The Conduct of Financial Market Supervision during the Financial Crisis

Expert advice for the Federal Finance Administration

David Green

January 2010

Expert advice on the Conduct of Financial Market Supervision during the Financial Crisis

Introduction

The following expert advice is prepared in accordance with the mandate given to me by the Federal Finance Administration to prepare expert advice on the conduct of financial market supervision during the financial crisis. It is arranged so as to correspond to the eight questions set out in the mandate, preceded by some general observations, and it also refers, as provided for in the mandate, to additional aspects crucial in evaluating the conduct of financial market supervision which I have felt it useful to address.

In the course of my work, I have talked to a number of individuals both within and outside Switzerland in order to increase my understanding of the issues set out in the documentary material made available to me, not all of which is in the public domain. As my work is not by nature an enquiry or investigation, I do not describe in my report what was said in those discussions, but have rather taken from those discussions views or information that have assisted me in forming my own opinion.

I have had brief discussions with Prof. Geiger about a number of the issues raised and we talked to a small number of people together. However, the views expressed in this advice are purely my own.

As specified in the mandate, I have taken the FINMA Report of 14 September 2009 into consideration. Where I cross refer to it, the page numbers correspond to those in the English version. The Report itself draws many lessons and I do not repeat these, other than where I think qualification or a different emphasis is needed. The lessons already learned are also covered in the statement of FINMA's strategic goals as approved by the Federal Council in its discussions with FINMA in September 2009. A number of the recommendations I make reinforce some of the goals already agreed.

General Remarks

Supervision is a risk-taking business. It operates within an uncertain and unpredictable world with extremely limited resources on the basis of information that can often be incomplete or wrong, using tools whose impact depends on the behavioural response of others.

The basic economic and social rationale for the regulation of financial markets is straightforward: there can be externalities generated by financial market activity that are not easily capable of being addressed by private sector actions. But the prime definition of those externalities and the nature of the interventions they justify is the subject of constant debate. Even if one excludes the extremes of the argument – those who argue for rigid state control of the financial sector, and those who prefer no regulatory interference whatsoever – there are many differences of opinion on the degree of regulation that is appropriate.

Supervision is designed to accommodate simultaneously the political desire to deal with market failure yet still leave markets some kind of freedom. The task of supervisors is continuously to balance this tension. It is inherent, for instance, within FINMA's legal mandate. On the one hand, FINMA has the objective set out in Article 5 of the Financial Market Supervision Act (FINMASA) of "protecting creditors, investors and insured persons as well as ensuring the proper functioning of the financial market", yet, on the other hand, of taking account of the costs of regulation and of "the effect that regulation has on competition, innovative ability and the international competitiveness of Switzerland's financial centre" (Art 7). (It is striking, incidentally, and perhaps unusual in international terms, that the "competitiveness of Switzerland's financial centre" is referred to twice in the legislation (both Arts. 5 & 7) in both the "Objectives" and "Principles" Articles.)

As Philipp Hildebrand notes (in his speech of 18th November 2009 on "Policy Implications of the Financial Crisis"), "Ultimately, it will be a political decision to choose the level of risk Switzerland is willing to accept, both for the financial and for the real sector." The difficulty for all systems of regulation is that in most countries the articulation of that political choice changes over time.

Thus the regulators and supervisors have an extremely difficult challenge in turning potentially conflicting mandates into politically acceptable day-to-day operational decisions in respect of the firms and markets they supervise. The public, and legislators, need to understand this.

1. Do you consider the information exchange that took place between the Federal Banking Commission and the foreign regulators as well as the SNB in the period from 2006 to 2008 to be adequate in terms of international comparison?

Information exchange with foreign regulators

Information exchange between regulators is always a delicate matter, particularly at a time of crisis when there are plausible concerns about liquidity and perhaps even solvency. Supervisors in different jurisdictions need to be able to trust each other if they are to react collectively in ways which will generate the probability of an optimum outcome for all stakeholders. A particular risk is that, if one supervisor provides information to another that could cause alarm, the supervisor receiving the information may feel obliged to act promptly and perhaps precipitately to protect its own interests, or at least those of stakeholders and especially creditors within its own jurisdiction. This may be to the possible or probable detriment of the rest of the firm concerned and perhaps risk precipitating a crisis that might otherwise have been avoided.

It is my understanding that the Swiss supervisors are felt by their peers abroad to have handled themselves as well as any during the recent crisis. Peers point to the fact that the Eidgenoessische Bankenkommission (EBK) has historically recognised that the global nature of the large Swiss banks and particularly their extremely large and complex operations in New York and London meant that the EBK needed to invest carefully and methodically in the supervisory relationships in those centres. This they did from at least the mid-1990s onwards and they were early promoters of the cross-border multilateral supervisory colleges that have only gradually become the international norm. This process is described in the FINMA Report (e.g. p. 20) as is the intensification of co-operation with the US and UK supervisors, with whom there was an unusually close dialogue.

In the course of these many meetings the EBK developed a reputation for being both frank and reliable. In particular, they did not in general seek to conceal any shortcomings that had arisen or concerns that they might have. In this their behaviour contrasted with that of some other supervisors, who were either economical in providing information or represented the position of their banks, whether knowingly or not, as better than in fact it was. The fact that the Swiss supervisors had proved reliable interlocutors over a period of years and built up close personal relationships with their foreign counterparts stood them in good stead as the crisis unfolded.

A crucial element in this was that foreign supervisors experienced no unwelcome surprises. If there was news of concern to convey, it was conveyed fully and accurately and in a timely fashion. This meant that, in the heat of the crisis, foreign supervisors were more likely to take supportive action or refrain from taking potentially unhelpful action such as, for instance, requiring local entities outside Switzerland to hold more capital or liquidity than otherwise. Although a degree of defensive action was taken by host supervisors, the approach adopted by EBK/FINMA over the years may very well have been material in securing a less adverse outcome than otherwise.

The one area where foreign supervisors feel there could have been scope for a better performance was in conveying during the crisis the extent of the degree of seriousness of a particular state of affairs. There were sometimes felt to be differences in the flavour of messages conveyed by the SNB and the supervisors relating to the same set of facts, with the SNB sometimes tending to convey a tone of greater concern or urgency. There were also felt to be differences of tone in relation to the messages delivered at different levels. Although in the end this did not affect behaviour or the ultimate outcome, there was a risk that it could have undermined overall confidence in the reliability of the message conveyed.

I recommend that FINMA should be encouraged to at least maintain and probably intensify the frequency and volume of information exchange with other supervisors, notwithstanding the resource cost involved. Because, in a crisis, a successful outcome ultimately depends on trust built up over time, FINMA needs to put in place adequate succession planning for the long-term management of the key supervisory relationships as well as providing ongoing depth of coverage. In my view, because of the complexity and importance of the overseas operations of the Swiss banks, FINMA's plans to intensify co-operation beyond the US and UK to a significant number of other priority partners should be encouraged and the necessary resources put in place.

I recommend that arrangements need to be in place for the close co-ordination of messages to foreign supervisors and central banks as between FINMA and SNB (and also the FDF to the extent that finance ministries become engaged in crisis management). This involves clarity on which counterparts are to be contacted by whom and on the tone of the message, as well as the factual content. This needs to be a standard part of the crisis management arrangements. (This is not at all, I should note, a lesson unique to Switzerland.)

I have been told that foreign confidence in the Swiss supervisors was reinforced by the initiatives that they and the SNB took in the international supervisory committees to tighten international capital standards. As the FINMA report notes (e.g. p 18), these efforts did not command general support until too late. Nevertheless they heightened the credibility of the Swiss authorities overall during the crisis as ones who were ahead of the game.

The FINMA Report notes (p 39) that the degree of close international co-operation with foreign supervisors, whether in the trilateral meetings or in wider groups, nevertheless did not help the EBK in detecting the crisis at an earlier stage. In my judgement this failure to gain advance warning did not reflect any desire on the part of foreign supervisors **not** to pass on concerns they had or any lack of trust in the Swiss authorities. Rather the foreign supervisors were very slow to identify those risks themselves for complex reasons, as has been documented elsewhere in considerable detail, e.g. in the UK FSA's Turner Review.

In general many, if not most supervisors failed to recognise early enough that a number of the fundamental theoretical foundations behind supervisory approaches were flawed. These problems included undue dependence on efficient market theory, misplaced reliance on sophisticated mathematics, unanticipated financial instability related to securitisation and the failure of market discipline.

As noted above, FINMA is planning to enhance further the scope and scale of its collaboration with foreign supervisors both bilaterally and within the cross-border supervisory colleges in which it participates as both a home and host supervisor. Such work is resource intensive in both personnel and direct costs. Nevertheless, such effort is vital for a country such as Switzerland, given its role as a major host to foreign firms and the global reach of its largest banks and insurance companies. Colleges with a large number of supervisors will not always be particularly efficient and perhaps frustrating, but they provide contact between the senior management of a firm and supervisors in smaller jurisdictions, which is likely to intensify the focus of senior management on the need to address the risks posed by a firm's geographical diversity.

While participation in bilateral, trilateral and college meetings is essential, consideration could also be given to more extended periods of directly working together with foreign supervisors on individual firms in greater depth, particularly given the complexity of some of the firms.

Concern about the problems which have recently beset banking should not distract attention or resources from appropriate cross-border co-operation in respect of insurance companies, where risks may sometimes be slower to crystallise, but be just as far-reaching in their consequences.

It remains possible, even if not necessarily very likely, that better informed questions put to foreign supervisors by the Swiss supervisors in the bilateral or trilateral discussions could have led to earlier discovery of the scale of the potential risks in the big banks. It may not be sufficient to rely largely on the judgment of a host supervisor in assessing the risks affecting a foreign entity. Some capacity to make independent judgments on those risks is necessary. Where the necessary analysis is undertaken and by whom is less important than that it is undertaken first at the macro level and then looked at at the level of the individual bank. In many countries this is the product of collaborative work between a macro surveillance function and those responsible for the supervision of individual firms (see also below). Although the foreign host supervisor may be close to the market concerned, they may also run the risk of being too close and less able to take a detached view. In future it could also, as a general rule, make sense for the Swiss supervisors internally to make more systematic judgments on the competence of host supervisors. The UK FSA, just to take an example, has a methodology for making such assessments.

Information exchange with the Swiss National Bank and the Federal Department of Finance

The relationship within a country between the macroeconomic functions (both fiscal and monetary), the central banking function and the various sectoral supervisory functions is critical to both macroeconomic and financial stability. Mistakes have been made internationally in both directions, with supervisors failing to take adequate account of what was happening in the macro-economy and central banks failing to take adequate account of what was happening in the financial system.

The interrelationship between the functions remains critical, irrespective of the precise institutional combination of these functions. This varies widely across countries. Sometimes decision-making for both fiscal and monetary policy is combined within a finance ministry. Sometimes decision-making for monetary policy and supervision is combined within a central bank. Sometimes banking supervision is combined with insurance and market supervision and sometimes not. As suggested by work done by the Bank of England, no institutional model has been conclusively shown to be superior, including in relation to performance during the recent crisis. Each has advantages and disadvantages.

The overall Swiss architecture in terms of division or combination of function may be seen as relatively standard by international comparison, with comparable models in a number of major countries. In one or two countries there have been recent proposals to transfer direct responsibility for banking supervision, or prudential supervision more generally, to the central bank. I see no reason why recent events should provide support for any change in the existing architecture in Switzerland, nor did anyone advance such a case to me. What is critical is the quality of the connection between the functions.

In recent years arrangements have been put in place in most countries to seek to clarify and to put on a systematic basis the division of responsibilities between the respective authorities. Often these are tripartite arrangements involving the supervisory function, the central banking function and the finance ministry.

Before coming to the relationship between FINMA and the SNB, I first refer to the position of the Federal Department of Finance (FDF). The formal involvement of the finance ministry in tripartite financial stability arrangements is in some countries a relatively recent development. The reasons for involving the finance ministry are threefold. The first is that fiscal policy may directly impinge on the financial system as part of macroeconomic policy generally, as well as through the impact of particular fiscal measures (such as tax deductibility of debt interest). The second is that crisis support for a financial firm may need to be borne by the public purse. The third is that the finance ministry will generally be responsible for the legal framework for supervision and needs to understand whether amendment may be desirable.

Because of the importance of these factors the finance ministry is sometimes, as currentlyin the UK and proposed in the US, responsible for presiding over the relevant tripartite co-ordination machinery. The finance ministry is usually accountable to parliament and the public for the adequacy of the supervisory arrangements. Of particular importance for the finance ministry is the maintenance and updating, where relevant, of the legal framework in the light both of evolution in the market place and of the effectiveness of supervisory approaches and techniques.

At the same time care is needed in the precise structuring of the arrangements in which the finance ministry is involved to ensure both the independence of monetary policy decision-making and of supervisory decisions in individual cases.

My own experience of other jurisdictions suggests that it may be appropriate for a review to be undertaken to see whether the relationship between the FDF and the other two parties should be more formal, as is the case elsewhere. In the Swiss case, my understanding is that co-operation in respect of crisis management takes place in the Finanzkrisenstab and is judged to have functioned efficiently. Crisis management lies at the core of many tripartite arrangements. I do not know whether the existing Swiss tripartite arrangements for co-operation in a crisis are based on any written document. Written documents are rarely referred to in the heat of a crisis, but can be valuable in making clear exactly what the responsibilities of each party are, as well as helping ensure continuity when there are changes of key personnel.

Beyond the field of crisis management, the main purpose of involvement of the finance ministry in a tripartite arrangement is to make clear that it too has a responsibility in respect of financial stability. It is generally responsible for the overall structure of financial regulation and the legislation that governs it and for accounting to parliament (as in the context of this present report) for the management of serious problems within the financial system and any measures used to resolve them. Making such a responsibility of the finance ministry for financial stability explicit (and I note at the international level the recent membership of the FDF on the Financial Stability Board, but not of FINMA), may assist in supporting the overall independence of the supervisory function, whether vis-à-vis the regulated firms or other political pressures. As noted above, it needs to remain removed from individual cases, except in exceptional circumstances, such as when fiscal support may be at issue.

Notwithstanding the SNB's independence in respect of monetary policy, to the extent that the SNB becomes more formally involved in supervisory policy-making, as I recommend below that it should, it could still be appropriate for its views on financial stability matters to be discussed in a tripartite context.

The sound functioning of the relationship between, on the one hand, the central bank (as macroeconomic policy maker and as direct participant in financial markets, especially as provider of liquidity support) and, on the other, the supervisor is critical.

It goes in both directions. Because of the central bank's need to analyze developments in the real economy to determine the overall monetary stance and developments in the financial system in order to understand the functioning of the monetary transmission mechanism, the central bank will have insights about the development of risks for individual firms whether arising from the evolution of the macro economy or from changing behaviour or relationships within the financial system.

Equally the supervisors of individual firms will obtain a range of intelligence not otherwise available about what each firm knows about what is happening in the economy and how they observe the behaviour of other participants. This requires capacity within the supervisor to analyse such intelligence from individual firms and to generate advice back to the supervisors of individual firms, as well as to provide additional information that can inform the conduct of monetary policy and macroeconomic policy more generally.

The interface between these two sets of data requires very closely related but separate and distinct roles and activities in both the monetary policy and supervisory functions. These functions tend to go by different names internationally. Very often they go under the generic if ill-defined term of financial stability whether located in the central bank or the supervisor. There is danger of overlap where the quite different analytical purposes are not made clear. One purpose is to convert information gained by central banks for monetary policy purposes into advice that can inform the actions of supervisors. The other is to convert information available to supervisors from their day-to-day supervision into advice that can inform the macroeconomic decision makers.

From the central bank side the analysis needs to be made available in ways that lead to recommendations for the supervisors to consider. A widely observed phenomenon in the recent crisis has been the extent to which the numerous financial stability reports produced by central banks have failed to give rise to supervisory response. In part this has been because risks are insufficiently prioritised or inadequately articulated. A central bank needs to give clear recommendations as to what it thinks the supervisory reaction should be. The process then requires capacity within the supervisor to convert a generalised concern about a given risk into operational guidance at the level of supervision of the individual firm.

In my view this will most effectively be delivered by the SNB writing formally to FINMA, setting out its analysis and making recommendations. FINMA can then be expected to respond and there should be discussions intended to reach a common understanding.

Such an arrangement should help to reduce the scope for circumstances such as those described in p 26 of the FINMA Report by putting a procedure in place, within the framework of a revised MOU, for the SNB periodically to articulate clearly the nature of its concerns and its precise views on how they should be addressed. Decisions can then be made in a considered fashion as to whether and, if so, in which form action should follow. Following this debate it will be for FINMA alone to reach a conclusion in relation to matters falling within its competence.

Once such a process has been put in place, it should be possible to co-ordinate public statements by each organisation more effectively so that they can be mutually reinforcing. If, following rigorous debate, differences still remain, due care needs to be taken in explaining such differences in public.

There also appears to be scope for co-operation to intensify on a day-to-day level. One of the information advantages the SNB has is its direct participation in markets. Where it receives intelligence directly relevant to a supervisor, this should be conveyed immediately rather than saved up for a periodic meeting, as may otherwise occur.

Consideration could be given to putting in place reciprocal secondment arrangements, if these do not already exist, as a way of enhancing institutional understanding of the distinctive requirements of each organization.

I have been told that arrangements have been made for the SNB to make on-site visits to the banks. Care may be necessary to ensure clarity about the purpose of such visits. They will most obviously be warranted when directly related to protection of the integrity of the SNB's balance sheet. Such visits will in all probability also generate information of supervisory relevance. It will be important that this is made available to FINMA immediately to avoid risk to either the SNB or to FINMA. If and when feedback is given to the firm inspected, the status of such feedback should be clear so as not to risk causing confusion, legal or otherwise, about whether or not such feedback is given within the context of FINMA's supervisory relationship with the firm.

2. **How do you evaluate the organisational structure of FINMA?**

3. **Is a change to the management structure indicated in order to strengthen FINMA? What specific changes to the management structure would you propose?**

4. **Is the independence of the FINMA staff and of information gathering by FINMA, especially relating to the supervision of major banks, always ensured? How would you assess the following measures designed to improve the independence of information gathering and evaluation?**

   - **Extension of the term of office of the governing bodies of FINMA to 8 to 10 years, without possibility of re-election.**

   - **Strengthening of the Executive Board by instituting a structure similar to the SNB (Governing Board).**

As these questions are closely related I have provided an answer that pulls together the various inter-related strands.

I am asked to consider whether the independence of information gathering and evaluation by FINMA would be improved by strengthening the Executive Board by instituting a structure similar to that of the SNB (in which the Governing Board, rather than the Bank Council, takes all major decisions).

I start by observing that the nature of the decisions taken by a central bank and those taken by a financial regulator and supervisor are quite different. Both the information gathering requirements and the evaluation or decision-making requirements differ substantially. Indeed, one reason why the roles of central bank, especially where it is the monetary policy decision-maker, and of supervisor are performed by different organizations in most major jurisdictions is because of the different kinds of decisions required.

Although there are other functions, decision-making in the central bank is in essence about the structure of its balance sheet and the impact this has on financial markets and hence on the wider economy. Very complex analysis is required to make relatively few big decisions with economy-wide impact, very often at extremely short notice, albeit implemented through complex mechanisms.

The supervisor's tasks and the decisions involved to perform them are quite different in character. Within the overall legislative framework the supervisor needs to issue a range of rules of general application and then apply them on a continuing basis and in detail to numerous firms, markets and individuals.

For this reason, it is not necessarily the case that the internal governance structure of a central bank or monetary authority is self-evidently appropriate to a regulator and supervisor. Nor is this the case for the external governance arrangements.

Most central banks are independent to varying degrees in respect of the implementation of their core monetary policy responsibility. This is the case with the SNB and the very strict independence arrangements set out in Art. 6 of the National Bank Act. The governance arrangements for FINMA are slightly different. The National Council and Council of States are responsible for FINMA's superintendence (FINMASA Art 21). The superintendence implies no operational control of FINMA, but focuses on how FINMA carries out the tasks and functions assigned. At least once each year FINMA reviews "the strategy for its supervisory activity and current issues of financial centre policy with the Federal Council". At the same time, "FINMA carries out its supervisory activity autonomously and independently". It deals with the Federal Council via the Federal Department of Finance.

This still leaves the question of whether the existing internal governance arrangements are the best available. FINMASA requires FINMA to "organise itself according to the principles of good corporate governance". However, looking at wider international comparisons, such principles are not absolute and tend to evolve over time. Nor are principles designed for the governance of commercial companies necessarily appropriate in every detail for a supervisory agency; supervisors are not accountable to shareholders for financial performance in the way that corporate boards are. In practice supervisory bodies are subject to a variety of governance arrangements internationally, though often, as is the case with the FSA in the UK, they draw on the national corporate governance code where it is relevant.

I have been told that the governance arrangements for supervision in Switzerland have evolved over time and were the subject of much debate during the process of deciding to establish FINMA. The current explicitly mixed arrangements, viewed from outside, can be seen as a compromise that was perhaps justified in the historic context. There was the need, on the one hand, to avoid taking unnecessary management risks while creating a new organization from very disparate elements and, on the other, to move away from an unsustainable situation where all decisions were the responsibility of the Board, as was, I understand, the case in the EBK.

In my view, at some point in the next few years, further change would be desirable to bring the arrangements closer into line with good practice elsewhere. The disadvantage in the present arrangement, certainly in terms of external appearance, which is itself important, is that the FINMA board simultaneously has the role of supervising the conduct of the Executive, but also itself decides on "matters of substantial importance", which has been interpreted to include some decisions on individual firms or persons.

This has the consequence that in the most important and sensitive areas the Board is supervising its own decision-making, both in individual cases and in international policy negotiation. This could inhibit it in exercising its oversight over the executive with complete clarity. It could also inhibit it from clearly exercising its proper role of acting as a buffer between the executive and the pressures of the outside world, whether from regulated firms or from political circles or from public opinion.

As well as exercising oversight over the Executive, the Board also has a role in protecting the Executive when unpopular decisions are made, as is an inevitable consequence of the role of a supervisor.

I am unable to judge whether the existing structure has had damaging consequences. Whether or not events might have been supportive of such a conclusion in the past, the arrangements leave open some possibility for such a situation, particularly in the event of the future departure from the Board of individuals with the existing depth of experience and reliability of judgment.

In my view, it would be preferable for the Board to be removed from supervisory decision-making on individual cases, even in relation to the largest banks and insurance companies. This would involve an amendment, or rather qualification, to the existing Art 9 of FINMASA. It should retain its decision-making role in relation to its regulatory policy role exercised, for instance, through the issuance of ordinances and circulars. Such a structure would be more in line with the governance arrangements in, for instance, the UK FSA.

The current arrangements have the advantage that they bring very substantial industry experience directly to bear on decisions on major cases. This is the case notwithstanding the restrictions on Board membership preventing current direct involvement in financial markets, or the fact that, as the FINMA report notes [p 46], even with a Board at full complement, gaps in expertise remain at Board level.

A move to remove the Board from decision-making in individual cases would entail the loss of certain advantages inherent in the current arrangements. These could be addressed through a variety of routes. It would be possible, for example, as some foreign regulators do, to seek to replicate the high level practical experience presently brought to FINMA through the Board by the appointment of very experienced senior advisors to the Executive with similar profiles of industry-specific practitioner experience to those available on the existing Board. Such senior advisors could be appointed full-time as well as part-time, which could make it possible to obtain more sustained and committed input to casework than is currently available from the Board. If involvement in individual supervisory cases were to be removed from the Board's role, it would also make it possible to include in the Board current, as well as former, market practitioners, though these would need to be particularly carefully selected.

Concern has been expressed that if decision-making in individual cases were removed from the Board, pressure would build for the Board to include membership representing wider interests, so that the perceived current potential risk of excessive influence by the financial services industry could be replaced by the risk of undue representation of other, perhaps political, interests. This need not be the case. Experience relevant to the financial services industry should still be an overriding criteria, but there could be room for wider representation of the users as well as of the providers of financial services, given that the statutory objective (FINMASA Art 5) is to protect "creditors, investors and insured persons" as well as contributing to "sustaining the reputation and competitiveness of Switzerland's financial centre".

Consideration could also be given to supplementing the experience provided directly through the Board by the establishment of standing panels of advisers, as, for example, in the UK, to supplement existing consultation arrangements. Such panels do not have decision-making powers, but bring access to a broader range of expertise as well as additional public scrutiny.

It can be argued that the sheer size of the largest banks and insurance companies and the degree of concentration in the domestic market means that the distinction between regulation and supervision is very difficult to make in the context of the Swiss market. It could also be argued that direct experience of individual cases is necessary to be able to take decisions on policy.

Nevertheless, a requirement to separate responsibility for decision-making could assist in ensuring not just the substance, but also the appearance of the integrity of both processes under all circumstances. This assumes, of course, the availability of sufficient experience at executive level to formulate appropriate policy propositions for the Board to debate and decide on.

The Board should seek to ensure that the policy provided for in the implementation of legislation through ordinances and circulars can apply without exception to all regulated firms. It will then be the role of the Board to ensure that such policy is applied by the Executive, irrespective of the kind of political pressure that the FINMA Report describes (see e.g. p 39). This does not necessarily preclude the Executive from seeking advice from the Board, whilst retaining the ultimate decision-making responsibility.

Even in supervisory agencies where the responsibility for decision-making lies with the executive and not with the supervisory board, there can be a public expectation that the chairman of the board remain accountable for failures of supervision in individual cases. This makes it particularly important to make it clear that the chairman is responsible for overseeing policy and process. An alternative arrangement (though not one used in the current UK model) would be to make the chairman also executive, but in this case it would be critical for the individual appointed to be manifestly independent of the regulated firms.

I have considered the suggestion that the independence of information gathering and evaluation might be strengthened by the extension of the term of office of the governing bodies of FINMA from eight to ten years without possibility of re-election. In my view, some amendment of the current arrangements is warranted, if not necessarily in this form, but a view on this point is partly dependent on whether or not the Board continues to take decisions in individual cases.

FINMA undertakes its activities within a political environment, albeit under a legal framework. As noted below, experience suggests that the political stance towards a particular approach to the implementation of supervision is prone naturally to change over time in ways that can be unhelpful in maintaining a consistent approach to supervision. At the same time, it must be possible within a democratic society for the Federal Council to influence the overall tone of the Board by making adjustments to the composition of the Board. There is thus a balance to be struck between independence and continuity on the one hand and responsiveness to the overall public climate on the other.

As suggested above, one element in helping to sustain independence would be if the Executive rather than the Board were to assume responsibility for individual cases. This would make it more acceptable for Board Members to be subject to appointment/reappointment as frequently as at present. However, it would be much better if a way were found, once the present terms expire in 2011, to stagger appointments systematically to preserve continuity of knowledge and a collegiate culture.

The appointment of Board members for eight to ten years, while paralleled in a small number of jurisdictions, though in very different overall contexts, would make it much more difficult to renew the expertise in the Board sufficiently frequently. If arrangements were made to stagger the term of Board members, a longer non-renewable term of, say, five or six years could be considered without prejudicing the fresh input of new expertise, but I am not convinced that this is necessary.

I have reviewed the Règlement opérationnel FINMA (état 1st December 2009). The management structure within the FINMA executive appears broadly appropriate, subject to my comments on the overall organizational structure.

5. What other measures do you propose to improve the independence of the staff and the independence of information gathering?

A supervisory agency always has to take account not just of its formal legal mandate and powers, but also the overall political environment in which it is operating. After all, its legal mandate can always be changed if its interpretation of the legal mandate is for too long at variance from the wishes of the political process. There is always political interest at a narrow level in the actions of supervisors because they can have a differential and sometimes significant impact on individual property rights and interests. This contrasts, for instance, with the rather more impersonal effects of monetary policy action.

Furthermore, in addition to more narrow and specific political and economic interests in individual cases, it is observable that there are cycles of variation in the degree of political support generally for a particular stance of supervision. Typically, the actual supervisory stance will of necessity lag behind core political opinion. Usually there will be some sort of crisis following which there is a consensus for tightening to address a perceived supervisory shortcoming. Such a tightening is ready for implementation just when alarm has subsided and the supervisors may then find themselves accused of acting as "bureaucratic, anti-competitive and detached from reality" (FINMA Report p 39) until there is another incident and the political climate shifts again. This is a familiar, understandable and perhaps natural cycle.

In order to function reasonably against such a background in which there is no right answer in absolute terms, a supervisor must act consistently, and be seen to act consistently, in line with a publicly declared approach. At a number of points, FINMA notes or implies in its Report (pp 23, 24, 39) that it failed vigorously to pursue deficiencies against breaches of known requirements either because of weaknesses in its own monitoring procedures or because it felt unable to implement its declared requirements due to concern about lack of political support or because the firms concerned were reluctant or unable to devote the necessary resources to rectification of the deficiency.

Internal controls are as important for supervisors themselves as for the firms they supervise. Although slavish adherence to process is no guarantee of avoidance of difficulties, failure to adhere to already agreed and publicly declared process runs risks.

A recent vivid example of such a danger can be seen in the weakness exposed in the supervision of Northern Rock by the UK FSA. Where supervisors have established internal processes to identify and then to address deficiencies, they need to adhere to them consistently and without exception. This may reduce the risk of the crystallisation of the shortcomings the procedures are designed to guard against. It will also act as a protection against political pressures from whatever source. Of course, the necessary tools to enforce rectification of deficiencies need to be in place. If the procedures specified are felt by the supervisors no longer to be appropriate then they should change them transparently, but until that point they should be adhered to, whatever the pressure to do otherwise.

As noted above, one issue that emerges from the FINMA report is a number of instances where FINMA had identified a shortcoming in, say, a firm's systems or controls, but had not required rectification with particular speed or vigour. Clearly, a judgment needs to be made on the materiality of a deficiency, but there need to be adequate remedies to ensure a response, particularly when rectification may be costly for the firms. One tool that is used in other jurisdictions is the capacity to suspend the line of business concerned unless the deficiency is rectified within a specified time period.

The supervisors themselves also need to ensure that their own internal processes are complied with. I have not enquired into the adequacy of FINMA's arrangements for ensuring compliance with its own procedures, but international experience shows that internal compliance can be a blind spot for supervisors and many have been re-examining their own internal systems, building on the lessons to be drawn from e.g. the FSA's internal audit report into the failure of Northern Rock or the SEC's internal report into the Madoff affair. In most supervisory agencies, the responsibility for checking on the adequacy of internal compliance procedures would rest with an internal audit function reporting direct to the supervisory board. This, too, is a tool for helping ensure independence.

One of the main areas where supervisors add value is through their ability to look across the regulated population. Not only is this needed in order to see where firms are outliers in terms of business strategy and practice and may therefore potentially be at greater risk, but it is also a tool in securing greater independence of analysis so as to be able to better challenge the reliability of information or the validity of arguments presented by an individual firm.

FINMA was, as it has noted in the Report, slow to see the benefits accruing from cross firm analysis, but has moved swiftly to rectify this through the creation, initially within the large banks group, of cross firm analytical functions in relation to investment banking, wealth management and retail business. Such analysis is a core supervisory tool in terms of independence from the supervised firms and the political process more generally, and should be extended across all relevant categories of supervised firms.

That said, FINMA faces an almost unique challenge in terms of the small size of the peer group for the two most complex firms. It is sensibly seeking to address this through seeking to enlarge the size of the effective peer group through dialogue with the foreign supervisors of comparable firms. The necessary resources need to be devoted to the continuation of such initiatives as one of the tools for enhancing independence from the largest firms.

The cross-border colleges for the Swiss-based firms are another tool in that they make it possible to undertake a crosscheck of what the firm has told FINMA about its business. This requires additional effort on FINMA's part since the host supervisors will still only have a partial view of the whole group's operations and possibly less incentive to pursue an issue diligently.

One of the advantages of an integrated financial services regulator is that it also enables comparisons to be made between sectors. This is self-evidently less easy to arrange than comparison within a sector. However, other integrated regulators internationally have achieved useful benefits by moving personnel internally between sectors, enabling fresh light to be brought to bear on conventional wisdom within a particular sector. Thus an experienced banking supervisor may bring fresh insight to the supervision of insurance firms, or infrastructure provider, and vice versa. FINMA's plans to facilitate such transfer of experience should also add to the supervisor's capacity to form an independent view.

One of the more striking observations in the FINMA report is the fact that "The reports issued by the auditor (of UBS) did not contain any general information that could have helped in foreseeing or avoiding the crisis". It has been a matter of widespread comment internationally that in general audited financial statements provided little warning of the problems to come. In part this is because they are essentially and explicitly **not** forward-looking. However, under the Swiss dual system the auditors also play the additional, and quite separate, role assigned to them under the "supervisory audit" arrangements whereby they perform the kinds of inspection of systems and controls often performed in other jurisdictions directly by the supervisor.

It seems clear that one factor contributing to the problems at UBS, even if not perhaps decisive, was serious shortcomings in the bank's own information and hence risk management systems. The "Shareholder Report on UBS's Write-Downs", commissioned by the EBK, sets out, with the benefit of hindsight, what these were. I have not been able to study this issue in any depth, but on the face of it, FINMA's own report, when combined with the Shareholder Report, raises the question as to whether the auditors performed their own duty adequately or, if they did, whether the mandate given to them was appropriately specified.

This in turn raises the question as to whether a review is necessary of the role that the auditors play under the dual system. Of course, serious shortcomings have emerged in countries where the supervisors perform their own inspections directly so that it is not self-evident that a switch to the use of direct inspection on a much larger scale is necessarily appropriate, but the issue merits study.

The relationship between the supervisor and the auditor is in any case under review in other jurisdictions where the auditor does not have a formal role in the supervisory regime. Auditors sometimes claim that they could have helped to give early warnings to the supervisors of emerging risks which were not revealed in the financial reports as statutorily prepared. In some countries informal arrangements were in place in earlier periods that enabled the auditors to convey such views, with or without the audited firm being present, but had been discontinued in the face of uncertainty as to the formal basis on which such discussions were held and how this interacted with the auditors' contractual obligations. This interface is being looked at again in some jurisdictions, but I am uninformed as to the current view on best practice.

6. In quantitative and qualitative terms, does FINMA have sufficient staff resources? What measures could be taken to counter any deficiencies in this respect?

Supervisors everywhere face a challenge in terms of staff resources. They need to have as complete as possible an understanding of the commercial market place, yet their role is not to substitute for or even second-guess the management of a firm. Instead it is to pursue a legal mandate, set by the legislature, but generally aimed at protecting the interests of depositors, policyholders and investors as well as the stability of the system as a whole.

At the core of the prudential, or safety and soundness, aspect of the role the need is to ensure that the institution insofar as possible continues to make money so as in turn to ensure that it can meet its liabilities when they fall due. There is thus, irrespective of the precise legal mandate, an implicit substantial economic content to the role.

The substantive role of the supervisor is to ensure that the firm itself understands how it makes money. The core skill of the supervisor is to be able to continue to ask questions until it is satisfied the firm itself understands its own business model. If it does not, remedial action will already be required. Even if it does, the further requirement is that the firm should understand what could happen to cause it to stop making money and what steps it could take to mitigate such risks.

The FINMA Report (p 25) refers to these responsibilities, noting that “the supervisory authority does not have the authority to approve a bank’s overriding aims, corporate strategy or business model”. It goes on to say that “the role of the supervisor is to monitor and evaluate any measures planned and their execution, the ongoing suitability of the control environment and, above all, the risks arising from the strategy adopted”. It could have gone on to say that the role of the supervisor was also to ensure that the firm had adopted, where relevant, measures to mitigate those risks. It is not entirely clear that the review of business models is now a routine part of the supervisory regime. Elsewhere in the Report (p 17) it is noted that “the role of the supervisory authority is to monitor compliance with legal provisions and take the necessary measures to ensure enforcement of financial market legislation”. It is my understanding that the legal provisions are sufficiently broad to encompass an examination of the risks of a firm’s business model, but it is important that this is generally understood, especially by the firms themselves. Stress testing of the model is essential and here the SNB can make a contribution in helping devise relevant scenarios, independent from those devised by the banks themselves.

The supervisor can never expect to have the same degree of knowledge of the market environment as a constantly active market practitioner. By definition they cannot be currently active participants. The advantage the supervisory agency has to counterbalance this is, as noted above, the capacity to know what each market participant is doing and compare and contrast this against what is happening in the market as a whole and in the wider environment surrounding it. They then need to deploy this knowledge in the supervisory dialogue with the individual firm.

Thus the senior supervisor needs a broad mix of both skills and of knowledge. Clearly core skills in relation to the legal requirements and the use of the legal powers available are a basic necessity. However, they are not sufficient. Knowledge of the market place, of different business models and of the wider environment is equally essential. Some of these skills can be brought in from the market. Others can be cultivated internally. In both these areas the quality of analytical approach is as important as the knowledge base. For the interface with the firm personal qualities of tenacity in the face of challenge are essential and are likely to need to be accompanied by a certain minimum supervisory experience both in terms of length and breadth of service.

Commercial experience is equally not of itself sufficient nor indeed is there a clear pattern of outcomes to be found amongst supervisory agencies in relation to the degree of commercial experience of senior management. During the recent crisis some agencies led by career supervisors are felt to have performed well while others with ample commercial experience at the top have done less so. What appears to be important is a balance and mix of skills.

Major steps have been taken as FINMA has been created to recruit larger numbers of staff and to increase the proportion with direct market experience of particular specialisms such as finance, risk management or audit. This has been explicitly in order to supplement the staff with more extensive supervisory service, traditionally predominantly with legal, methodological or quantitative specialist knowledge. At the same time, it is intended to recruit larger numbers of younger entrants without prior supervisory experience in the knowledge and expectation that a proportion will leave. It is intended that former market participants should be able to serve for a period of time and then move on with their CV enhanced and that staff in general should not find themselves so specialized that they cannot leave for other jobs.

This approach is very much in line with that taken by other leading supervisors to address the need to keep their technical expertise up to date in the face of an extremely complex and challenging environment.

However, it is important for the Board to bear in mind that, vital though market knowledge, expertise and experience is, the profession of supervisor is also separate and unique. Management may need to avoid overshooting in terms of recruiting market professionals. The core job of the supervisor is to challenge the market professional and where necessary stand in the way of the risk the market is prepared to take. The experience of other supervisors is that not all those with market experience can make the transition from poacher to gamekeeper satisfactorily and may be tempted to give former market colleagues the benefit of the doubt. They may also have future job opportunities at the back of their mind if FINMA is seen as just one stage in a market career.

This means that the balance of skills and experience must be managed very carefully and that personality, character and approach are key criteria in the selection of those staff who will take the main supervisory decisions. A concern for the public interest is critical.

The distinctive value-added brought by the supervisory function is the ability to understand and analyse what is being done right across the relevant business sector at the level of the management of the firm. Such experience inevitably takes time and can only be thoroughly acquired when working within the supervisor. This experience is critical in creating confidence to overcome fear of lack of respect from the supervised firm, who will always have superior resources or skills in one area or another.

This makes it important to recognize that supervision is itself an independent profession, much in the same way that central banking is, and for staff to aspire to acquire over time the distinctive and wide-ranging set of skills involved and to feel proud of the contribution this role brings to society.

I am not able to comment on whether current remuneration practices are such as to attract the right mix of staff. It is certainly appropriate, and in line with leading practice internationally, for salaries to be set independently of the standard scales for central government. At the same time salaries will not usually match those at the higher levels of the financial services sector. A good senior supervisor will need to find their satisfaction in promoting the public good, in the range of interest in the subject matter with which they deal and the opportunity to have direct access to the leaders of the financial industry.

It is important for the Board to reinforce such a perception and understanding of the supervisory role both internally and externally. The failures of supervisors are always public and the risks they manage to avert must usually be kept secret. Only insiders will be able to reach an accurate view on a day-to-day basis of where credit is due and ensure that it is recognized.

On the basis of my very limited exposure to FINMA staff, I can confirm that FINMA possess individuals who, in terms of their grasp of the very special nature of the role, are on a level with their peers internationally.

As to the quantity of staff employed, the Swiss supervisors have historically been amongst the more thinly resourced by comparison with the supervisory functions in jurisdictions having a comparably important and complex financial system. In part this is because of the outsourcing of much work to the auditors under the dual system. I discuss this elsewhere. In the event that changes were made to reduce the scale of reliance on the auditors and to substitute for this through greater use of direct inspections there would be immediate resource implications.

In a number of jurisdictions the resource devoted to the supervision of the most complex firms is currently being increased. FINMA has already announced plans to increase its staff numbers overall over the medium term. I am unable to judge whether this is the right amount. The current resources still look modest by international comparison, especially in view of the extreme complexity of its large firms evidenced by the FINMA and UBS Shareholder Reports. One line supervisor per 10,000 firm employees does not look extravagant in the case of the large banks. In the event that the Executive judges in due course that yet further resources are required, such an increase is likely to merit serous consideration.

I have been told that some thought is being given to the possibility of FINMA opening offices in Zurich and perhaps Geneva. This could enhance recruitment opportunities as well as enable some staff to be more closely located to the firms and markets they supervise. Clearly such an arrangement would pose a number of management challenges, but I note that some other supervisors based in a national administrative capital that is not the financial market centre, such as the Canadian prudential regulator, appear to have found effective solutions.

7. **From an international perspective, are the supervisory tools set out in the FINMASA sufficient?**

8. **What other supervisory instruments do you consider desirable in international terms, especially in comparison with the U.K. (e.g. accreditation standards for rating agencies and financial products, definition of minimum rules for salary systems etc.)?**

Though I have not addressed this issue comprehensively, as far as I can judge the supervisory instruments available to FINMA are broadly comparable to those available in other major jurisdictions and in some areas helpfully broader and more flexible. In general the scope for discretion is considerable. If anything, the supervisors need to remain alert to the possibility of using the full scope of their powers. One instance was mentioned to me where there was said to be delay in raising capital requirements because of uncertainty about whether adequate powers existed when in fact the legislation already gave ample discretion.

Nevertheless, the position needs to be kept under review in the light of evolving supervisory practice internationally. This will include the outcome of work on so-called "macro-prudential tools", though in general these seem likely to involve the existing supervisory toolkit, albeit used in different ways.

The FINMA Report refers to delay in raising capital requirements and introducing a leverage ratio while trying to secure international agreement for a general tightening of standards (p 18). One supervisor said to me that there was sometimes a public tendency to see FINMA as a "facilitator for the banks". It needs to be publicly understood that the demand from the industry for a level playing field internationally (c.f. discussion on p 14 re the resistance to the "Swiss finish") cannot preclude the taking of prompt measures at a national level if there is either delay in making progress in changing international standards or the particular circumstances justify additional national measures. In the Swiss case, the concentration in the financial system and size of the big banks relative to the size of the economy provides such a justification.

The fact that the "competitiveness of Switzerland's financial centre" is referred to twice in FINMASA in relation to FINMA's objectives could be read as requiring a considerable burden of proof on the supervisor to justify stricter measures. Some supervisors felt that, perhaps for this reason, the Board placed the burden of proof on the Executive to justify why tightening was needed, whereas the burden should perhaps have been placed on the firms to justify why it was not. This feature of FINMA's mandate could be looked at again when the legislation is next revised. It could also be helpful if it was clearer which other body or bodies were responsible for the promotion of the Swiss market place.

I recommend that FINMA be given the explicit objective of contributing to the stability of the financial system, to parallel the language in Article 5 of the National Bank Act. A similar amendment to the UK FSA's objectives is currently planned in the UK.

At the same time it may also be necessary to respond to requirements introduced in other jurisdictions that may impinge on the competitiveness of Swiss firms or markets.

Question 8 refers to rating agencies. It is increasingly recognized, following the shortcomings uncovered during the crisis, that rating agencies that have global reach need ideally to be subject to conduct of business regulation that is identical or at least comparable globally. Within the EU, this role is to be played collectively by the new European Securities Markets Authority (ESMA). Furthermore, with the object of securing a level playing field for investors within the EU and for ratings used by financial supervisors within the EU, EU legislation is proposed which would have extraterritorial effect in terms of requiring equivalence for ratings generated outside the EU. This would have direct significance for the one rating agency based in Switzerland

and may lead to the need for the introduction of a rating agency oversight regime in Switzerland that meets EU equivalence criteria. Otherwise I understand that ratings for Swiss-listed companies are usually generated outside Switzerland.

The indirect use by FINMA in its own supervision of ratings generated outside Switzerland may cause FINMA to wish to co-operate with, and perhaps influence, those operating new or enhanced registration and conduct of business regimes for rating agencies elsewhere and it is possible this may require new arrangements in Switzerland to facilitate such co-operation.

The proposed new arrangements for the supervision of alternative investment vehicles, particularly in the EU, may also have implications for Switzerland, particularly where they claim extraterritorial reach. It is too early to say at this stage whether new arrangements will be needed in Switzerland in order properly to protect the competitiveness of business undertaken in Switzerland.

The broad international consensus is that there is no strong evidence that alternative investment schemes, loosely categorized as hedge funds, private equity and similar funds, were a significant independent contributor to the current crisis though, of course, exposure to such funds can have and has had impact on regulated firms. For the time being the activities of such funds need to be monitored adequately by FINMA and the SNB, as is done in other major jurisdictions. It may be necessary to review whether additional authority or resources are necessary to undertake this sufficiently carefully so as to ensure that any emerging risks are identified in good time.

In terms of rules for firm remuneration, I have been told that FINMA has adequate tools to ensure that the structures of reward systems are fully consistent with appropriate firm risk appetite, including in particular the structure of incentives in relation to the commitment of the firm to risk by individuals,.

Techniques and tools continue to evolve in this area and in other countries new regulatory arrangements are being put in place to ensure that practical effect is given to this intention. This is an extremely complex area with direct interface with, and sometimes conflict with, private contract law. For this reason, supervisors are tending to monitor adherence to codes of practice rather than hard, auditable rules. Supervisory practice is developing rapidly in other jurisdictions under close political scrutiny and FINMA will need to devote the necessary resources to ensuring that it keeps abreast of the debate.

At the same time, it is important that supervisory action is directed exclusively at ensuring that systems of remuneration support prudential objectives. Pressure needs to be resisted to prevent supervisory tools being misused to meet wider social objectives. This is important because this would undermine the integrity of the supervisory objective, as expressed in Article 5 of FINMASA, both in terms of its role in protecting users of financial services and sustaining the competitiveness of Switzerland's financial centre. Measures to influence financial sector remuneration in pursuit of other social or economic objectives should not make use of the supervisory process.

One tool under active discussion internationally is to require firms to produce recovery and resolution plans, or so-called "living wills". The issue of the adequacy or otherwise of cross-border insolvency arrangements as they impinge on Switzerland lies outside the scope of my mandate. However, an important part of the process of preparing plans for recovery and resolution is the requirement for a firm to understand in precise terms how the numerous entities within a complex group fit together, including the nature of the risks in each legal entity and their aggregate impact on the position of the group as a whole.

It is clear from the publicly available material that such information was simply not available in some of the Swiss firms on an accurate or comprehensive basis. Such information should be core supervisory information regardless of whether or not the firm itself considers it useful for its own purposes.

Requiring the firms to reach the position where they have sufficient clarity about their own structure is likely to involve the firms in considerable cost. The process itself may well reveal the desirability of corporate restructuring in order either to be able to identify risks sufficiently clearly or to manage them effectively. The firms are likely to resist this process and FINMA may need to adopt new supervisory tools (and conceivably enhanced legal powers) in order to secure a satisfactory outcome.