June 2007
IMF Country Report No. 07/198

Switzerland: Financial Sector Assessment Program—Factual Update—Basel Core Principles for Effective Banking Supervision

This factual update of the Basel Core Principles for Effective Banking Supervision for 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 in May 2007. 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.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund ● Publication Services
700 19th Street, N.W. ● Washington, D.C. 20431
Telephone: (202) 623 7430 ● Telefax: (202) 623 7201
E-mail: publications@imf.org ● Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

SWITZERLAND

FACTUAL UPDATE:

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

MAY 2007

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

Contents **Page**

Acronyms

Basel Core Principles for Effective Banking Supervision	BCP
Federal Financial Market Supervision Authority	FINMA
Federal Office of Private Insurance	FOPI
Financial Services Authority	FSA
Money Laundering Control Authority	MLCA
Swiss Federal Banking Commission	SFBC

I. INTRODUCTION

1. **This note presents a factual update of the 2001 assessment of Switzerland's compliance with the 1997 *Basel Core Principles for Effective Banking Supervision* (BCP),** including a follow up on implementation of the 2001 BCP assessment, undertaken in the context of the original FSAP in 2001.[1] The note was based on a factual update prepared by the Swiss Federal Banking Commission (SFBC); interviews with staff of the SFBC, external auditors, industry, and professional associations; and various legal and other background documents. The update follows the revised BCP, which came into effect October 2006.

2. **This update is based solely on the laws, supervisory requirements, and practices that were in place at the time of the assessment.** However, the mission made note of regulatory initiatives which have yet to be fully implemented or which are not final, such as the draft Federal Financial Market Supervision Authority (FINMA) Act.

3. **The mission is grateful to the SBFC for its full cooperation and assistance with the logistical arrangements and co-coordination of various meetings with industry bodies and companies.** Discussions with SFBC staff during a series of technical meetings facilitated a meaningful update of Switzerland's regime.

II. OVERVIEW: SUPERVISORY SCOPE

4. **The SFBC is responsible for supervising all banks in Switzerland, along with securities firms, exchanges, and investment funds.** It is headed by the commission, whose members are appointed by the Swiss Federal Council. The commissioners, with the exception of the president, have other professional activities, and all are subject to independence and conflict of interest conditions.

5. **The SFBC has made impressive progress both organizationally and to its supervisory practices to strengthen Switzerland's banking supervisory framework.** The mission commends the SFBC for the many important measures adopted since the 2001 FSAP. The SFBC will undergo additional changes with the anticipated passage of the draft FINMA Act, which will result in the inclusion of the Federal Office of Private Insurance (FOPI), and the Money Laundering Control Authority (MLCA).[2]

---

[1] Prepared by Teresa Rutledge (U.S. Banking supervision expert, Office of the Comptroller of the Currency).

[2] FOPI is the supervisor for the insurance/reinsurance sector and the MLCA supervises the so-called nonbanking, noninsurance sector (e.g., asset management agencies, fiduciaries, bureaux de change), either indirectly (through SROs) or directly.

6. **The SFBC's organization reflects the dual nature of the banking sector.** The Large Banking Groups Department is dedicated to the supervision of the two large banks. It includes a risk management unit, on-site reviews unit, and units assigned to continuous off-site supervision of the two large banks. The small and midsized banks are in the Banks/Securities Firms Department. Units in other departments also exist for licensing and problem banks.

7. **The SFBC has significantly improved its outreach to foreign supervisors and its collaboration with external auditors and the industry.** The SFBC's relationship with host supervisors of the two large banks, the Federal Reserve Bank of New York and the Financial Services Authority (FSA), is considered a model for cross-border cooperation. The SFBC is in regulator contact with external auditors performing supervision related audits. The SFBC regularly consults with the industry before implementing guidance. Additionally, the SFBC pays attention to developments in the EU affecting financial institutions, and participates in Basel and international working groups.

8. **The SFBC understands the need to continue to advance the depth of its staff expertise and skills.** This is a major challenge for all supervisors, particularly those who supervise the most complex, globally active banks in the world. In this context, the SFBC should continually ensure that it has the necessary resources, expertise and advanced skills.

III. BCP Factual Update

9. **The SFBC has addressed most of the areas in the "Recommended Action Plan—Basel Core Principles" from the 2001 FSAP and the mission commends the SFBC for its efforts.** The earlier BCP assessment gave Switzerland a high compliance level but also made some recommendations.[3] The narrative below summarized measures that have been adopted and addresses each of the recommendations from the 2001 FSAP. Two noteworthy areas remain a concern—SFBC's budgetary independence and liquidity monitoring. The discussion below is divided into the seven broad categories of the 2006 Revised BCP. Additional recommendations for consideration are also noted.

Objectives, independence, powers, transparency and cooperation (Principle 1)

10. **Supervision of the financial system will be integrated under a new supervisory body, FINMA.** The draft FINMA Act is currently being discussed in Parliament. The authorities anticipate that the statue will be adopted in 2007. Given that the Parliamentary process is expected to take more time than originally anticipated, FINMA is expected to

---

[3] Switzerland was assessed as compliant with Principles 2–25 and largely compliant with Principle 1.

become operational in mid to late 2008, as opposed to the originally envisaged date of January 1, 2008.

Progress on recommended actions from the 2001 Assessment

11. **While all economic regulation necessarily involves balancing the public benefits with the costs of regulation to industry, the draft legislation may give a weight to the latter which could limit the capacity of FINMA to be an effective regulator.** Some provisions in Article 7 of the draft Act could give the industry excessive leverage in opposing needed regulation and could provide a cover for forbearance on the part of FINMA in situations where strong action is needed to preserve the health of the financial system.

12. **The SFBC has not yet achieved full budgetary independence.** Currently, the SFBC is still part of the expense calculation of the central government's budget. The authorities expect this to change when the draft FINMA Act adopted by Parliament. However, there are some provisions in the draft Act that could have implications on the operational and budgetary independence of the FINMA. These provisions include the federal oversight of (i) the strategy and policy issues applicable to the financial center (Article 21); (ii) the remuneration scale of FINMA employees (Article 13); and (iii) approval of the oversight tax to fund FINMA (Article 15). The authorities assured the mission that the intention of Article 21 was not to interfere with the independence of FINMA but to provide a channel for the exchange of views; the Federal Council had no competence to overrule FINMA single case decisions and regulations. Similarly, the Federal Council powers to approve the oversight tax and remuneration were intended to provide the necessary checks and balances.

Licensing and structure (Principles 2–5)

13. **There have been no major changes to the SFBC's licensing regime. The SFBC grants roughly 8–10 licenses a year.** The SFBC indicated that in reviewing applications, it evaluates such areas as corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities. The SFBC also indicated that it looked through companies to identify ultimate shareholders when evaluating changes in ownership. The SFBC publishes a list on its website in three different languages of licensed banks and branches of foreign banks operating within its jurisdiction.

Progress on recommended actions from 2001 Assessment

14. **An exception in the Banking Ordinance continues, which permits nonbank employer sponsored deposit-taking entities (i.e., Betriebssparkassen).**[4] The Federal

---

[4] These entities are not licensed or regulated as financial institutions.

Council and Parliament determined in 2005 that the systemic risk emanating from the very few remaining Betriebssparkassen was negligible, thus the exception remains. The Federal Council decided to enhance the protection of depositors by means of active information about the risks of Betriebssparkassens. The Basel Core Principles Methodology allows for such exceptions, provided that the nonbank-deposit taking entities do not hold a significant proportion of deposits in a financial system.

Prudential regulation and requirements (Principles 6–18)

15. **Since the earlier FSAP, the SFBC has issued circulars addressing a number of prudential areas such corporate governance, internal controls, large bank supervision, supervisory reporting, audit, audit companies, anti-money laundering and self-regulation.** Five circulars relating to Basel II will enter into force on January 1, 2007 and cover credit, market, operational, capital adequacy disclosure and large exposures. Also, the Capital Adequacy Ordinance will enter into force at the same time. These guidelines, along with SFBC circulars issued prior to the 2001 FSAP (e.g., interest rate risk, outsourcing) and the SFBC-endorsed guidelines from the Swiss Bankers Association, generally address BCP essential criteria.

16. **Swiss banks will be subject to modified versions of Basel II.** Switzerland incorporates all of the approaches in Basel II and the three pillars into its regulation. The authorities reported that advanced approaches to operational (AMA), credit (A-IRB), and market risk are being adopted from Basel II in unmodified form. The advanced approaches will be used by the two large Swiss banks and a few of the larger banks, while the rest of the sector will adopt the simpler approaches. The effective date for the advanced approaches is January 1, 2008.

17. **Most other Swiss banks will apply the simpler approaches to measuring risk under Basel II.** The effective date for implementation of these approaches is January 1, 2007. Banks using the simpler approaches are given two choices: Swiss approach (SA-CH) or the international approach (SA-BIS). SA-CH is different from Basel II in certain credit risk weights, although operational risk calculation is the same under both approaches. SA-BIS is "Basel II pure," with certain multipliers (greater than 1) for credit risk. The multipliers were added as the SFBC determined through an impact study [5] that the "Basel II pure" calculation resulted in less capital than under the SA-CH, particulalry for banks active in traditional lending businesses (cantonal, regional, and Raiffeisen banks). The multipliers were therefore chosen to ensure that, on average, capital requirements under Basel II would not be lower than Basel I requirements. The impact study also indicated that banks active

[5] Quantitative Impact Study Switzerland 5 (QIS-CH 5). The two large banks were excluded as they participated in the international QIS 5

primarily in asset management, investment advisory or trading services would have an increase in required capital, due to the new operational risk charge.

18. **The Swiss capital requirement (both under Basel I and Basel II) is effectively higher than the 8 percent requirement.** In practice, the SFBC expects banks to hold 20 percent additional capital, or total capital to risk weighted assets ratio of 9.6 percent. If a bank falls below the 20 percent threshold, the bank is placed under closer supervision by the SFBC, and is required to raise its capital adequacy ratio back to above the 20 percent threshold. This buffer is applied to all banks under Basel I and will continue to apply under Basel II above the pillar I requirements.

19. **There is the question whether an additional capital charge should apply to the two large banks after the adoption of Basel II.** The additional charge should consider the specific risks in the banks' operations that are not adequately covered in Pillar I requirements of Basel II, and the systemic importance of the banks to the Swiss economy and financial system. In view of their size and importance, serious financial problems in the two large banks would have significant implications for the Swiss economy and its reputation as a financial center. For the large banks, Pillar II capital requirements should be thoroughly evaluated and considered. These need to be re-assessed on an annual basis for each bank to reflect the institution specific risk profile and supervisory/regulatory concerns. The approach could require the SFBC to intensify its oversight, particularly in market risk and would provide flexibility in the capital charges to keep up with the banks' changing risk profile.

Progress on recommended actions from the 2001 Assessment

20. **There are plans to abolish the current 12.5 percent capital reduction for cantonal banks.** On November 3, 2005, the Association of Swiss Cantonal Banks announced in a public statement that the reduction will be phased out gradually after the implementation of Basel II in 2007 with full elimination by 2011.

21. **Supervision of bank-specific liquidity is one area that still needs to be addressed.** The current approach, as outlined in the SFBC Banking Ordinance, is outdated and does not take account of the nature and complexity of the large banks' operations. The mission acknowledges that the SFBC does not only rely on the liquidity statement prepared in accordance with the Banking Ordinance in assessing liquidity in the large banks; external auditors also have to assess the adequacy of the banks' liquidity management systems, and SFBC staff monitors quantitative liquidity measures. The SFBC noted its plans to address liquidity more fully and that it has not addressed this area yet due to resource restriction and other priorities (e.g., Basel II).

22. **As per the earlier FSAP recommendation, the SFBC developed an early warning system for small- and medium-sized banks, which was recently implemented.**

Considerations are given to quantitative and qualitative factors. Additionally, the Large Banking Groups Department developed an assessment tool it uses as an early warning indicator. A rating is established based on the assessment of eight criteria. For both early warning systems, the SFBC takes into account information received directly from banks, external auditors, its own reviews and from other supervisors. The rating influences the supervisory strategy for the bank. Since the systems are new, their effectiveness will need to be evaluated over time.

23. **The SFBC has improved its data collection from banks and is currently collecting additional data such as asset quality and gap reports.**

Methods of ongoing banking supervision (Principles 19–21)

24. **The SFBC continues to use a two-tier system of supervision, with SFBC-approved audit firms performing onsite reviews and SFBC retaining responsibility for overall supervision and enforcement measures.** For the small- and medium-sized banks, all on-site reviews are performed by external auditors. An annual regulatory audit report is completed. The early warning system recently implemented is intended to aid SFBC's off-site monitoring. Additionally, the auditor quality assurance unit formed since the prior FSAP, which includes a quality review of the auditors' working papers and performing an audit quality review at the bank while the external audit team is executing its audit, had been beneficial to the SFBC.

25. **For the two large banks, the SFBC has developed a formal on-site review program, although still limited given the size of the two large banks.** Two on-site reviews per year are performed by SFBC staff in each bank. External auditors perform the bulk of on-site supervision work. External auditors have to file an extensive annual regulatory audit report that includes qualitative assessments on the risk management of the bank. Two in-depth audits are performed also, on a specific business activity or regulatory issue. The SFBC's off-site work includes a review of external auditor reports and bank provided information, regular contact with external auditors and the bank, and regular contact with domestic nonbank and foreign banking supervisors. For the two large banks, the SFBC should continue to advance its expertise and engagement with the banks, through performing more on-site work.

Progress on recommended actions from 2001 Assessment

26. **Contact with senior management of banks has improved and is focused on banks presenting a higher risk profile.** The SFBC Large Banking Groups Department staff meets at least quarterly with various management levels of the large banks. Regarding the small- and medium-sized banks, the SFBC meeting frequency depends on the bank's risk profile.

27. **One of the major changes since the 2001 FSAP has been the addition of the Audit Firms Department, which evaluates external auditors' work performed in the small and medium sized banks.** This has been working well. For the large banks, the process is not under the quality assurance unit, but that unit assists the Large Banking Groups Department in conducting quality assurance on large banks' auditors. The Audit Firms Department's review process includes going onsite at the bank, reviewing working papers, and interviewing auditors.

Accounting and disclosure (Principle 22)

28. **As noted elsewhere, external auditors play a very important role as they not only audit the financial statements but also check bank compliance with all legal and regulatory requirements.** The SFBC approves audit companies and lead auditors. Auditors in charge are rotated every seven years, but there is no requirement to rotate the audit company. The SFBC has full access to the external auditors' working papers. Also, it has the power to require additional audits. Annual financial statements have to be fully audited every year, and the SFBC is to be immediately informed of any serious issues. External auditors work closely with internal auditors on scope of reviews and the SFBC have the ability to comment on the audit scope. Given the dependence on external auditors, it is recommended that the SFBC involve different international experts and audit firms for special audits. Also, the SFBC should consider the periodic rotation of audit firms.

Corrective and remedial powers of supervisors (Principle 23)

29. **Amendments to the Banking Act in 2004 specified the grounds for action by which the SFBC could issue "protective measures" against a bank or individual.** The grounds include a bank that has serious liquidity or capital adequacy issues. Protective measures include issuing instructions for the bank to do something (wide powers per the SFBC), appoint someone to perform an investigation, or appoint someone to run the institution.

Progress on recommended actions from 2001 Assessment

30. **The SFBC continues not to have the direct authority to impose civil monetary penalties on banks or directors or managers, and this authority is not contemplated under the draft FINMA Act.** The draft FINMA Act introduces an explicit sanctioning regime for breaches of the law and regulations, though in some cases, the maximum sanctions seem modest and unlikely to deter abuse.

31. **The draft FINMA Act addressed the publication of an oversight decision. Specifically, Article 34 of the draft FINMA Act states that in case of a strong violation of supervisory provisions, the FINMA can publish its final decision, and personal data**

may be given. Additionally, under the 2004 amendments to the Banking Act, the SFBC can publish protective measures.

Consolidated and cross-border banking supervision (Principles 24–25)

32. **Regarding consolidated supervision, an amendment to the Banking Act, effective January 1, 2006, established formal legal rules for financial groups, insurance groups, and financial conglomerates.** The same rules apply to securities firms through another law. This provides for a more comprehensive set of legal rules for the supervision of financial conglomerates.

33. **Since the last FSAP, on-site visits by host supervisors have been conducted in Switzerland by seven different regulators.**

Progress on recommended actions from 2001 Assessment

34. **The SFBC has formalized Memoranda of Understanding or exchange of letters with most banking supervisors in strategically significant countries.** Since the last FSAP, the SFBC has concluded Memoranda of Understanding with the French Commission Bancaire, the State of Connecticut Department of Banking, the UK FSA, the Hong Kong Monetary Authority, and the U.S. Federal Reserve Board, OCC, and FDIC. Exchange of letters regarding information sharing occurred with the Belgian and the New York State Banking Department and with Banca d'Italia.

35. **The SFBC's tripartite arrangement with the U.S. and UK regulators on the supervision of the two large Swiss banking groups is considered effective and a model for supervisory cooperation.** The regulators meet frequently among themselves and with the two banks. The SFBC visits other foreign regulators and the two large banks in other strategically significant countries.

IV. KEY RECOMMENDATIONS

Table 1. Key Recommendations—Basel Core Principles

2006 Basel Core Principles (BCP)	Recommendations
Objectives, independence, powers, transparency, and cooperation BCP 1	Revise provisions in Article 7 of the draft FINMA Act, which presently could give industry representatives excessive leverage in opposing regulation. Continue to advance the depth of staff expertise and skills.
Licensing and structure BCP 2–5	
Prudential regulation and requirements BCP 6–18	As part of Basel II implementation, review in depth the capital adequacy of the two large banks. Develop an advanced supervisory framework for bank-specific liquidity risks.
Methods of ongoing banking supervision BCP 9–21	Consider advancing engagement with banks, through performing more on-site discovery work.
Accounting and disclosure BCP 22	Consider using a renge of international experts and audit firms for the special audits. Consider the periodic rotation of audit firms.
Corrective and remedial powers of supervisors BCP 23	The SFBC should have the authority to impose direct civil monetary penalties on banks, directors, or managers.
Consolidated and cross-border banking supervision BCP 24–25	

V. AUTHORITIES' RESPONSE

36. **Under Basel II, Pillar II capital needs will be evaluated for the two large banks; this is expected to be implemented over the next 2-3 years.** According to the New Basel Capital Accord, the Pillar 2 capital charges will be evaluated on a regular basis for each bank to reflect the institutions' specific risk profiles and supervisory concerns of the SFBC. To this end, a great deal of effort is undertaken to understand and evaluate the two large banks' complex risk profiles and models. The SFBC's internal rating system for the two large banks

is the main tool to structure our Supervisory Review and Evaluation Process of the banks' risk and capital situation. This instrument undergoes a periodic validation and improvement process. Currently, this tool is improved with respect to a more detailed inclusion of information from the banks' internal capital models and stress testing among other things. The additional Pillar 2 capital requirements will be based on the findings of this institute-specific Supervisory Review and Evaluation Process.

37. **The SFBC agrees that the supervisory approach to assess liquidity risks needs improvement.** In this context, considering resources and other priorities, the liquidity supervision approach for the two large banks was reviewed in the second half of 2006. A new assessment method of bank-specific liquidity was introduced in December 2006 in the context of the internal rating system of the two large banks. Further, the SFBC participates in the current efforts of the Basel Committee to review the international supervisory standards for assessing bank-specific liquidity risks and will consider the improvements in this area and examine their implementation in the Swiss banking regulation.