criteria for SNB's governing board members (practices 1.1.5 and 1.1.7) had already been taken up; the rules of internal governance and conduct of personal financial affairs (practices 4.2.2 and 4.4) would be subject to a comprehensive review; the lender-of-last-resort function of the SNB was already under review and, in that context, the question of establishing internal rules for disclosing emergency financial support would be addressed (practice 3.2.3); and the appropriateness of publishing in its 10-day statements information on claims on government would be examined (practice 3.2.1). The SNB did not agree with the recommendation to disclose the principles for selecting counterparties in FX operations (practice 2.1.2) noting that the selection is based on the quality of services rendered by these counterparties and this is the information given to prospective applicants.

## B. Transparency of Financial Policies

### Main Findings—Summary

*Clarity of roles, responsibilities and objectives of financial agencies*

228. The broad objectives and institutional framework governing the roles, responsibilities and objectives of financial agencies are in general clearly defined in various pieces of legislation and regulations, and disclosed to the public in a timely and accessible manner. Neither the regulatory agencies nor the legislature, however, have set out the purpose of supervision or the objectives of each agency. The Zufferey report on financial sector supervision in Switzerland recommended that the Banking Act, as well as laws relating to securities and insurance supervision, contain a statement of the principle objectives of supervision as a signal to both financial institutions and their customers as to the purposes of supervision.

229. The procedures for appointment of the heads and Board members of all financial agencies are publicly disclosed. Procedures for the appointment, the terms of office, and criteria for dismissal of the staff of these agencies, including their head, are defined by the Swiss laws for public servants. The Director and the Deputy Director are appointed by the Federal Council acting within its prerogatives under the Swiss Constitution. These two, other staff of the regulatory agencies, as for all Swiss public servants, have a contract, and in their case it provides for a four-year term (to be changed shortly to an indefinite period).

230. There may be scope for formalizing the relationships between the supervisory agencies, the central bank, and the ministry of finance. Although there are regular exchanges of views among these institutions—a key, largely informal working relationship exists, for example, between the FOPI and the SFBC—more formalized arrangements would help to enhance transparency. In addition, it would be desirable to formally regulate the relationship between the SFBC and the professional associations (the SBA and the SFA).

*Open process for formulating and reporting of financial policies*

231. Overall, the conduct of policies by financial agencies is transparent. The law defines the regulatory framework clearly and the operating procedures governing the conduct of, and changes in, financial policies are publicly disclosed and explained. Supervisory activities in Switzerland involve a considerable amount of reliance on the work of external auditors and company actuaries; all regulatory agencies supply companies and their reporting professionals with all the necessary instructions, which are also made available to the general public through the Internet. The agencies maintain a steady dialogue with industry players in the formulation and application of supervisory policy.

*Public availability of information on financial policies*

232. There is a large amount of information available in Switzerland on developments and trends in the financial system, as well as regulatory changes. All financial agencies have a

well-developed publications program, including in all cases an annual report and a website. Appearances and other information instruments are used by senior staff as required. The heads of these various agencies and other members of senior staff represent the agencies at industry and public conference.

233. In the case of banking and securities, the SFBC annual report does not contain information on the activities—for instance, balance sheet developments and profitability—of the supervised institutions. Financial statistics covering these institutions are published by the SNB. Data on the SFBC's activities, including the issuance of licenses, is published in the SFBC annual report.

234. There are two principal means by which transparency in the area of information availability could be improved further with regard to the coverage and timeliness of annual reports. Specifically, (i) the FOPI's annual report could also include a discussion of FOPI's main activities and of emerging risks to the sector; and (ii) the FOSI's annual report could be published in a more timely fashion, and pension statistics could be updated more frequently and posted on the agency's website.

***Accountability and assurances of integrity by financial agencies***

235. Accountability and assurances of integrity by financial agencies are in the form of a broad reporting requirement on the major developments in the sectors for which they carry designated responsibility. Moreover, if necessary senior officials of financial agencies may be heard by the relevant public authorities, including parliamentary committees. According to the law, accountability before the plenary Parliament (the Federal Council) is by the relevant ministry—the FDF in the case of the SFBC, the Federal Department of Justice and Police in the case of the FOPI, and the Federal Department of Home Affairs in the case of the FOSI.

236. Although financial supervisory agencies have considerable operational autonomy, they have little financial independence, and for financial purposes they are treated as an integral part of the federal government. Practices on disclosure of these agencies' financial accounts have therefore been assessed as not applicable.

237. Rules on the legal protection for staff of financial agencies are publicly disclosed. As for all civil servants, officials of financial agencies may only be subject to criminal prosecution with the approval of the Federal Department of Justice and Police, which protects them from unsubstantiated claims of alleged criminal behavior. A civil suit may not be brought against staff of financial agencies, but has to be brought against the confederation. Recourse can only be had to the staff member if he or she has caused damage intentionally or by gross negligence.

## Recommended Action Plan and Authorities' Response

Table 9. Recommended Action Plan—Financial Policies Transparency

| Reference Practice | Recommended Action |
| --- | --- |
| BANKING AND SECURITIES | |
| V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies | As noted in the Zufferey report it would be helpful if the SFBC's objectives could be enshrined in the Banking Act when it is next revised.<br>There may be scope for formalizing the relationships between the SFBC, the FOPI, the SNB and the Federal Finance Administration. |
| INSURANCE | |
| V. Open Process for Formulating and Reporting of Financial Policies | The FOPI should consider including in its published annual report a discussion of its policy objectives and its achievements in meeting those objectives. |
| VI. Public Availability of Information on Financial Policies | The FOPI's annual report could also include a discussion concerning emerging risks, as well as a summary of FOPI's principal activities. |
| PENSIONS | |
| V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies | It would be advisable that the FOSI annual report be published in a more timely fashion. |
| VI. Public Availability of Information on Financial Policies | More frequent and timely disclosure of statistics of the pension system would be advisable. It would also be recommendable that annual reports be posted on the agency's website. |

### *Authorities' response*

238. The authorities were in agreement with the assessments.