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CONTENTS

FOREWORD BY THE CHAIRMAN 5

INTRODUCTION BY THE CEO 6

SELECTED TOPICS

Supervisory approach 10
Proposals for solving the 'too big to fail' problem 10
Capital and liquidity requirements 13
The situation in the mortgage market 16
The challenges of a low interest rate environment 19
The Swiss Solvency Test and European solvency rules 21
Regulatory project on distribution rules 24
Remuneration schemes 26
Investigations and lessons from the crisis 27
Increase in legal and reputational risks in cross-border financial services 29
Enforcement practice 31
UBS cross-border business – possible proceedings against former executives of the bank 32

INTERNATIONAL INVOLVEMENT AND AGENDA

FINMA's international presence 36
Switzerland's international cooperation 37
Revision of the regulatory and supervisory framework for managers of alternative investment funds 38
Supervisory colleges 38
International administrative assistance 39

FINMA: THE AUTHORITY

Board of Directors 42
Committees of the Board of Directors 42
Executive Board 43
Extended Executive Board 43
Enforcement Committee 43

ORGANISATION CHART 44

FINMA'S REPRESENTATION IN INTERNATIONAL WORKING GROUPS 46

Dr Eugen Haltiner, Chairman (left), Dr Patrick Raaflaub, CEO

FOREWORD BY THE CHAIRMAN

Achievements

An annual report is the means by which an organisation gives an account of its activities. It offers a transparent commentary on what has been achieved and an assessment of the challenges that lie ahead. All of this holds true for a supervisory authority such as FINMA, whose decisions have in recent times increasingly attracted both attention and criticism from the public at large. The benchmark against which our work is judged is a comparison between what we have accomplished and the objectives we had set ourselves. FINMA's strategic goals were first approved by the Federal Council in September 2009 and subsequently published. They are divided into seven topic areas, which provide a longer-term orientation for the activities of the supervisory authority. Supported by annual targets at all management levels, the implementation of these goals is carried out within the framework of projects.

All areas have begun tackling the tasks with which they are entrusted and significant milestones have been achieved. This Annual Report contains the details.

FINMA is on course and is effectively fulfilling the legal mandate with which it has been entrusted. A range of organisational measures, combined with targeted recruitment, have enhanced the authority's efficiency and professionalism. Integration of our predecessor organisations is not yet complete, but the first synergy gains are already evident, while cross-sector collaboration has been significantly improved. Such collaboration is vital, since the risks involved in financial intermediation increasingly affect multiple areas rather than individual sectors. Comparable risks require comparable standards; where there are differences in the approach to regulation, methods and the tools available, the aim should be to achieve convergence wherever this is justifiable. Further efforts also need to be made to encourage networked thinking that views the supervision of individual institutions within the framework of the macroeconomic environment. Risk monitoring, for example, needs to be seen in a broader context; one which takes account of potential developments in the economy at large that are of importance to the system as a whole.

FINMA's staff have demonstrated admirable commitment to achieving these aims. They deserve public gratitude and recognition for their work, which is carried out under difficult circumstances and in fields where the potential for conflict is ever-present. There are many areas of tension and these can never be resolved to the satisfaction of all. Undaunted by criticism which is often based on false assertions and incomplete knowledge, the staff of FINMA work tirelessly to achieve our goals, without ever losing their sense of direction. I hold each and every one of them in the very highest regard.

Dr Eugen Haltiner, Chairman
December 2010

INTRODUCTION BY THE CEO

FINMA set itself ambitious and demanding targets for 2010 that gave substance to the overarching strategic goals approved by the Swiss Federal Council. The challenges both inside and outside our authority have been considerable and remain so. While the economic environment on the financial markets has improved from the crisis situation of recent years, the conditions under which FINMA-supervised institutions work are nevertheless persistently difficult. The threat of an economic downturn has not gone away and all-time-low interest rates together with central banks' emergency injections of liquidity into the markets bring the risk of new price bubbles.

Moreover, a supervisory authority's work is not done when a crisis comes to an end. On the contrary, in fact: the financial crisis brought to light major deficiencies in the existing regulatory system that must now be rectified. The Basel Committee's comprehensive reform project to overhaul international banking regulation under the Basel III rules reflects the will among regulators around the world to act on lessons learned from the crisis. It is also clear that the resulting rules represent solutions based on international consensus and are thus either largely or completely unable to take account of country-specific challenges in particular areas.

With respect to Switzerland, one of FINMA's main strategic goals was to find suitable regulatory responses to the systemic risks affecting the Swiss financial sector due to the size and complexity of the big banks. FINMA's active involvement in the 'too big to fail' Commission of Experts to report on limiting the economic risks posed by large companies, which submitted hard and fast proposals to the Federal Council, is of central importance in this respect. However, much has also been achieved in other fields by maintaining a sense of proportion, avoiding activism and acknowledging international efforts, which are very similar to the Swiss measures in terms of liquidity requirements and amending capital adequacy requirements.

Targeted improvements to client protection constitute another of FINMA's overarching strategic goals and progress was made with key work in this area last year. The fallout from the collapse of Lehman Brothers, which spread as far as Switzerland, and from the Madoff fraud case triggered a

wide-ranging FINMA investigation that highlighted room for improvement as regards client protection and in particular transparency guidelines. FINMA subsequently produced a detailed discussion paper on regulating the distribution of financial products with a focus on small clients, which from FINMA's perspective shed light on shortcomings in the present regulation and suggested potential courses of action. In insurance supervision, the full implementation of the Swiss Solvency Test represents a significant milestone in improving protection for policy holders.

With a view to enhancing the effectiveness and efficiency of its operations, FINMA developed a risk-based supervisory approach for each of its fields of activity. To this end, institutions are to be split into a number of supervisory categories in line with their size and risk impact. These categories will be subject to direct FINMA supervision with differing degrees of intensity. The aim is to focus the limited supervisory resources available on the biggest risks to creditors, investors and policy holders.

Besides these challenges and achievements in specialist fields, further progress was made with FINMA's operational development in 2010. We are already seeing functional synergies paying off in key areas as a result of the merger. By combining the three former authorities into a single entity and strategically expanding important areas of supervision that were previously understaffed, we have created a larger organisation of some 400 people. This has given rise to a need for organisational changes. We intend to harmonise our processes and employ new tools in order to increase efficiency so that we can make an even greater contribution with the same resources. This highly ambitious internal development plan was devised and begun in 2010 and will now be moved forward in stages.

After weighing up all the goals set and milestones reached, I can only conclude that FINMA succeeded in mastering a very demanding year in 2010 and setting a course for further success going forward. I would therefore like to take this opportunity to thank all of my colleagues most sincerely for their hard work. Buoyed by the experience of the past two years, I look forward to facing the challenging tasks that lie ahead in 2011 together with the staff of FINMA.

Dr Patrick Raaflaub, CEO
December 2010

SELECTED TOPICS

SELECTED TOPICS

Supervisory approach

FINMA aims to act as an efficient and effective supervisory authority in line with the strategic goals approved by the Federal Council. It has therefore begun work on optimising and realigning its supervisory approach in its various fields of activity.

Considering the wide range of assignments that fall under FINMA's remit and the high demands made in many regulatory areas, FINMA's human resources are very limited. Responsible and economical deployment of the funds available therefore requires a focus on those tasks which demand greater attention owing to the underlying risks involved. One important element is the consistent pursuit of a risk-based approach in all areas subject to FINMA supervision. The various supervisory laws grant FINMA a degree of flexibility in terms of the extent to which it supervises individual institutions. The aim in future is to make more systematic use of this flexibility, taking due account of the risks emanating from the institutions concerned.

Against this backdrop, FINMA has allocated all the institutions it supervises to one of six categories according to their risk impact on creditors, investors, policy holders and the system as a whole, as well as the reputation of the Swiss financial sector. The institutions in category 1 are those that are of major and even global relevance, and therefore pose correspondingly significant risks at various levels. The risk potential of the institutions in the remaining categories decreases progressively down to category 5; market participants in the low-risk category 6 are subject to non-prudential supervision.

As well as being allocated to a risk category, each institution receives an internal rating corresponding to FINMA's assessment of its current state. On the basis of these two parameters – categorisation and institution rating – the supervisory approach, the extent of supervision, the use of supervisory tools, and the interaction between direct supervision by FINMA and the assignment of audit firms for the individual institutions are then established.

Through this regulatory approach, FINMA aims in future to achieve further differentiation in supervision and a more efficient allocation of the resources at its disposal.

Proposals for solving the 'too big to fail' problem

The global financial and economic crisis clearly demonstrated that the failure of individual companies in the financial sector can pose a major systemic risk to a nation's economy. During the crisis, governments were obliged to offer support to banks that were of systemic importance, in order to maintain the operation of banking functions critical to the economy. These institutions were 'too big to fail'. Their size, in terms of market share and total assets, the impossibility of substituting at short notice the services they provide, their international scope and the fear of contagion affecting the entire financial system mean that Switzerland's two big banks enjoy an implicit guarantee. This results in a distortion of competition vis-à-vis banks that are smaller or not deemed to be of systemic importance. In addition, the market mechanisms that impose discipline are rendered ineffective and the balance between risk and reward is distorted. The global rescue packages largely shielded the management and investors of banks from the losses arising out of their decisions. Internationally, central banks, bank supervisory authorities and politicians are currently searching for solutions to this 'too big to fail' problem. The aim is to put in place preparatory measures that will enable even banks that are of systemic importance to be restructured or liquidated in an orderly manner should another crisis occur. Moreover, shareholders and creditors must be

reminded once again that in bankruptcy scenarios they must themselves bear the losses arising out of their investment decisions. This in turn should reduce their willingness to take risks and thereby contribute to improving the stability of the financial sector. Following the events of October 2008, when a combination of a federal government mandatory convertible note and a transfer of assets to the Swiss National Bank (SNB) was required in order to support UBS, the Federal Council set up on 4 November 2009 a Commission of Experts to report on limiting the economic risks posed by large companies. The Commission's members included representatives of Swiss financial companies, the Swiss Federal Finance Administration (FFA), the SNB and FINMA.

Final report by the Commission of Experts

In its final report published on 4 October 2010,[1] the Commission began by explaining the term 'systemic importance'. According to its definition, a company is systemically important if it is indispensable to the economy owing to its size, market position and interconnectedness with a large number of other market participants, as well as the impossibility of substituting the services it provides within a reasonable period of time. In the Swiss financial sector, at least the two big banks, UBS and Credit Suisse, currently meet these criteria. Although the insurance sector is unquestionably of key importance to the Swiss economy as a whole, the Commission did not find evidence that, under the benchmark applied and the current circumstances, there are any 'too big to fail' or 'too big to be rescued' situations in the Swiss insurance sector.

If the state were obliged to intervene for reasons of social policy, for example in order to support the occupational pension system, life insurers would be affected by the measures taken, as they provide backing for the occupational pension schemes. However, government intervention motivated by such social policy concerns should be distinguished from an unacceptable systemic risk to the financial sector and the real economy of the kind being discussed in connection with banks.

Furthermore, unlike with the banks, the rating agencies do not base their assessments of the creditworthiness of the major insurers on the existence of a de facto state guarantee. This, nevertheless, does not entirely rule out the possibility of systemic risks emerging in the insurance sector, especially via activities that are remote from insurance and closely related to banking. Since the existing supervisory regime for insurance companies, backed by the traditional insurance business model, is considered to be essentially adequate, there is no pressing reason for fundamental changes to the approach to insurance supervision at present. As part of its investigations for the Commission of Experts, in June 2010 FINMA published a working paper entitled 'Assessing the potential for systemic risks in the insurance sector. Considerations on insurance in Switzerland'.[2] It recommends targeted improvements in the supervisory regime as part of the general process of refining insurance supervision.

The Commission proposed four mutually complementary core measures in the areas of capital, liquidity, risk diversification and organisation.

Core measures recommended by the Commission of Experts

In view of the situation outlined above, the Commission of Experts chose to focus its attention on the banking sector. It proposed measures that are both appropriate and feasible for Switzerland and will enhance the crisis resistance of systemically important banks. If a systemically important bank fails, the aim is to ensure its exit from the market while at the same time securing the continuance of its systemically important functions without the need for state aid. In order to achieve this, the Commission proposed four mutually complementary core measures in the areas of capital, liquidity, risk diversification and organisation. It refrained from recommending size limits or dismantling big banks,

[1] See http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en

[2] See http://www.finma.ch/e/finma/publikationen/Documents/wp_juni2010_systemische-risiken-im-versicherungssektor_20101004_e.pdf

or far-reaching interventions in their structure. It also rejected tax-based solutions of the kind being discussed elsewhere in Europe, believing that such approaches do not make an effective contribution to financial stability and may, unless backed by a credible threat of bankruptcy, actually create false incentives.

Higher capital requirements

The first core measure envisages a substantial increase in the capital requirements for the two big banks, in terms of both quality and quantity. In future, these will be divided into a minimum requirement, a buffer to absorb substantial losses, and a progressive component that will rise in line with the banks' importance to the system.

The level of the requirements will be measured on the basis of risk-weighted assets and, using the leverage ratio, non-risk-weighted assets.[3] At least ten per cent of the risk-weighted assets must consist of top-quality capital (common equity). Up to 35 per cent of the buffer requirements can be satisfied using contingent convertible bonds (CoCos). The progressive component, which under current conditions would amount to about six per cent of risk-weighted assets for each of the two big banks, can consist entirely of CoCos. CoCos are capital instruments that are automatically converted into equity when a bank's equity ratio drops below a predefined level (trigger) or are written off. If CoCos are used for parts of the buffer, they are converted at a trigger level of seven per cent, in order to prevent the bank slipping into the restructuring or liquidation (recovery or resolution) phase. For CoCos in the progressive component, the Commission proposes a trigger level of five per cent, in order to make sufficient funds available to carry on the bank's systemically important functions and ensure the orderly resolution of the remainder of the bank.

More stringent liquidity requirements

As part of its second core measure, the Commission of Experts backs the more stringent liquidity requirements for Switzerland's two big banks that were implemented at the end of June 2010. Since that time, UBS and Credit Suisse have been subject to liquidity requirements under which they must be able to cover the liquidity outflows expected in a stringent stress scenario from their own resources for at least 30 days.[4]

Reducing concentrations of risk

In its third core measure regarding risk diversification, the Commission calls for a reduction in other banks' concentrations of risk relative to the systemically important institutions, and vice versa. This is accompanied by measures to reduce smaller banks' various operational dependencies on systemically important banks.

Organisational requirements

The final key part of the overall package is the organisational requirements for systemically important banks. The Commission of Experts demands that such banks be able to secure the continuation of their systemically important functions even when faced with the threat of insolvency. These functions include in particular payment services and domestic deposit and lending business. Furthermore, in the event of transferring systemically important functions to another entity, the contingent capital should contribute significantly to funding both the new legal entity that assumes these functions and the remainder of the bank, making them financially viable. In the light of constitutionally protected rights and freedoms, the implementation of the required organisational measures is primarily the responsibility of the bank concerned (subsidiarity principle). However, if the bank is unable to demonstrate that it has put effective measures in place, such as a convincing and transparent recovery and resolution plan (RRP), FINMA must order it to do so.

Bridge bank and incentive system

As soon as a bank's equity ratio falls below five per cent of risk-weighted assets, it must be possible to transfer its systemically important functions to an independent legal entity (bridge bank) within a short

[3] Additional requirements can also be imposed to take account of off-balance-sheet transactions.
[4] See 'New liquidity regime for Switzerland's large banking groups' in the 'Capital and liquidity requirements' section, p. 13.

time. At the same time, CoCos would be converted into equity in order to provide the financial basis for implementing the emergency plan. If a bank exceeds the minimum organisational requirements placed upon it and thereby facilitates its potential restructuring and liquidation, this is rewarded by a rebate on the progressive capital component. In this way, companies are encouraged to simplify their business models, legal and organisational structures. Important data and services must be available in full whenever required. Interdependencies and risks of contagion within the company should be reduced. By minimising geographical imbalances and ensuring a geographical congruence of assets and liabilities (self-sufficiency), banks can reduce the risk of ring-fencing by national supervisory authorities. In conjunction with the incentive system described by the Commission, the ongoing revision of bank insolvency legislation will also improve the situation regarding the restructuring and liquidation of systemically important banks.

The implementation of some of the measures proposed by the Commission of Experts requires an amendment to the Banking Act. The Commission therefore submitted a corresponding draft for a partial revision, which is serving as the foundation for further work by the legislature.

At its meeting on 22 December 2010, the Federal Council submitted for consultation legislative proposals on dealing with the systemic risks of big banks. The draft amendment to the Banking Act is based on the Commission's proposals. The Federal Council is also proposing tax measures to promote the issue of new conditional and convertible capital in Switzerland. The consultation will last until 23 March 2011.

Capital and liquidity requirements

In 2010, FINMA focused on three regulatory issues concerning capital and liquidity requirements for banks:

- The new liquidity regime for the two large banking groups came into force on 30 June 2010.
- In terms of capital requirements, measures were taken by FINMA based on international regulatory developments, notably the market risk rules laid down by the Basel Committee on Banking Supervision (BCBS) ('Basel 2.5').
- FINMA also published a discussion paper on adjustments to capital requirements under Pillar 2 and the introduction of a leverage ratio,[5] and indicated that it would be issuing a circular on this subject.

New liquidity regime for Switzerland's large banking groups

It had been clear for some time that there was urgent need for action on liquidity requirements, especially for the big banks. The existing Swiss liquidity regime was unable to adequately ensure the crisis resistance of large and complex banking groups with international operations. The SNB and FINMA therefore worked closely with the big banks concerned to devise a new liquidity regime, which came into force on 30 June 2010. The new regime is based on the following concept: the SNB and FINMA define a general stress scenario and lay down the relevant parameters, and the big banks then determine the liquidity inflows and outflows that are to be expected under that scenario.

The scenario assumes a general stress situation on the financial markets and a major, specific loss of confidence among the bank's creditors. Nervous depositors withdraw their money. The bank is no longer able to refinance itself on the interbank market or the financial markets. The new regulations require the banks to have sufficient liquidity available to cover the outflows estimated under this scenario for at least a month. This will ensure that the bank and the authorities have the minimum time

[5] See http://www.finma.ch/d/finma/publikationen/Documents/diskussionspapier-saeule-2-bei-kmb-20100618-d.pdf (German version).

they need to initiate further measures and stabilise the crisis situation. The new liquidity requirements are anticyclical in design: the banks are expected to build up or maintain a liquidity buffer in good economic times, which can then be drawn down in a stress situation. The two big banks are required to submit monthly reports demonstrating that they are fulfilling the requirements.

The international minimum liquidity coverage standards finalised by the BCBS at the end of 2010 cannot be viewed as a substitute for requirements geared specifically to the particular features of a systemically important bank in Switzerland. In terms of methodology, they are compatible with the Swiss approach, though the underlying stress scenario is less conservative. The SNB and FINMA are currently examining the need to adapt these regulations to bring them into line with international standards that will come into force in 2015 and 2018. The introduction of a net stable funding ratio, however, could provide a structural measure of liquidity over a one-year horizon which would be a logical complement to the Swiss approach. The liquidity requirements for the remaining banks are expected to be introduced in parallel with the international regulations.

Market risks and securitisations

The financial crisis highlighted clear shortcomings in the regulatory system, notably in the excessively low capital requirement for market risks and securitisation products. This non-risk-based approach encouraged the build-up of large risk positions in the run-up to the crisis, although the key capital indicators (BIS ratios) remained adequate. The BCBS had identified these developments before the crisis broke and had already begun work on reforms. As we now know, however, these came too late, especially given that it takes several years for the revised Basel minimum standards to be enacted in national law. The BCBS published the most urgent supplementary measures – the revised capital adequacy regime for market risks and securitisations – in July 2009. Although it was originally intended to come into force at the end of 2010, its implementation was unexpectedly postponed by a year to the end of 2011. This was announced in the second quarter of 2010, by which time the national working group headed by FINMA had already virtually completed drafting of the necessary amendments to the Capital Adequacy Ordinance and the associated implementing provisions in the form of FINMA circulars. The large banking groups, which are principally affected by this revision, were already well advanced along the path of implementing the new regulations by mid-2010, and had sufficient equity capital to meet the more stringent requirements. FINMA therefore argued in favour of adhering to the original schedule and against postponing by a further year the rectification of what all agreed was a regulatory deficit, despite the Basel resolutions. In November 2010, the Federal Council decreed that the original timescale for the revised capital adequacy requirements for market risks and securitisations should be maintained, and the revised Capital Adequacy Ordinance came into effect on 1 January 2011.

The revision of the Capital Adequacy Ordinance was accompanied by amendments to four FINMA Circulars: 08/19 'Credit risks – banks',[6] 08/20 'Market risks – banks',[7] 08/22 'Capital adequacy disclosure – banks',[8] and 08/23 'Risk diversification – banks'.[9] The revised Circular 08/20, together with the corresponding capital adequacy regulations, enshrined in Swiss law the new Basel II standards for Pillar 1 in the area of market risks. A new EU Directive on risk diversification regulations, chiefly in respect of interbank business, imposed a tightening of existing national rules and was implemented in the amendments to Circular 08/23. This regulation was introduced in consultation with the State Secretariat for International Financial Matters (SIF) and the SNB.

Discussion paper on amendments to the capital adequacy requirements under Pillar 2

As part of moves to ensure that institutions' available capital is more closely matched to the risks they are exposed to, FINMA launched a further initiative in 2010 with a discussion paper on adjust-

[6] See http://www.finma.ch/d/regulierung/Documents/finma-rs-2008-19.pdf (German version).
[7] See http://www.finma.ch/d/regulierung/Documents/finma-rs-2008-20.pdf (German version).
[8] See http://www.finma.ch/e/regulierung/Documents/finma-rs-2008-22-e.pdf
[9] See http://www.finma.ch/d/regulierung/Documents/finma-rs-2008-23.pdf (German version).

ments to the capital adequacy requirements under Pillar 2. The regulation foreseen will cover all the banks, apart from the big banks, which will instead fall under the rules of the 'too big to fail' regime.

Basel II lays down minimum standards for capital adequacy regarding credit, market and operational risks. Pillar 1 sets out the minimum requirements in terms of equity capital to support those risks. Pillar 2 goes further, stating that all types of risk which are material to the institution concerned must be underpinned by capital determined using the bank's internal measurement methods. The capital requirements under Pillar 2 extend beyond the minimum standards set out under Pillar 1.

The aim of this Pillar 2 safety margin is to ensure that in future the minimum requirements of Pillar 1 can be complied with at all times and also that risks that are either omitted from or incompletely captured by the minimum requirements can be covered, even in the midst of a serious crisis. For Pillar 2, the bank can use both an individual model for calculating risks and a definition of capital that differs from that under the Pillar 1 rules.

In June 2010, FINMA drafted the discussion paper mentioned above, covering adjustments to the capital adequacy requirements under Pillar 2 and the introduction of a leverage ratio. In this paper, which was designed to flesh out the BCBS principles on Pillar 2 and was appended to its Newsletter 10,[10] FINMA explained to the institutions the motivation for and basic features of the new capital adequacy regime. In general, position statements issued by the banks welcomed the goals which FINMA aimed to achieve through the Pillar 2 Circular.

It was pointed out, however, that the requirement for additional capital under Pillar 2 would need to be brought into line with the reform package under Basel III and the recommendations of the Commission of Experts reporting on limiting economic risks posed by large companies. Taking account of the comments on the discussion paper, the Basel III reform of the BCBS capital requirements (which has essentially been decided upon) and the recommendations of the Commission of Experts, FINMA will compile a draft of the circular on additional capital under Pillar 2, and expects to present this for public consultation in the first quarter of 2011. The circular is scheduled to come into force in the middle of 2011.

With respect to Pillar 2, today's practice established under Basel I requires small and medium-sized banks to maintain excess capital amounting overall to at least 20 per cent above the minimum Pillar 1 requirements under Article 33 CAO. Furthermore, additional capital adequacy targets specific to a particular institution may be imposed under certain circumstances. Article 34 CAO enshrines in Swiss law the principle of the additional capital requirement under Pillar 2. FINMA will now implement a more risk-oriented approach for the capital adequacy requirements under Pillar 2. This will involve clearer differentiation, in terms of risk categories, between the small and medium-sized institutions involved.

In future, this categorisation using objective criteria will be deployed to set the level of additional capital required under Pillar 2. Because the failure of a major institution has a greater effect, they will be required to maintain a larger risk buffer. In order to ensure that the additional capital requirements can be both predicted and monitored, the categorisation criteria first had to be established. FINMA chose to include the balance sheet total, assets under management, privileged deposits and regulatory capital requirements. Justified concerns on the part of the supervised institutions expressed in their comments on the discussion paper will be taken into account in the draft of the FINMA Circular on Pillar 2, as will the relationship to the reform plans under Basel III, which have since been finalised.

Further regulatory activities and the impact of Basel III

The regulations on capital and liquidity that are expected to come into force internationally over the next few years will trigger further wide-ranging adjustments in Switzerland. FINMA, for its

[10] See http://www.finma.ch/d/finma/publikationen/Documents/finma-mitteilung-10-2010-d.pdf (German version).

part, plans to enshrine the Basel III framework in Swiss law with effect from 1 January 2013. This will require a revision of Federal Council ordinances as well as the associated implementing provisions of the supervisory authority (FINMA circulars). Chiefly affected are the Capital Adequacy Ordinance and the Banking Ordinance. The national working group that was already involved in implementing Basel II has also been charged with the implementation of Basel III. The SNB, the SIF and FINMA embarked on the corresponding preliminary work in the fourth quarter of 2010.

Basel III and the changes it brings, notably in the area of eligible capital, required capital, liquidity and leverage ratios, will have a greater impact on Switzerland's large banks than on those of medium and small size. However, the changes to the liquidity regulations will also have a tangible impact on numerous other institutions. Basel III provides for lengthy transitional periods so that in FINMA's view the consequences for the banks will be manageable. Nevertheless, the large banks will experience a significant tightening of regulations concerning eligible capital and the capital required for OTC derivatives transactions as soon as Basel III comes into force.

The situation in the mortgage market

For some time now, FINMA has noted an increase in real-estate lending among both banks it supervises and other financial intermediaries. With interest rates at attractive levels for borrowers, demand for mortgages has risen sharply. The market is also subject to fierce competition, and this is reflected in both tighter margins and, in some cases, less stringent quality requirements in areas such as affordability and loan-to-value conditions.

A number of real-estate indices point to rising prices, though there are significant regional differences. By international standards, however, the price trend in Switzerland is less marked than it was in the countries that experienced a real-estate bubble, such as the US, Spain, the UK and Ireland. Moreover, the current trend cannot be compared to the situation at the end of the 1980s, the last time Switzerland experienced a property bubble. The economic situation and the supervisory environment are different today. That said, scarcity of land, low levels of home ownership and high levels of immigration into Switzerland are combining to push prices upwards.

FINMA steps up its supervision of the mortgage market

FINMA is monitoring developments on the mortgage market closely. There is evidence at present of factors that might encourage a real-estate bubble, and these are accompanied by the widespread belief that real estate is a low-risk investment. FINMA enhanced its supervision of the mortgage market in 2010, investigating more closely the situation in individual banks, banking groups and the market as a whole. The investigations focused on analyses of growth, market share and credit portfolios.

Regulatory audit companies carry out annual, risk-oriented audits at all banks, and the mortgage business of numerous banks was subjected to an in-depth audit in 2010. The audit firms detail their findings in a comprehensive audit report, which is submitted to the bank's board of directors and to FINMA. Shortcomings are discussed and deadlines set for improving the situation.

Supervisory focus on the lending process and credit risk management

FINMA also carried out on-site inspections of its own at selected banks, with a particular emphasis on the lending process and credit risk management. Specialists from FINMA conducted supervisory reviews lasting several days, gathering information about the operational handling of the lending business and carrying out spot checks to analyse credit risk management. The inspections revealed that in some cases the banks' internal guidelines, regulations and processes concerning loans secured by mortgages were incomplete or inappropriate to the institution's particular situation. There is, for instance, a need for changes to the way the affordability of loans to private individuals secured against real estate is assessed and, in particular, how the borrower's income is established. There may also be weaknesses in the way models are used to estimate property values. Particular attention needs to be paid to the treatment of what are termed exception-to-policy transactions. These are loans which are granted in deviation from the lending bank's own internal guidelines, for example because the loan-to-value ratio, affordability or amortisation conditions lie outside the limits set by the institution, and which should therefore be subjected to a special approval procedure. The proportion of such transactions has risen sharply. In some cases, however, the banks lack the organisational and technical capacity to manage them in a way that takes sufficient account of the attendant risks. As a result, they are often unable to compile aggregate evaluations of such lending.

Similar findings by the SNB and FINMA

FINMA's findings coincide with the results of a survey of 32 selected banks carried out by the SNB in the first quarter of 2010.[11] The SNB also established that a number of banks had no data on mortgage lending practices that deviated from internal guidelines.

SBA guidelines

FINMA responded to this situation with dialogue and public relations activities aimed at improving qualitative credit risk management. The core elements are currently set out in the guidelines on the examination, valuation and processing of loans secured by mortgage[12] published by the Swiss Bankers Association (SBA). FINMA recognised these guidelines as minimum standards when they were issued in 2004 as part of the self-regulatory process.

FINMA is currently working with the SBA to establish the extent to which the guidelines need to be revised and made more specific. The focus is on the conditions concerning affordability, loan-to value ratios and valuations as well as the treatment of exception-to-policy transactions. The option of introducing quantitative guidelines for loan-to-value ratios, affordability and repayment period will also be considered. Regulatory auditors are also being requested to comment in more detail on compliance with the SBA guidelines in their audit reports, and in particular to investigate more thoroughly the treatment of exception-to-policy transactions.

FINMA's expectations and measures

FINMA expects the banks to take swift action to remedy any shortcomings identified in their credit risk management processes. Independently of this, FINMA is reviewing the capital requirements for loans secured by mortgage, and is looking particularly closely at whether the current risk weightings for mortgage-backed lending to private individuals need to be raised.

FINMA also imposes temporary additional capital requirements on specific institutions in individual cases. It can do this, for example, in response to increased credit growth or credit exposures in critical segments, or due to inadequate credit risk management. FINMA is also stepping up its analytical activities, and in particular looking into the use of stress tests.

In parallel to this, FINMA will continue its on-site inspections of the banks. The findings of FINMA

[11] See SNB Financial Stability Report, p. 25, Box 2; http://www.snb.ch/en/mmr/reference/stabrep_2010/source/stabrep_2010.en.pdf

[12] See http://www.swissbanking.org/richtlinien_grundpf_kredite.pdf (German version).

reviews are discussed with the management of the banks, and where appropriate, FINMA will order measures to improve the situation or require further investigations by audit firms.

Real estate and mortgages in the insurance sector

Also for insurers, real estate and mortgages are an important asset class in investment portfolios that are mostly broadly diversified. As of 30 September 2010, mortgages accounted for nine per cent of the total capital investments (tied and free assets) of life insurers; for non-life insurers the figure was three per cent, and for reinsurers one per cent. The proportion of mortgages in free assets is negligible.

The mortgage business of insurance companies in tied assets is required to comply with the provisions of the Insurance Supervision Ordinance[13] and FINMA Circular 08/18 'Investment guideline – insurers'.[14] Essentially, mortgages on properties located outside Switzerland are not permitted as investments in tied assets. Only residential and business properties that meet the criteria of the investment guidelines may be used as collateral for loans. This excludes, for example, building land, production sites, factories, sports facilities, hotels, restaurants, old people's and care homes, holiday apartments and houses as well as jointly owned properties. There are also fairly strict regulations on collateral values for insurance companies. Specific requirements apply where the loan-to-value ratio exceeds 66²/₃ per cent of the market value.

The total allocation to mortgages which insurance companies are permitted to make is limited to 25 per cent of the debit amount of the tied assets, and an individual mortgage may not account for more than five per cent of the debit amount. An insurance company may not hold more than 35 per cent of real estate and mortgages in its tied assets. There are also specific record-keeping requirements for real estate and mortgages. External auditors review compliance with the regulations relating to tied assets on an annual basis.

In parallel with its enhanced supervision of banks, in the fourth quarter of 2010 FINMA also carried out on-site inspections of mortgage and real-estate business at selected insurance companies, in order to form its own picture of compliance with the regulations. The inspections focused on the investment strategy, investment processes, valuation issues and record keeping.

These checks did not reveal any serious problems or a substantial need for extra regulation. Isolated shortcomings were discussed with the companies concerned, and implementation of improvement measures monitored. There are plans to include further insurance companies in the enhanced auditing process in the first quarter of 2011.

[13] Art. 79 para. 1 let. g ISO
[14] See http://www.finma.ch/d/regulierung/Documents/finma-rs-2008-18.pdf, in particular margin nos. 282 to 305 (German version).

The challenges of a low interest rate environment

Uncertainty over the future development of the global economy in the wake of the financial and economic crisis remains high. The after-effects are still being felt, as government support programmes have negatively impacted the public finances of many industrialised countries. The flight into safe investments – not least as a reaction to government deficits in other countries – continued to push the yields on dependable Swiss bonds lower. Yields on longer-term Swiss Confederation bonds continued to decline in 2010. In mid-June the yield on ten-year bonds stood at 1.55 per cent; by the end of August it had fallen to 1.07 per cent – a long-term low – before rising again to 1.62 per cent at the end of December 2010.

The importance of interest rates as exemplified by long-term life insurance contracts

Long-term liabilities are a typical feature of the conventional life insurance business. In the case of a deferred annuity, for example, the contractual period can be several decades. For this reason, interest rates are an important factor, influencing both fee schedules and the constitution of reserves. The technical interest rate gives the client a guaranteed minimum rate of interest on the savings component of the premium at the time when the contract is concluded. The technical interest rate therefore dictates the minimum interest rate for the entire term of the contract; it cannot be adjusted at a later date. Changes to the guaranteed interest rate invariably apply only to new contracts. This is currently a problem for the sector, because the large number of old contracts with relatively high guaranteed interest rates still in existence means that an average guaranteed interest rate of around 2.5 to 3 per cent still needs to be generated in the pool of insureds.

Life insurers need to substantially strengthen their reserves

Despite these binding undertakings, life insurers are not permitted to incur major risks in connection with their investments. For this reason, they allocate a large proportion of their assets to fixed-income securities and are therefore directly dependent on interest rates. Although the accounting principles are chosen carefully, both when the policy is taken out and in relation to the mortality assumptions, the example of interest rates shows that in reality things can turn out entirely differently. Life insurers are therefore required to constitute additional reserves in order to provide future policy holder benefits. For the major life insurers, a 0.5 percentage point cut in the interest rate used for reserves can lead to a strengthening requirement running into hundreds of millions.

Today, it is still sometimes the case that distributions exceed the net interest rate earned on investments. The reason for this (in reinsurance for occupational pension schemes, for example) is that the income initially flows into the surplus fund. This enables companies to better control their distribution policy in the long term. Now, however, this freedom of manoeuvre is likely to have become considerably smaller so that in an environment of persistently low interest rates substantially lower allocations must be expected.

Risk capacity of insurance companies

At present, it is virtually impossible to achieve a return on investments that is at least equal to the average guaranteed interest rate using low-risk capital investments (Confederation bonds). One obvious way of seeking out higher returns would therefore be to increase exposure to riskier or alternative investments. In the wake of the financial crisis, however, some life insurers have drastically reduced their investments in this area. From the point of view of financial stability too, such an approach would be highly undesirable. Restrictions on investment policy for direct insurance are imposed by the investment guidelines and also by the Swiss Solvency Test (SST),[15] which stipulates the minimum amount of equity capital required in relation to the risks incurred.

[15] See section 'The Swiss Solvency Test and European solvency rules', p. 21.

Owing to the low level of interest rates, the risk capacity of life insurers is currently more limited than it otherwise would be. Under the SST, both assets and liabilities are valued at market prices. In the case of technical provisions, this means that they are always valued using the current term structure of interest rates: the lower the interest rates, the higher the value of the technical provisions and the lower the eligible own funds in the SST. The SST provides FINMA with a tool that renders the low interest rate problem immediately visible, whereas the conventional Solvency I rules offer almost no transparency in this area. It thus enables FINMA to take steps to protect policy holders if the situation so requires.

Protracted low interest rates and rapid rate rises are a serious problem

When interest rates remain low for a long period, it becomes increasingly difficult for life insurers to generate even the guaranteed interest rate. This creates a serious problem for the sector, with its large portfolio of conventional policies and long-term liabilities. In Japan, for example, the extended period of low interest rates in the 1990s resulted in several life insurers going bankrupt.

If high levels of government debt lead to rapidly rising inflation, this can be expected to lead to higher interest rates, but it takes time for a life insurance company to restructure its capital investments. A sharp rise in inflation would therefore reduce income further in the short term, while payouts would lose their value, and it would take time for yields to recover. The most serious problem that a life insurer is likely to face in such a scenario is the expected increase in surrenders. Life insurance policies normally impose a surrender penalty, but if interest rates are rising sharply, surrenders may nevertheless occur. As a result, the life insurer also generally suffers a loss. It is probable that rising interest rates will force the insurer to sell the fixed-income capital investment held to cover the liability at a price that is below the surrender value.

The Swiss Solvency Test renders the low interest rate problem immediately visible.

Precautionary measures to protect capital

FINMA is devoting considerable attention to the problems threatening the life insurance sector and is acting to raise companies' awareness of them. Following the complete introduction of the SST on 1 January 2011, precautionary measures can now be taken to protect capital in the event that an insurer's solvency is deemed insufficient. These may include prohibiting dividend payments or share buybacks, in order to prevent the equity capital being diminished or to defuse a risk situation. Where necessary, the company's executive bodies may have their decision-making powers withdrawn and assets can be blocked. In extreme cases, the authorities can order the transfer of the portfolio to another insurance company that is prepared to take it on.

Low interest rates also a problem for banks

Low market interest rates are also a major challenge for the banks. Interest rates on account deposits have been at historic lows for months now, and there is no scope for further material reductions. Nevertheless, the banks are recording growth in client deposits and therefore rising costs for client relationship management. As regards lending, fierce competition, especially in the domestic mortgage market, is squeezing interest income. Riskier or alternative forms of investment that offer higher interest rates are available only at the cost of an increased likelihood of default. Overall, this situation is leading to a marked reduction in net interest income. Investments made a few years ago at higher interest rates are now maturing and can only be reinvested at the lower rates on offer today, further depressing earnings.

There has also been a marked increase in demand for long-term, fixed-rate mortgages over recent months. Terms in excess of five years are particularly sought after, as they enable borrowers to lock in

lower interest payments over the medium term. Although this generates welcome interest income for the banks in the short term, it increases their exposure to interest rate risk. If market rates were to rise sharply in the near future, the banks would probably be forced to increase the interest paid on account deposits to avoid substantial withdrawals of client funds. With fixed-rate mortgages, on the other hand, the interest income remains unchanged until the mortgage matures, and if the lender fails to hedge the interest rate risk, this can lead to a further tangible reduction in net interest income. Moreover, hedging the risk itself gives rise to costs.

The Swiss Solvency Test and European solvency rules

On 1 January 2006, the fully revised Insurance Supervision Act and the associated Federal Council Supervisory Ordinance came into force, bringing with them a new method of assessing the solvency of insurance companies: the Swiss Solvency Test (SST). Under this approach, the financial situation of an insurance company is assessed on the basis of the ratio of eligible own funds (risk-bearing capital) to required capital (target capital). These are determined taking into account the risks incurred.

Risk-bearing capital

The major life and non-life insurance companies have been using the SST since 2006, and the remainder since 2008. Insurance companies must accrue the risk-bearing capital required to cover the target capital within five years of the Supervisory Ordinance coming into force, i.e. by 1 January 2011.[16] From this date on, they are required to submit the results of the SST based on a reference date of 1 January by no later than the following 30 April. For insurance groups, the SST calculation is carried out semi-annually, taking 1 January and 1 July as the reference dates.

Target capital and minimum capital requirement

The SST is a principle-based supervisory tool that adopts a total balance sheet approach and is underpinned by market-consistent economic valuation methods. It assesses the financial security of an insurance company or an insurance group on the basis of the risks to which it is exposed. The target capital is a risk-based capital requirement and corresponds to the actual solvency check level. It is designed to reflect all the quantifiable risks which the insurer faces and take account of risk reduction techniques. If the risk-bearing capital is greater than the target capital, this means that an insurance company has sufficient eligible own funds to bear the average loss in what is termed a '100-year event'. In addition to the target capital, a minimum capital requirement is set. If the capital falls below this level, regulatory measures are taken which, in the most extreme cases, can lead to the withdrawal of the company's licence.[17]

Standard model, internal model or provisional transitional model

The SST allows for two methods of calculating target capital: a standard model prescribed by FINMA[18] or, if this does not adequately reflect the company's risk situation, a partially or completely internal or company-specific model,[19] provided this has been submitted to FINMA for approval. In its Newsletter 11[20] of 16 July 2010, FINMA announced a redefinition of the standard model for life insurers. This is known as the delta gamma approach. The aim is to better capture non-linearity effects, which was not possible under the existing standard model. Such effects occur particularly in life insurance portfolios, since contracts normally include return guarantees or options for the policy holder, such as early surrender. However, around half of

[16] under Art. 216 para. 4 let. d ISO
[17] See section 'The challenges of a low interest rate environment', p. 19.
[18] under Art. 43 para. 2 ISO
[19] under Art. 43 para. 3 ISO
[20] See http://www.finma.ch/d/finma/publikationen/Documents/finma-mitteilung-11-2010-d.pdf (German version).

the insurance companies that are subject to the SST will (partly) use an internal model. Often, these are simulation-based risk models. Experience has shown that developing an internal model is an extremely time-consuming and labour-intensive undertaking, and the same applies to the subsequent testing process. For this reason, fewer internal models than originally expected were approved by the end of the transitional period. With a view to enabling the timely implementation of the SST on 1 January 2011, a transitional solution was therefore found. By 30 September 2010, FINMA notified every insurance company that is subject to the SST of the basis on which it is to calculate its target capital for the SST 2011: the standard model, an internal model or a transitional model. The information was communicated in the form of a supervisory letter together with a technical supplement explaining the reasons for the choice of model.

Real-estate risk model

For some time now, individual insurers have been discussing with FINMA how real estate is to be treated under the SST. Opinions differ as to the extent to which property prices are influenced by changes in interest rates. There is general agreement that rents are a more or less stable source of income which – like coupon payments on bonds – can be used to cover current expenditures arising out of life insurance contracts. However, there is no consensus on the extent to which these payment streams affect the price of a property. It is impossible to demonstrate a significant linear relationship between property prices and interest rates of the kind which the life insurance industry demands. The reason for this may lie in the complexity of the relationship between these risk factors, or the fact that the link between interest rates and property prices cannot be viewed in isolation. Rather, it must be assumed that interest-rate effects are overlaid by other price-determining variables. It has not been possible to prove that real estate behaves similarly to bonds and can therefore be used for duration matching purposes.

New intervention thresholds come into force

Timely implementation of the SST has been further complicated by the consequences of the financial crisis and record-low interest rates; these have created major challenges for life insurers, especially as the implementation of the SST coincides with the entry into force of the provisions set out in Appendix 4 (Intervention thresholds) of FINMA Circular 08/44 'SST'.[21] Under these provisions, where the risk-bearing capital is below the target capital, in other words the solvency ratio is less than 100 per cent, the company must present and implement an appropriate mitigation plan. In this event certain decisions, such as those relating to dividend payments or the allocation of surpluses, must be approved by FINMA. Many (life) insurers are considering stabilising measures in order to prevent this situation arising.

If an insurance company has insufficient risk-bearing capital to cover the target capital, it can restore legal compliance by increasing the available capital or reducing its risks and therefore the capital required. This can be done by means of capital injections but also using other instruments, such as hybrid capital, reinsurance and, to a degree, guarantees from well-capitalised group companies. Where there is sufficient cause to do so, FINMA may allow the company a period of up to three years to cover the target capital with risk-bearing capital.

With the definitive implementation of the SST, the solvency requirements hitherto known as 'Solvency I' remain in force for the time being. This will be harmonised with the introduction of Solvency II in the EU.

New solvency requirements in the EU

The European Parliament and the European Council also follow the rules of Solvency I. Also in the EU, however, it became clear that a more fundamental and comprehensive review of the solvency requirements was necessary, one that took account of the entire financial and risk situation of insurance companies. This project is known as 'Solvency II' and, as far as is currently known, aims to introduce

[21] See http://www.finma.ch/e/regulierung/Documents/finma-rs-2008-44-e.pdf

from 1 January 2013 solvency requirements for all EU Member States that are based on the economic risk of insurance companies and insurance groups. As with the SST, the new solvency requirements will be more balanced, to take better account of the actual risks to which individual insurers are exposed. The Solvency II Directive, which standardises both capital requirements and wide-ranging elements of insurance supervision throughout the EU, was approved by the European Parliament in April 2009 and by EU finance ministers in November of that year.

The three-pillar structure of Solvency II

Solvency II is based on a three-pillar structure. The first pillar consists of the quantitative requirements: the solvency capital requirement and the minimum capital requirement. The solvency capital requirement can be ascertained using either a European standard formula or internal company models. All quantifiable risks must be taken into account. Companies that breach the minimum capital requirement will have their licences withdrawn.

The second pillar of Solvency II sets out the principles and methods of supervision, and the qualitative requirements for the conduct of insurance business.

Finally, the third pillar contains rules on reporting and disclosure. Companies will be required to publish certain information that is conducive to market discipline and assists in maintaining the stability of insurers (disclosure). They are also expected to provide additional information to their supervisory authorities (reporting to the supervisor).

The basic principles of the SST and Solvency II, such as market-consistent valuation of assets and liabilities and risk-based solvency capital requirements, are the same. There are, however, differences in the framing of certain details.

Rules for insurance groups

Solvency II will also modernise the supervision of insurance groups and acknowledge the economic realities of the structures and processes within such groups. The new rules will reinforce the rights of the group supervisor and ensure that group-wide risks are not neglected. Cooperation between supervisory authorities will also be stepped up. Insurance groups will be enabled to use group-wide internal models and exploit diversification benefits across the group.

Recognising the equivalence of European and Swiss supervision

FINMA seeks to gain the recognition of Swiss insurance supervision as equivalent to the European supervisory regime based on the Solvency II Directive. The primary focus of attention is on insurance group supervision, including the quantitative and qualitative requirements. Supervision of reinsurance is also under examination, although CEIOPS recognised Swiss reinsurance supervision as equivalent to the EU Reinsurance Directive (a precursor of the Solvency II Directive in this area) in February 2010. If recognition of equivalence with the Solvency II Directive were achieved, it would mean that Swiss insurance (sub-)groups would thenceforth be subject to prudential supervision by a single authority in the EU area, namely FINMA.[22] However, no decision in respect of the recognition of equivalence is expected before summer 2012.

The Swiss Solvency Test is a principle-based supervisory tool that adopts a total balance sheet approach and is underpinned by market-consistent economic valuation methods.

[22] See section 'Switzerland's international cooperation', p. 37.

Regulatory project on distribution rules

Among its strategic goals for 2010 to 2012 as published in September 2009, FINMA is charged with improving client protection in the Swiss financial market. FINMA therefore announced its intention to carry out a cross-sector investigation of distribution rules, and to examine the supervisory rules for intermediaries as well as the demarcation between qualified investors and small clients. The investigation was also to cover the relationship between distribution and product rules. A further aim was to promote the enforcement of appropriate due diligence, disclosure and information obligations in connection with the distribution of financial products at the point of sale. FINMA's objective was to draft the relevant principles for the distribution rules in a cross-sector and product-neutral manner.

Results of the Madoff and Lehman investigations

At the beginning of March 2010, FINMA published the results of its two full-scale investigations into the distribution of financial investments connected to Bernard L. Madoff and Lehman Brothers Holdings Inc. It revealed that not all the institutions examined had exercised the same degree of care when selecting and recommending financial products for their clients. FINMA identified a need for improvements in terms of

- transparent information on potential profits and losses in sales documentation,
- clear client profiles based on an in-depth clarification of the client's risk capacity and risk awareness, and
- adequate diversification of investments.

FINMA Distribution Report 2010

FINMA subsequently launched a project on distribution rules, covering all financial products and financial services regulated by FINMA. Taking account of developments in foreign and international law, it set out to examine the following topics:

- business conduct and distribution rules
- remuneration rules
- product rules
- rules on cross-border distribution from other countries into Switzerland
- rules on the supervision of intermediaries.

FINMA's findings were published in November 2010 in a report entitled 'Regulation of the production and distribution of financial products to retail clients – status, shortcomings and courses of action' (FINMA Distribution Report 2010).[23] The consultation period is open until 2 May 2011.

The findings collated in the report reveal a substantial information gap and therefore power imbalance between producers, distributors and other financial services providers on the one hand, and retail clients on the other with regard to the distribution of financial products. Retail clients often have only a superficial understanding of financial matters and little experience with investments. In some cases, they also lack access to the necessary information. Professional providers, by contrast, generally have the specialist knowledge required in order to properly assess the opportunities and risks of a transaction. Existing law takes only piecemeal and insufficient account of these and other significant problems.

Problem areas in products and distribution

Under current law certain financial services providers are not subject to a registration requirement. This makes the protection of clients far more difficult. FINMA therefore proposes introducing such a requirement for providers that have not hitherto been supervised. This would also enable adherence to the planned rules of business conduct to be monitored.

The investigation also revealed a need for enhanced transparency in respect of financial products. The prospectuses of investment products, for example, must explain to clients the key risks

[23] See http://www.finma.ch/d/regulierung/anhoerungen/Documents/diskussionspapier-vertriebsregeln-20101110-d.pdf (German version); for a summary of the key points in English see http://www.finma.ch/e/regulierung/anhoerungen/Documents/kernpunkte_bericht_vertriebsregeln_20101110_e.pdf

involved. The comparability of complex financial products also needs to be improved by publishing product-neutral, standardised information on the essential features of the products concerned (product description). Finally, appropriate follow-up publications for those products should also be made available.

Neither the requirements for product descriptions nor the prospectus obligations themselves have yet been standardised. In the event of disputes, clients regularly find themselves confronted with a burden of proof that makes it difficult to assert their claims in civil court proceedings. In addition, there are substantial differences between the client protection offered by Swiss financial services providers and that of cross-border providers from abroad. The approaches to these issues adopted in the various Swiss financial market laws are not harmonised. In particular, Switzerland has no regulations covering cross-border cold calling[24] by banks and securities dealers from other countries. Equally, there is no licensing requirement for cross-border advertising in relation to public deposits.

As regards distribution, there are currently no product-independent rules of business conduct at the point of sale. FINMA believes that the introduction of standardised, or at least better harmonised, rules of conduct for all financial services providers would be a sensible move. Such rules specifically include appropriate clarification, information and documentation requirements in relation to client profile and client consultations. Existing and potential conflicts of interest as well as remuneration paid to third parties must be systematically disclosed. When framing these requirements, a distinction must be made between advisory and asset management services on the one hand, and straight sales and execution activities on the other.

Product-neutral client segmentation and expansion of the Swiss ombudsman system

The introduction and monitoring of the measures set out above would lead to a substantial expansion of FINMA's supervisory mandate. However, the introduction of regulatory measures is to be avoided where the benefit fails to justify the resulting workload. FINMA therefore favours the introduction of product-neutral client segmentation. Professional clients generally require less advice and can obtain the information they require even in the absence of detailed prospectus documentation. For such clients, the requirements to supply and obtain information imposed on producers and financial services providers are therefore to be implemented in a much reduced form. A further measure to facilitate the resolution of disputes relating to financial services is the extension of the Swiss ombudsman system. The creation of an independent ombudsman's office as an arbitration mechanism for financial services in the Swiss financial sector can prevent retail clients from having to initiate costly and risky legal proceedings against their contracting partner at the point of sale.

Federal Council ordinance and a financial services act

In order to implement the options it advocates, FINMA suggests in its report the creation of a general law covering financial services. However, experience shows that it would take several years to implement a legislative project of this nature, even if it had clear political backing. A more rapid solution would be to draft and implement a Federal Council ordinance on duties of business conduct in securities dealing and the distribution of collective investments.

[24] 'Cold calling' is the practice of unsolicited advertising by telephone.

Remuneration schemes

The actions of financial institutions are guided not only by checks, but also by incentives. FINMA Circular 10/1 'Remuneration schemes'[25] came into force on 1 January 2010. It lays down minimum standards for remuneration schemes at banks, insurance companies, securities dealers and other market participants. These standards correspond to those laid down by the FSB in 2009. The Circular imposes duties on the board of directors concerning the design and management of remuneration schemes, and requires factors, such as performance, risk and use of capital, to be included when calculating the remuneration. Remuneration schemes should encourage the staff of a financial institution to promote its long-term success and stability. Institutions covered by the Circular are required to have implemented it in full by 1 January 2011.

In 2010, FINMA devoted most of its attention to the existing remuneration practices of the leading banks and insurers. It also focused on the preparations made by financial institutions to deal with the adjustments made under Circular 10/1. For important discussions, FINMA involved the chairs of the remuneration committees or other representatives of the respective institution's board of directors, reflecting the central role which the Circular ascribes to that body.

FINMA's responsibility is not to fix or limit the level of compensation or prescribe the use of specific compensation tools, but rather to ensure that the individual arrangements made are consistent with the long-term financial success of the company. FINMA therefore expects boards of directors not to approve any remuneration schemes that encourage disproportionate levels of risk to be assumed. FINMA's particular concerns here are:

- how the institution concerned reaches its decisions on compensation,
- the nature of the institution's corporate governance,
- the performance criteria used,
- how well the institution applies those criteria, and
- what adjustments the institution makes to anticipate foreseeable changes in its capital position, liquidity, profitability and future risk exposure.

Some companies amended their remuneration practice even before the implementation deadline by, for example, decreasing leverage, increasing the proportion of deferred payouts and reducing the overall complexity of their remuneration structures. There are also indications that firms generally are subjecting their remuneration policy to more rigorous governance and stricter risk management.

[25] See http://www.finma.ch/e/regulierung/Documents/finma-rs-2010-01-e.pdf

Investigations and lessons from the crisis

On 12 May 2010, the Federal Council published its report on the conduct of financial market supervision during the financial crisis and the lessons for the future[26] ('David Report'). The report was compiled in response to two parliamentary procedural requests[27] and is based on two external expert advisory assessments[28] and a report by FINMA itself[29] analysing the financial crisis.

In its report, the Federal Council concluded that the authorities concerned and FINMA had acted circumspectly and decisively in the crisis. It did not identify any major weaknesses in FINMA's organisation or governance. Essentially, it argued that the lessons of the financial crisis did not necessitate any amendments to FINMASA, but that instead there was a need for corrections to other financial market legislation, notably the Banking Act, to defuse the 'too big to fail' problem.

In the David Report, the Federal Council responded to a number of parliamentary procedural requests. FINMA was not officially requested to comment on the report, and was therefore not directly required to add anything to its comments on the report by the Control Committees (CC) of the National Council and Council of States.

On 31 May 2010, the CC published their investigation entitled 'The Swiss authorities under the pressure of the financial crisis and the disclosure of UBS customer data to the USA'[30] (CC Report). Together with the FINMA report of 14 September 2009[31] and the Federal Council report of 12 May 2010 based on two external advisory assessments, the CC Report is the principal examination of the conduct of the authorities during the financial crisis from a Swiss perspective.

The CC Report requested FINMA to state its position on the findings and recommendations relevant to it by the end of 2010, and to indicate how and by when it intends to implement the recommendations of the two commissions. FINMA issued its response in the form of a comment dated 26 November 2010. It welcomed the analysis by parliament's supreme supervisory body of the events surrounding the conduct of the authorities during the financial crisis and the disclosure of UBS client data. The CC's presentation is meticulously researched and offers a balanced view overall. Accordingly, FINMA's comment addressed only a few of the findings which it believes to be important for the future of its supervisory activities, namely the authority's access to the Federal Council and its independence.

Independent decision-making by FINMA

FINMA arrives at its decisions solely on the basis of the matter at hand and the legal mandate entrusted to it, and is not guided by pressure from third parties or influenced by the institutions under its supervision. Such decisions are taken independently and in the exercise of its protective function. FINMA noted that the former Swiss Federal Banking Commission (now FINMA), having reached its own assessment of the risks involved, advised the Federal Council clearly and in good time that fulfilment of its legal mandate would ultimately oblige it to order the disclosure of the client data in accordance with the Banking Act. Contrary to the CC's finding, however, FINMA was not placed under any pressure by the Federal Council to take this decision.

More in-depth discussions between FINMA and the Federal Council

The CC called on the Federal Council to invite the Chairman of FINMA's Board of Directors for regular meetings. When requested by FINMA's Board of Directors, further meetings should also be held between the Chairman and the Economics Committee of the Federal Council. The Financial Market Supervision Act (FINMASA) mandates at least one meeting per year between FINMA and the Federal Council. FINMA considers this exchange to be a valuable complement to its independence and therefore expressly welcomes the thrust of the CC's recommendation. It also believes that discussions with a committee of the Federal Council are very useful.

[26] See http://www.efd.admin.ch/dokumentation/zahlen/00578/01697/index.html?lang=de
[27] David request (08.4039) and motion WAK-N (09.3010).
[28] Expert advice on the conduct of financial market supervision during the financial crisis by Prof. Hans Geiger, 31 December 2009, and 'The Conduct of Financial Market Supervision during the Financial Crisis', David Green, January 2010 (see http://www.efd.admin.ch/dokumentation/zahlen/00578/01697/index.html?lang=de).
[29] FINMA report 'Financial market crisis and financial market supervision', 14 September 2009 (see http://www.finma.ch/e/aktuell/Documents/Finanzmarktkrise-und-Finanzmarktaufsicht_e.pdf).
[30] See http://www.parlament.ch/e/dokumentation/berichte/berichte-aufsichtskommissionen/geschaeftspruefungskommission-gpk/berichte-2010/Documents/bericht-gpk-ns-ubs-kundendaten-usa-2010-05-30-res-e.pdf (summary in English).
[31] See FINMA Annual Report 2009, pp. 12 ff. (http://www.finma.ch/e/finma/publikationen/Documents/finma_jb_2009_e.pdf).

As regards the CC's recommendations, FINMA began by stating its position on recommendation no. 10. This is the only one that is aimed directly at FINMA. Recommendation no. 10 calls on FINMA 'in view of the great momentousness of this affair, (to examine in depth) the question as to how much the top management of UBS knew about QIA infringements by the bank and its staff'.[32]

Cooperation between authorities

At a number of points in the CC report, it addresses the issue of cooperation between the authorities. The CC called for roles and competencies to be clarified. As FINMA indicated in its comment to the CC, it regards the division of responsibilities between the SNB and FINMA as particularly important. FINMA considers the existing legal regulations to be basically correct. The clear allocation of competencies and accountabilities that has already been established is of central importance. Supervisory instruments should where possible pursue a single objective, and responsibility for their use should lie with a single authority. Similarly, competencies and accountabilities should be clearly allocated when new instruments are being discussed. Functional overlaps or a commingling of responsibilities would jeopardise the effectiveness of the instruments in question and ultimately weaken both institutions.

Finally, FINMA stressed that once the examination of past events is complete, it is important to consider forward-looking measures to improve regulation and supervision. FINMA has already set these activities in train. This Annual Report contains some examples. Key issues, however, are the responsibility of the legislature, since it is they who create the conditions for a stable financial sector and successful supervision.

Federal Administrative Court ruling of 5 January 2010

With its ruling of 18 February 2009, FINMA ordered the release of almost 300 UBS client data files to the US authorities to avoid the real threat of the US authorities starting proceedings against the UBS. FINMA based its decision on Articles 25 and 26 of the Swiss Banking Act, which give it the authority to impose preventive measures if it has reasonable grounds to suspect that a bank has serious liquidity problems.

On 5 January 2010, the Federal Administrative Court ruled the order issued by FINMA as unlawful. The Court claimed that the provisions applicable in the Banking Act did not provide sufficient legal basis to release the data of bank clients to foreign authorities. FINMA decided to lodge an appeal against the Federal Administrative Court with the Federal Supreme Court.

[32] See section 'UBS cross-border business – possible proceedings against former executives of the bank', p. 32.

Increase in legal and reputational risks in cross-border financial services

FINMA considers cross-border financial services and the concomitant developments to be of strategic importance. In 2009, it focused on the banks' cross-border asset management activities and the associated legal and reputational risks, while in 2010 attention shifted to the activities of life insurers involving clients resident abroad, with a particular emphasis on the use of insurance wrappers. FINMA conducted both a fundamental analysis and an assessment of the situation at selected institutions under its supervision, in some cases accompanied by on-site inspections. Once this work was complete, FINMA looked into various alternative courses of action and, in autumn 2010, decided to set out its views in a position paper. This paper is aimed principally at the banks, insurance companies and securities dealers that are supervised by FINMA, as well as licence holders subject to prudential supervision under the Collective Investment Schemes Act that engage in cross-border financial services business. It pinpoints risk areas and formulates the expectations of the supervisory authority. Implementation of these specific supervisory conditions for cross-border business forms the subject of enhanced discussions with supervised institutions in the context of the supervisory process. In future, FINMA's position will also be reflected in its enforcement practice.

The legal and reputational risks that can arise in cross-border business as a result of breaching or circumventing foreign laws have increased markedly over recent years. This is due not so much to a tightening of those laws as to their more systematic enforcement. Moreover, foreign authorities have in some cases changed their evidence-gathering methods.

Sources of legal and reputational risks

The sources of legal and reputational risks in cross-border financial services business are many and varied. They are often to be found in the applicable foreign supervisory law. There are two principal risk areas: the cross-border provision of financial services, and the cross-border supply of financial products. Both are subject to restrictive requirements in many legal systems, such as physical presence, registration or licensing, obligations concerning prospectuses, and so on. While Switzerland erects comparatively few barriers to foreign participants in the banking sector, some countries restrict or actually prohibit even relatively simple activities, such as unsolicited telephone calls. Such rules inhibit access to foreign markets. Failure to comply with them harbours substantial legal and reputational risks for the institutions concerned and, in some cases, their staff, and may result in sanctions under both administrative and criminal law. Infringements of supervisory law may often give rise to the risk of civil liability claims against institutions. Those that simultaneously serve the same market via onshore subsidiaries or branch offices or maintain other relevant relationships with a country are particularly vulnerable. In terms of tax and criminal law, there is the risk of a financial intermediary or its employees being viewed under foreign law as parties to the criminal actions of foreign clients, for example by aiding or abetting tax offences. In some jurisdictions, criminal offences can even include acts performed exclusively or largely outside the country, e.g. on Swiss territory. Frequent cross-border activities and the repeated physical presence of the financial intermediary's representatives may also give rise to a tax liability. A further important issue in the area of tax is the US Foreign Account Tax Compliance Act (FATCA). As of 1 January 2013, the US is introducing a new withholding tax regime that will have very wide-ranging

FINMA expects institutions to pay particular attention to complying with foreign supervisory law and to establish a service model for each market that is in conformity with it.

implications for Swiss financial intermediaries. This plan will lead to a further tangible increase in the legal and reputational risks that financial institutions face. Additional risks may result from foreign money laundering legislation, civil law, conflict of laws and procedural law, as well as other commercial law in certain states.

The use of insurance wrappers

The risks set out above also apply in essence to the use of insurance wrappers. These are insurance contracts under which the premium is paid in the form of a securities portfolio. The products concerned are often distributed via foreign-licensed subsidiaries of Swiss insurance companies. In many cases they are tailored to the requirements of civil, supervisory and tax law of the client's country of domicile, and therefore offer entirely legal tax privileges. It should be borne in mind, however, that the privileged tax status of the product does not necessarily imply that the policy holder is in compliance with tax law. There are also products that do not meet the requirements for life insurance in the client's domicile; they thus do not receive preferential tax treatment and are also subject to the risk of changes in the law. Although such insurance contracts meet needs that are legitimate and understandable, their supply during sensitive periods (such as tax amnesties) may be viewed with particular suspicion. In such cases, institutions must consider the risks of contributory involvement in tax offences committed by clients.

A product may, for instance, be misused to conceal the beneficial ownership of assets deposited at a bank with the aim of illegally reducing tax liability or circumventing obligations under inheritance or bankruptcy law. This situation arises because, once the client has signed the contract, the insurer begins to act as a contracting partner of the bank and, owing to a loophole in the Agreement on the Swiss banks' code of conduct with respect to the exercise of due diligence, was not in the past required to submit a declaration of beneficial ownership. FINMA Newsletter 9 of 27 April 2010 entitled 'Handling of insurance wrappers in accordance with the Swiss Anti-Money Laundering Act'[33] reduced the potential for concealment by introducing a requirement to identify the beneficial owner of the assets linked to the insurance wrapper. Irrespective of this, insurers remain responsible in all cases for fulfilling their identification requirements. Newsletter 9 threw up a number of questions. Following discussions with representatives of the banking and insurance sectors, FINMA clarified the obligations of the financial intermediaries concerned in FINMA Newsletter 18 of 30 December 2010 entitled 'Handling of life insurances with separately managed accounts/portfolios'.[34] The new Newsletter superseded Newsletter 9.[35] It incorporates the information contained in the earlier version, the experience gained with the issue of insurance wrappers as a whole, and the points raised in discussions with sector representatives. Newsletter 18 aims to ensure that such products are handled in an appropriate manner.

Appropriate capture, limitation and monitoring of risks

Except where the Insurance Supervision Act imposes specific requirements, Swiss supervisory law does not impose any direct or explicitly formulated duty on supervised institutions to comply with foreign law. However, breaches of foreign regulations may be relevant from a Swiss supervisory law point of view and in particular compromise the assurance of proper business conduct. Chiefly, however, the organisational regulations under supervisory law require all risks, including legal and reputational risks, to be appropriately captured, limited and monitored and an effective internal control system to be put in place.

FINMA believes that in the light of developments over recent years it is essential for supervised institutions to analyse in depth the legal framework within which they conduct their cross-border financial services business and also the associated risks. This process must include familiarisation with all the respective institution's target markets and the foreign legislation applicable to them. Institutions must

[33] See http://www.finma.ch/e/finma/publikationen/Documents/finma-mitteilung-9-2010-neu-e.pdf
[34] See http://www.finma.ch/e/finma/publikationen/Documents/finma-mitteilung-18-2010-e.pdf
[35] FINMA devoted particular attention to the legal risks of insurance wrappers in a position paper (see http://www.finma.ch/e/finma/publikationen/Documents/positionspapier_rechtsrisiken_e.pdf).

examine whether the activities in which they actually engage are in accordance with the law, and also capture the risks those activities entail. They should then take appropriate steps to eliminate or minimise those risks. As a supervisory body, FINMA expects institutions to pay particular attention to complying with foreign supervisory law and to establish a service model for each market that is in conformity with it. The implementation of these expectations will be a key focus of FINMA's ongoing supervisory activities in future years, and will ultimately also be reflected in its enforcement practice.

Enforcement practice

Enforcement is a key pillar of FINMA's activities. It comprises gathering evidence relating to suspected serious breaches of supervisory law as well as ordering and securing the implementation of corresponding corrective measures as part of formally instituted single-party or multi-party proceedings. If preliminary investigations give rise to suspicions that a serious breach of supervisory law has occurred, FINMA initiates enforcement proceedings. These accord particular importance to respecting the legal rights of the parties concerned. The outcome of such proceedings is a ruling. It either confirms that an irregularity has been identified and orders corrective measures or it indicates that the proceedings are closed and the cost issue is settled. Appeals against FINMA rulings can be made to the Federal Administrative Court. The costs of enforcement proceedings are borne by the institution concerned.

The intention of the legislature, backed by the practice of the courts, is for FINMA's actions to be viewed as the application of administrative law and administrative procedural law. However, in order to ensure appropriate governance, FINMA has set up an Enforcement Committee (ENA) that reviews the instigation of important proceedings and all rulings that result from enforcement proceedings. The Committee is made up of members of the Executive Board and representatives of the organisational units directly concerned.

The Enforcement Policy published on the FINMA website in 2009[36] has been refined: FINMA increasingly seeks cooperation with criminal prosecution authorities and, in individual cases, will consider in particular whether it is expedient to involve them at an early stage of proceedings, for instance in order to secure evidence. The law obliges FINMA to file a criminal complaint with the relevant authority when it obtains knowledge of a felony, misdemeanour or offence against the Financial Market Supervision Act or one of the financial market laws. FINMA is in regular contact with criminal prosecution authorities, especially in relation to the prosecution of insider dealing and price manipulation as well as breaches of licensing requirements.

[36] See http://www.finma.ch/e/sanktionen/enforcement/Documents/FINMA_Enforcement-policy_2010120_e.pdf

UBS cross-border business – possible proceedings against former executives of the bank

FINMA was criticised by the CC[37] for its actions in respect of former senior executives of UBS in the aftermath of the subprime crisis and in connection with cross-border business with the US.

In 2008, the then Swiss Federal Banking Commission (SFBC) examined the conduct of UBS in connection with cross-border business involving US private clients. Simultaneously, a number of authorities in the US were investigating possible breaches of US law by the bank. The SFBC's proceedings under supervisory law were completed in December 2008 with the issuing of a ruling in which the SFBC concluded that UBS had been guilty of serious violations of proper business conduct and organisational obligations set out in the Banking Act. In particular, it did not adequately capture, limit and supervise the legal and reputational risks associated with cross-border business involving US private clients.

The SFBC further stated that it had not, during its investigation, identified any indications of breaches of supervisory law duties by those responsible for ensuring proper business conduct that would justify taking measures against them under supervisory law. Rather, responsibility for the failures identified lay with the bank as a whole.

The SFBC sanctioned the conduct of UBS by prohibiting it from engaging in cross-border business with private clients resident in the US. The bank was also ordered to appropriately capture, limit and supervise the legal and reputational risks inherent in the provision of cross-border services at the global level. Implementation of this order is subject to checks by FINMA.

FINMA did not initiate any proceedings against individuals immediately following its supervisory law proceedings. These are not, however, excluded in the event that new grounds for reasonable suspicion emerge in the future. The persons responsible for assuring the proper conduct of business who were involved in the UBS cross-border case left the bank in 2008 and 2009. In accordance with FINMA's established practice and its predecessor organisations as confirmed by the courts, the issue of whether they are still able to provide such assurance will be assessed if and when they occupy or intend to occupy a position of this type again. If they are not in a position that requires them to provide an assurance of proper business conduct, there will not normally be any interest in establishing whether they are able to do so. FINMA initiated two conduct of business proceedings against former managers of UBS. However, these proceedings were closed when the persons concerned indicated that they no longer intended to occupy such a position at a supervised institution. Apart from its duty to notify the criminal prosecution authorities in the event that it obtains knowledge of a common law felony or misdemeanour, FINMA has no power to bring civil actions or initiate criminal investigations involving present or former executives of a bank. As is now known, in the wake of the UBS cross-border case the Public Prosecutor's Office of the Canton of Zurich examined whether there was a reasonable suspicion that senior executives of UBS had committed criminal offences in connection with the bank's cross-border business with US private clients. No suspicious circumstances have so far been identified that merit launching a criminal investigation.

In May 2010, the CC called on FINMA to examine in depth the extent to which the top management of UBS was aware of QIA infringements by the bank and its staff.[38] FINMA is aware of the impact of the events concerned and therefore carefully examined the options for further investigations available under supervisory law, taking account of advice from external experts. It concluded that no new evidence had emerged which would warrant a review of earlier supervisory law investigations, and that in any case the instruments available would not permit FINMA to do so.

Based on the information obtained during a wide-ranging investigation, the SFBC had concluded

[37] See section 'Investigations and lessons from the crisis', p. 27.
[38] See footnote 37.

in 2008 that there were no grounds for ordering the bank to remove the then Head of Wealth Management, CEO or Chairman of the Board of Directors. Unless FINMA is presented with hitherto unknown evidence that the persons concerned were guilty of a serious breach of duty, there is still no reason to initiate proceedings to investigate proper business conduct if they assume a new executive function at a supervised institution. However, FINMA requires them to make a formal written declaration that they had no knowledge of any relevant breaches of duty under Swiss supervisory law. If it should emerge that this declaration is untrue, criminal proceedings would result. Even on the basis of the information currently in its possession, FINMA would have grounds for initiating proceedings against certain figures below the top management level, and it would do so if they attempted in the next few years to take on a position in the supervised sector that required them to provide an assurance of proper business conduct.

Prohibition from practising a profession

FINMA is considering making increased use of the prohibition from practising a profession that was introduced under FINMASA on 1 January 2009. A prohibition of this type may be imposed for a maximum of five years in cases where a person is responsible for a serious breach of supervisory law. FINMA has the power to ban such a person from taking on or continuing to exercise a senior function in a supervised institution. Measures of this type against individuals are to be used in future to prevent actions that jeopardise the interests of investors or policy holders, or to sanction irregularities or breaches of administrative law.

The existing practice of requiring an assurance of proper business conduct as a prerequisite of granting a licence to a supervised institution is to be maintained. This policy, developed by the SFBC and confirmed by the courts, means in particular that the assurance requirement applies only to persons acting or intending to act in a senior capacity in the supervised sector. As a result, proceedings to investigate business conduct are not initiated against persons who are no longer exercising responsibilities covered by supervisory law. The issue of opening such proceedings will only arise if the person concerned indicates their intention of taking up another senior function.

INTERNATIONAL INVOLVEMENT AND AGENDA

INTERNATIONAL INVOLVEMENT AND AGENDA

FINMA's international presence

The globalisation of the financial markets and the cross-border activities of financial institutions add an international dimension to FINMA's activities, in terms of regulatory initiatives, supervision and enforcement. FINMA therefore attaches great importance to maintaining close relations with foreign supervisory authorities and active involvement in the work of international financial market supervisory bodies, such as the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the Financial Stability Board (FSB).

Coordination of international regulatory projects: a complex task

The amount of work required to coordinate international initiatives substantially restricts the scope for action in this area. Nevertheless, successful harmonisation of national regimes prevents regulatory arbitrage and thereby contributes to the integrity and stability of the financial markets throughout the world. However, certain major differences remain between the frameworks within which individual countries operate.

Globally applicable minimum standards

Globally applicable minimum standards need to be both concrete and binding, but they must also grant the countries concerned sufficient flexibility to enable effective national implementation. However, the minimum standards do not constitute binding law for the member states. Compliance is increasingly being assessed via peer reviews. If loopholes are discovered in the rules or their implementation, institutions in the country concerned are viewed less favourably, and under certain circumstances they may even face obstacles to market access.

Active participation by Swiss representatives at international level

FINMA represents the interests of Switzerland on the bodies listed above; on the BCBS and FSB it sometimes acts in conjunction with the SNB and SIF. Switzerland has established a recognised international presence over the years, thanks to the proactive involvement of the SNB and FINMA. Its contributions to the 'too big to fail' debate, the regulation of remuneration and the supervision of insurance groups, for example, have flowed directly into the development of international standards.

Optimising access to foreign financial markets for Swiss financial institutions

Because Swiss financial institutions supply cross-border services, the issue of optimum access to foreign markets is of ongoing importance. In many cases, access to the often comprehensively regulated financial market of another country is only possible if the institutions concerned satisfy the requirements of local supervisory law. As in other countries, the activities of Switzerland's supervisory bodies are closely aligned with the guidelines laid down by international regulators, albeit with occasional divergences on secondary issues. Nevertheless, differences of greater or lesser importance repeatedly emerge. Even small deviations in regulatory approaches can lead to problems and impede or indeed prevent the provision of financial services by Swiss institutions abroad. One instrument among many is the formal recognition of equivalence between the Swiss regulatory system and the supervision applied in other countries. FINMA is campaigning vigorously for such recognition to be applied. In some areas, though, amendments to the Swiss framework are unavoidable. FINMA is working to identify the areas where action is needed and assess the possible options.

There are also points of international contention in relation to supervisory issues, chief among them being the exchange of information regarding institutions' risk exposure. Supervisory activities related to individual institutions frequently serve as the basis for more extensive cooperation, for example in the field of regulation. Exchange in connection with the supervision of individual institutions also serves to build trust. FINMA additionally works together with the relevant foreign authorities in the cross-border prosecution of stock exchange offences.

Switzerland's international cooperation

The European Union

FINMA conducts regular discussions with high-ranking representatives of the European Commission and works together with committees of the European supervisory authorities in the fields of banking (Committee of European Banking Supervisors [CEBS]), insurance (Committee of European Insurance and Occupational Pensions Supervisors [CEIOPS]) and securities (Committee of European Securities Regulators [CESR]). FINMA participates as an observer in the CEIOPS subcommittee on the supervision of insurance groups whenever Swiss groups are involved. Following the conversion of the existing EU committees into European supervisory authorities – the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA), all of which assumed wider powers as of January 2011 – cooperation is to be continued and, where possible, stepped up.

In spring 2010, FINMA carried out a comprehensive comparison of Swiss financial market law and the corresponding EU acquis. This revealed differing levels of congruence between Swiss and European legislation. In February 2010, CEIOPS acknowledged the equivalence of Swiss reinsurance supervision with the EU Reinsurance Directive. In November 2010, the European Commission indicated to CEIOPS its willingness to include Switzerland in the list of countries first in line for an examination of its supervisory regime, with a view to assessing equivalence under the Solvency II Directive on insurance supervision.[39] This assessment is currently under way.

International Association of Insurance Supervisors

FINMA is actively involved in the work of the Executive Committee, Technical Committee and Financial Stability Committee of the IAIS, as well as in various subcommittees. In October 2010, the Vice-Chair of FINMA, Dr Monica Mächler, was elected Chair of the Technical Committee.

In 2010, the recently created Financial Stability Committee of the IAIS focused its attention on an analysis of the potential systemic risks in the insurance sector, and on drafting principles and tools for macroprudential supervision. The IAIS is also in the process of creating a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). Following completion of the preparatory phase in summer 2010, work on establishing the specific details of regulations on supervision of insurance groups began under the auspices of FINMA's Vice-Chair.

[39] See section 'The Swiss Solvency Test and European solvency rules', p. 21.

Revision of the regulatory and supervisory framework for managers of alternative investment funds

The funds market is also affected by ongoing regulatory initiatives at the international level. In the wake of the financial crisis, the need for changes in the regulation of hedge funds has come under particularly close scrutiny. IOSCO, with Swiss participation, has drafted six principles for the regulation and monitoring of hedge funds which in particular provide for enhanced transparency obligations in respect of investing clients and the supervisory authorities. They also include prudential requirements in areas such as risk management. The EU has adopted the Alternative Investment Fund Managers Directive (AIFM Directive) covering all collective investments that are not EU compatible. As with the existing UCITS regulations, the AIFM Directive aims to establish a uniform market for alternative investments within the EU. Under the final version of the Directive, the 'EU passport' will also be accessible to non-EU providers, including those from Switzerland; but only if they comply with regulations that, in some areas, extend far beyond the IOSCO principles. These would be difficult to achieve without intervening in the Swiss revision of the regulatory and supervisory framework for managers of alternative investment funds.

Need for action in Switzerland

Regardless of the international situation, there are also areas that require attention here at home. Switzerland must decide on its position with respect to the provisions of the AIFM Directive. In some areas, these go far beyond the requirements of IOSCO, the provisions of the Collective Investment Schemes Act and the UCITS Directive.

With regard to the potential systemic risk of hedge funds, Switzerland is actively involved in IOSCO's worldwide inquiries and has already carried out two surveys of Swiss fund managers. Given the cross-border nature of the business, international coordination is vital.

Supervisory colleges

The remit of a national supervisory authority does not end at the nation's frontiers. The 'home regulator', normally at the place where a financial group's head office is located, monitors the latter's foreign business activities together with a 'host regulator' responsible for each country. It is important to ensure the appropriate flow of information between the supervisory authorities involved. The host regulator, for example, is better placed to judge the foreign risk exposure of an institution under its supervision, while the home regulator has a clearer picture of its business activities and strategy at consolidated group level. FINMA already has many years of experience in committees set up to coordinate this information flow. Close contact with other authorities, notably those in the UK and US, proved extremely effective during the financial crisis.

International bodies, such as the FSB, BCBS and IAIS, advise their members to institutionalise cooperation between supervisory authorities in the form of supervisory colleges. Convened by the home regulator of an institution engaged in cross-border activities, these bring all the relevant supervisory authorities together with the top management of the institution for regular meetings that also include the opportunity for an exchange of views. FINMA, which played a key role in developing the relevant BCBS and IAIS standards, has headed supervisory colleges for a number of institutions and taken part in colleges for foreign groups that are involved in business activities in Switzerland. It has also organised crisis management colleges for the big Swiss banks. Similar meetings are planned in 2011 for the major insurers.

International administrative assistance

In recent years, FINMA has received increasing numbers of requests for cooperation from foreign authorities. This tendency accelerated in 2010 in all areas for which FINMA is responsible. International cooperation is no longer limited to requests for the exchange of information as part of investigations into individual offences, but extends more and more often to other situations in which foreign authorities seek both information and assistance from FINMA. In addition to the usual enquiries, most of which concern stock exchange-related issues, such as insider dealing, price manipulation or breaches of disclosure requirements, FINMA is now also being asked to provide information and assistance in issues including consolidated supervision, supervisory colleges, cooperation in crisis situations, cross-border activities and outsourcing.

As regards stock exchange matters, after many years FINMA finally succeeded in February 2010 in obtaining A signatory status in IOSCO's Multilateral Memorandum of Understanding (MMoU) on mutual cooperation and exchange of information between stock exchange supervisory authorities. In the light of this, international expectations towards FINMA will increase, in terms of both the number of applications and the scope of the information requested. However, the change of status did not resolve the difficulties with the EU. CESR and its members continue to criticise Swiss practice in the area of administrative assistance, focusing on the Swiss client procedure and the specific regulation relating to powers of attorney for the management of assets ('uninvolved third parties'[40]).

Swiss law too restrictive

The Federal Administrative Court (FAC) upheld two decisions by FINMA, thereby confirming that the executives of an offshore company were not 'uninvolved third parties' and that employees of an external asset manager do not enjoy the status of parties to an administrative assistance process. At the same time, however, it held that external, independent asset managers do have party status where powers of attorney for the management of assets are concerned. The fact that a professional asset manager or financial intermediary can be active on foreign markets but refuse to allow the direct disclosure of its name has rightly met with incomprehension from foreign authorities.

In the light of rapid developments in international cooperation, Swiss law has proved too restrictive to permit appropriate cooperation in the interests of the Swiss financial sector, not only in terms of administrative assistance in stock exchange matters, but also as regards consolidated supervision and cross-border investigations. FINMA informed the Federal Council of the negative implications of this legal situation so that it can consider a revision of the law.

[40] See FINMA report 'International administrative assistance in stock exchange matters', section 6.2, p. 19 (http://www.finma.ch/d/aktuell/Documents/Amtshilfebericht_20090916_d.pdf – German version); for an English summary of the key points see http://www.finma.ch/e/aktuell/Documents/Amtshilfebericht_KeyPoints_20090916_e.pdf

FINMA: THE AUTHORITY

BOARD OF DIRECTORS AND EXECUTIVE BOARD

Board of Directors

Dr Eugen Haltiner[41]	Chairman
Dr Monica Mächler	Vice-Chair
Daniel Zuberbühler	Vice-Chair
Prof. Anne Héritier Lachat[42]	Member
PD Dr Sabine Kilgus	Member
Paul Müller	Member
Charles Pictet	Member
Dr Bruno Porro[43]	Member
Prof. Jean-Baptiste Zufferey	Member

Committees of the Board of Directors	Dr E. Haltiner	Dr M. Mächler	D. Zuberbühler	Prof. A. Héritier Lachat	PD Dr S. Kilgus	P. Müller	Ch. Pictet	Dr B. Porro	Prof. J.-B. Zufferey
Takeover Committee				Chair		●			●
Appointment and Remuneration Committee	Chair		●	●		●			
Audit Committee					●			Chair	●

[41] Dr Eugen Haltiner stepped down as Chairman of the FINMA Board of Directors at the end of December 2010. He was succeeded on 1 January 2011 for the remainder of the current term of office by Prof. Anne Héritier Lachat.
[42] From 1 January 2011 Chair of the FINMA Board of Directors.
[43] Dr Bruno Porro stepped down as a member of the FINMA Board of Directors at the end of December 2010. His successor for the remainder of the current term of office is Dr Eugenio Brianti.

Executive Board

Dr Patrick Raaflaub	CEO
Dr Urs Zulauf	Deputy CEO Head of Strategic and Central Services Division
Mark Branson	Head of Banks Division
Dr René Schnieper	Head of Insurance Division
Franz Stirnimann	Head of Markets Division

Extended Executive Board

Dr Urs Bischof	Head of Risk Management
Kurt Bucher	Head of Accounting, Audit Firms and Rating Agencies
Hans-Peter Gschwind	Head of Supervision of Non-life Insurance Head of Insurance Supervisory Law
Dr Urs Karlen	Head of Qualitative Risk Management
Daniel Sigrist	Head of Supervision of Life Insurance
Yann Wermeille	Head of Collective Investment Schemes
Andreas Wortmann	Head of Central Services
Dr David Wyss	Head of Enforcement and Market Supervision

Enforcement Committee

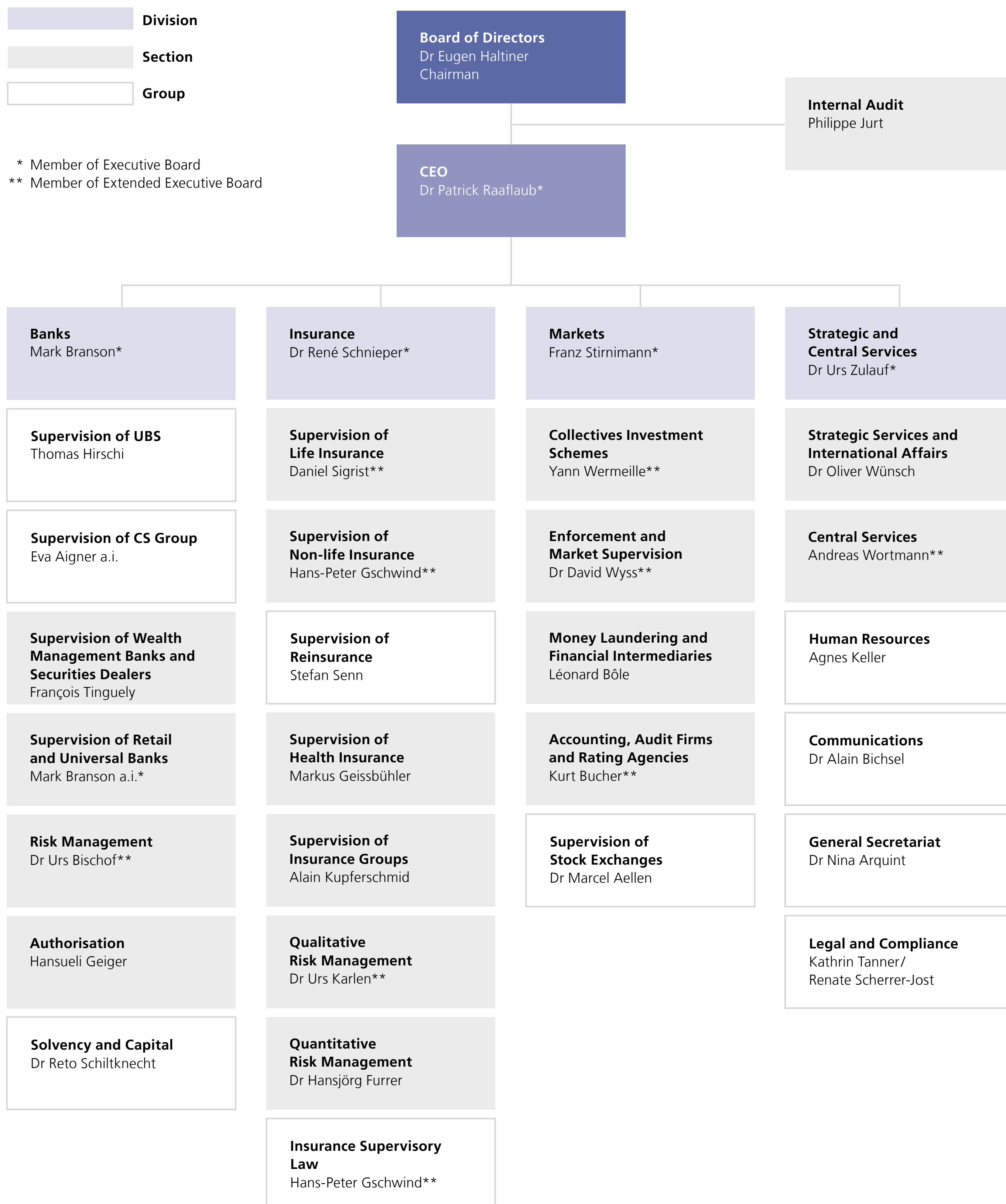
The Enforcement Committee (ENA) passes enforcement rulings or prepares proceedings for consideration by the Board of Directors.

Permanent members: Dr Patrick Raaflaub
Dr Urs Zulauf
Franz Stirnimann
Dr David Wyss

Where a supervised institution is the subject of enforcement proceedings, the Executive Board member responsible for its supervision joins the Enforcement Committee for that specific case. The member of staff responsible for international administrative assistance also has permanent attendance and voting rights in administrative assistance proceedings.

ORGANISATION CHART

(status: 31 December 2010)



FINMA'S REPRESENTATION IN INTERNATIONAL WORKING GROUPS

International organisations and committees

Financial Stability Board (FSB)

- Standing Committee on Supervisory and Regulatory Cooperation
- Steering Group on Resolution
- Cross-Border Crisis Management Group
- Peer Review Group on Compensation

Joint Forum

- Plenary session (representing banks and insurance companies)
- Task Force on the Differentiated Nature and Scope of Regulation
- Working Group on Risk Assessment and Capital Standing
- Working Group on Revising the Principles on Supervision of Financial Conglomerates

Basel Committee on Banking Supervision (BCBS)

- Governors and Heads of Supervision
- International Conference of Banking Supervisors
- Main Committee
- Policy Development Group
- Macroprudential Group
- Working Group on Liquidity
- Trading Book Group
- Definition of Capital Subgroup
- Basel II Capital Monitoring Group
- Risk Management and Modelling Group
- Capital Interpretation Group
- Cross-Border Banking Resolution Group
- Standards Implementation Group
- Standards Implementation Group on Operational Risk
- Standards Implementation Group on Validation
- Accounting Task Force
- Anti-Money-Laundering/Combating the Financing of Terrorism Expert Group
- Governance Task Force
- Top-down Calibration Group

International Association of Insurance Supervisors (IAIS)

- Executive Committee
- ComFrame Task Force
- Financial Stability Committee
- Technical Committee
- Implementation Committee
- Budget Committee
- Internal Review Task Force
- Solvency Subcommittee
- Accounting Subcommittee
- Insurance Contracts Subcommittee
- Reinsurance Subcommittee
- Insurance Groups and Cross Sectoral Issues Committee
- Governance and Compliance Subcommittee
- Market Conduct Subcommittee
- Insurance Core Principles Coordination Task Force

International Organization of Securities Commissions (IOSCO)

- Technical Committee
- Presidents' Committee
- European Regional Committee
- Technical Committee Task Force on Audit Services
- Chairs' Committee and Auditing
- Standing Committee 2 (Regulation of Secondary Markets)
- Standing Committee 3 (Regulation of Market Intermediaries)
- Standing Committee 4 (Enforcement and Exchange of Information)
- Standing Committee 5 (Investment Management)
- Standing Committee 6 (Credit Rating Agencies)
- Screening Group
- MMoU Verification Team 6

International forums

- Task Force on Unregulated Entities
- Task Force on Commodity Futures Markets
- Task Force on Derivatives Regulation

Financial Action Task Force (FATF)

- Plenary session
- Expert Group A/Expert Group B
- Working Group on Typologies in the Securities Sector

Organisation for Economic Co-operation and Development (OECD)

- OECD Insurance and Private Pensions Committee (IPPC)
- IPPC Private Sector Advisory Group
- IPPC Task Force on Corporate Governance
- IPPC Task Force on Insurance Statistics
- OECD Committee on Financial Markets
- OECD Economic Survey

International Monetary Fund (IMF)

- Financial Sector Assessment Program (FSAP)
- Article IV Consultation

- Swiss Futures and Options Markets Regulators' Meeting (Bürgenstock Meeting)
- Futures Industry Association/International Futures Industry Conference (Boca Raton Meeting)
- Enlarged Contact Group (meeting of investment fund supervisory authorities)
- Wilton Park Securities Supervision Conference/International Cooperation and Enforcement
- Senior Supervisors Group
- OTC Derivatives Regulators Forum
- Meeting of four German-speaking nations (Germany, Austria, Liechtenstein and Switzerland) in banking and insurance
- *Conférence Francophone* (insurance) with France, Luxembourg, Belgium and Switzerland
- *Groupe des Superviseurs Francophones* (banking)

The list is limited to international committees in which Switzerland is actively involved.

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