finma
Eidgenössische Finanzmarktaufsicht FINMA
Autorité fédérale de surveillance des marchés financiers FINMA
Autorità federale di vigilanza sui mercati finanziari FINMA
Swiss Financial Market Supervisory Authority FINMA

Speech at the Small Bank Symposium held on 2 October 2017 in Bern

Mark Branson
FINMA Chief Executive Officer

Innovative regulations for a diverse financial services industry

Ladies and gentlemen

It is my pleasure to welcome you to the Small Bank Symposium here in Bern today. And thank you for turning out in such large numbers. I look forward to some lively interaction with many of you later on.

In Switzerland, approximately 300 banks and securities dealers are in operation. Just under 260 institutions – that is 85% – come under the small bank and microbank category and at FINMA are Category 4 and 5. However, their total assets amount to slightly less than 10% of the total representing all banks and securities dealers in Switzerland. The smallest bank in Switzerland is the Spar- und Leihkasse Leuk. Leuk, or Loèche in French, is a small town in the highlands of Canton Valais. This bank has 0.9 full-time equivalents spread over three part-time employees in case you were wondering how they handle cross-checking. The total assets of this microbank in Leuk are around 40,000 times smaller than those of UBS.

So it is abundantly clear that Switzerland's banking sector is extremely diverse. That is good for competition, and it helps ensure that a wide range of customer needs can be met. At the same time, however, such a patchwork complicates the tasks of regulating and supervising, not least because equality as a legal principle dictates that equals should be treated equally and unequals unequally. I want to concentrate on the second idea and that is differentiation in terms of regulation. I will comment on where we are at in financial market regulation today and where we see potential in this area.

Banking-sector diversity constitutes an asset for the Swiss economy

In springtime this year I visited a tiny bank in Canton Aargau. This time, not accompanied by a watchdog; rather I went to find out more about microbanks and their business environment, challenges and prospects. This particular bank has 12.5 full-time equivalents. It specialises in offering retail banking services with a personal touch, within its catchment area, and it is thriving in this specific niche. In my view, this bank is representative of many other small banks in Switzerland.

As I had mentioned, at FINMA small banks are Category 4 and 5, which are usually banks with total assets below CHF 1 billion. These 260 banks and securities dealers are scattered across Switzerland. Some of these banks are geared towards customers from the surrounding villages, while others have a more international focus. Headcounts at small banks also vary markedly. Some have just a few employees; the largest Category 4 banks, on the other hand, can have as many as 450 full-time equivalents. Services on offer range from conventional retail banking and wealth management to pure e-banking, in other words operating without actual bricks-and-mortar branches.

Laupenstrasse 27
3003 Bern
Tel. +41 (0)31 327 91 00
Fax +41 (0)31 327 91 01
www.finma.ch

This wealth of diversity in Switzerland's banking industry confers several advantages. These are banks that can readily offer sophisticated services, that remain in close contact with their customers and which know the in's and out's of their localities. All of this adds considerable value to Switzerland as a business location. In this setting, small banks are stirring up competition. They are just the right size to road-test and drive innovation.

But being small also has drawbacks. Many small banks have established successful niches – in terms of either regional coverage or product offering, we also see that, on average, small banks are much less profitable than the larger institutions, and vast swathes of research concur that big banks save costs based on scale. KPMG has found that the return on equity at large private banks is on average as much as 2.5 percentage points higher than at small private banks. The picture for retail banks is similar. A recent report from IFBC consultancy shows that larger banks continue to outperform their smaller competitors in terms of both profit per employee and cost/income ratio.

FINMA wants to intensify its dialogue with small banks

It is important to FINMA that small banks have a fair chance to grow, progress and continue to operate profitably in their various value propositions. That is why the unnecessary hurdles and costs faced by small banks should be identified and whenever possible eliminated. More on this in a moment.

It is also harder for small banks to make themselves heard. They are under-represented in the industry organisations, where they are drowned out by the big leaguers. The same goes for the world of politics. Perhaps major banks have a hard-wired incentive to influence regulation to keep barriers to entry nice and high. Major banks are also more crucial for financial stability, meaning that oversight bodies are more mindful of their interests – especially in the wake of a financial crisis.

I would therefore like to make greater use of the open communication channels we have, so that your concerns become our concerns. I will touch on this later.

Regulatory response to the crisis

How does the regulatory framework look today? Does it fit properly with this broad patchwork that is the Swiss financial services industry? First, let us take a brief look back over the past decade, a period which has in many ways shaped the regulations in their current form.

On 1 October 2007, ten years ago almost to the day, UBS announced its first billion-franc write-off. The consequences of this, especially the dramatic events of the autumn of 2008, are common knowledge. The global costs arising from this financial and economic crisis have been colossal. Hundreds of billions in direct state aid, millions of jobs destroyed, billions lost through reduced economic growth, the monetary policy experiments of central banks, and then the steadily growing burden of debt, both public and private.

The root cause of the financial crisis can be summed up in one word: leverage. Many financial institutions had low levels of capital but held high volumes of risky transactions on their balance sheets.

The reaction of regulators, of course, has been to focus on this Achilles heel. The requirements for equity capital and liquidity coverage ratios have been tightened in line with global Basel III standards. In Switzerland, additional safety margins have been required from systemically important banks – which has undoubtedly been the right thing to do.

Today, major banks worldwide and particularly in Switzerland have much larger capital and liquidity buffers. This has made our system significantly more stable. And the progress made in this area must not be undone.

Calibration of safety margins and rising complexity

If I examine the regulatory framework in recent years, two significant developments spring to mind. Firstly, the notion of safety has been **calibrated** based – as I have already said – on more stringent capital adequacy and liquidity requirements. This was an absolute necessity, and the wider safety margins must be protected. Secondly, however, regulatory requirements have become much more **complex**.

On both counts –calibration and complexity – it is vital that we differentiate on the basis of an institution's size and the risks involved.

The principle of proportionality is already widely applied today. We were consistently even-handed when recalibrating safety margins, making sure that a disproportionate burden was not placed on smaller institutions.

Capital adequacy requirements, for example, were calibrated to FINMA-defined categories. Banks in Category 5 must have a capital ratio of 10.5%. For Categories 4 and 3 the minimum standard is 11.2% and 12%, respectively. UBS and Credit Suisse must have a capital ratio of 14.3% and hold an additional 14.3% of loss-absorbing debt capital. They must also comply with a liquidity regime for major banks and have a resolution plan in place.

However, regulatory complexity plays out somewhat differently, and this is a real challenge for small institutions. Many have informed us that they simply do not have the HR resources to keep pace with the new regulations that are being lined up.

It is more difficult to apply proportionality to regulations than to capital requirements. The fact is that regulation is highly complex in some areas, and in some cases this complexity is driven by international standards, while in others it has actually been the brainchild of overcautious industry representatives. Regulations reflect and are in many cases guided by the complexity of major institutions. For small banks, however, the burden arising from increased complexity is an undesired side-effect. Differentiating properly between large and small institutions and reducing the requirements for smaller players is an ongoing task at FINMA, and one that we take seriously. Much of the load has already been lifted from the shoulders of Category 4 and 5 banks. For example, small banks are subject to less frequent and more condensed liquidity-reporting requirements. They also have reduced disclosure obligations and simplified procedures with regard to the capital that must be held against market risks. In future they will also benefit from easier outsourcing requirements. These relaxed requirements are not inconsequential; otherwise Category 3 banks would not be so interested in them! In August this year, a study by the Financial Stability Institute confirmed that Switzerland's approach to

proportionality – as regards both overall concept design and the scope of differentiation – can be considered as advanced based on an international comparison.

Nevertheless, we believe that the principle of proportionality can and must be applied even more rigorously. It would be ideal if we could set up an entirely separate regime for small banks, but this is simply not possible. Nonetheless, we have tried to introduce some leeway into existing structures and develop new solutions – solutions which are less of a burden on small banks but which do not result in increased risk.

Forward-looking regulation and supervision for small banks

Now I would like to briefly outline the key areas in which we can imagine making adjustments to the regulatory framework, including the strategic direction, the target audience and the starting points.

In making these adjustments we have two aims. Firstly, we want to make regulation and supervision more efficient and lift unnecessary administrative burdens. Secondly, we want to preserve the current level of stability and safety margins for small banks.

The first question is how to define the leeway for easing regulations. For this purpose, we retain our existing bank categories because this has proven effective in implementing the principle of proportionality. We see potential for reducing the administrative burden primarily in Categories 4 and 5. The risks posed to the stability of the Swiss banking system by individual banks in Categories 4 and 5 are manageable. We have also seen that it is possible to resolve a small bank in an orderly way without there being dramatic consequences either for creditors or the system as a whole.

On the other hand, systemically important institutions must continue to be subject to high prudential standards. And no, FINMA does not regard Category 3 banks as small. They play too fundamental a role in our retail banking market as well as weighing heavily in the wealth management industry or their respective regional economies.

As regards the supervision of conduct, we see very little scope for differentiation. Unlike in prudential regulation, risk metrics relating to conduct, for example market conduct or the fight against money laundering, cannot be scaled down. Even small banks can launder significant amounts of money. Sometimes internal controls at these banks are also less advanced. In these matters, the reputation of the whole finance industry is at stake, not simply the repute of one unscrupulous bank. From our perspective, the standards governing conduct are non-negotiable and must be observed by all institutions, regardless of their size.

Three starting points

So what concrete steps could be taken towards granting small banks a little more breathing space? We envisage three starting points whereby our solidly entrenched principle of proportionality can be more fully applied.

Our first approach would be to alleviate the above-mentioned problem of regulatory complexity. To lighten your workload, we want to simplify the calculation method for key indicators, especially where those figures do not actually depict an institution's risk profile, for instance the non-risk-weighted

leverage ratio and net stable funding ratio (NSFR). Calculations here can be simplified without rendering the indicators meaningless. And we would like your input on this because there is no point making simplifications that have no ready application at your end.

The second approach is more radical, whereby small stable, conservative banks would be exempted from some regulations. In other words, they would no longer have to calculate, report or disclose certain global benchmarks in cases where basic capital requirements are largely exceeded. 40% of all small banks have a leverage ratio of more than 10%, giving them an adequate buffer to absorb relatively high losses. So they could be freed from having to report risk-weighted capital ratios. Here we need to become comfortable with the idea of less comprehensive oversight. Hence we want to test the system carefully first by carrying out a pilot project on twenty or so Category 5 banks in 2018. Depending on our findings, we could then extend the system to other institutions or key indicators. In the meantime, please let us know if there is demand for such a change.

The third way forward involves auditing. We have been working on this idea for some time now and are relatively far ahead. Auditing needs to be fine-tuned to be more risk-focused. And auditing is another area where proportionality must be applied more consistently. Low-risk Category 4 and 5 institutions with a solid track record should only be audited for supervisory purposes every two or three years – not every year. The audits would not need to be so extensive. We have a clear goal here: help you to save time and money.

Small bank regime provides scope for innovation

The diversity of the Swiss finance industry is a singular advantage for the whole economy and should be safeguarded. Current business conditions are particularly challenging in the shape of low interest rates, technological advances and the paradigm shift in cross-border business. Those successfully negotiating these challenges will be those who are forward-looking and play their part in shaping the future.

FINMA offers its support in reducing administrative overheads in order to give smaller institutions equality of opportunity.

So where to now? We have come up with a number of ideas for a small bank regime on which we would like to have your feedback today. When it comes to establishing the specifics, small banks should be closely involved in the work. Our idea here is to set up an expert panel for small banks so that the discussions can take place through official channels. There are already four topic-specific expert panels: one on private banking, one on retail banking, another on asset management and the last one deals with questions relating to the capital market. Key industry and supervisory players active in these forums meet to discuss current issues. I particularly value this dialogue as it allows us to establish trends and tackle specific issues in a timely fashion. Small banks are not not well represented on these existing panels, so it is definitely the right time to set up such a forum.

FINMA would like to start a candid, solution-oriented conversation with small banks. Please tell us where the rub is. We also want you to understand our priorities and our goals as an oversight body. I am delighted today that we can lay a foundation for the future.