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Banking *Info*

Regulatory Developments 1999/2000

ATAG Ernst & Young

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Regulatory and Supervisory Developments 1999/2000

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Banking and finance is changing dramatically, both world-wide and in Switzerland. Rapid developments in technology, information processing and communications are causing the changes. They lead to further globalization of the financial markets and increased competition. At the same time, traditional banking business is being displaced by new products and services. All these developments are also raising the degree of concentration in the financial sector to new heights: Financial institutions operating globally react to the increased competition and are merging to create larger and larger entities.

The developments in banking and finance are presenting the supervisory authorities with new challenges. The globalization of the financial markets demands an internationally effective supervision. Since no supranational supervisory authority exists, the Basel Committee for Bank Supervision has assumed the task of standardizing and further developing the supervisory norms.

Most of the regulations implemented at the national level during the past years (e.g. the new equity requirements) bear the unmistakable mark of the Basel Committee. The flood of new and sometimes complex regulations tend to overwhelm especially small and medium-sized banks and are expensive to implement.

With this issue of Banking Info *we provide boards of directors, supervisory boards, members of management and other interested parties with a recapitulation of last year's and this year's major regulatory and supervisory developments.*

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Circular 99/1 « Measurement, management and monitoring of the interest rate risk (rate risk) » will take effect on 1 July 2000. After a one-year transitional period, banks and securities traders - with the exception of those which do not have a licence to engage in banking activity and to the extent that they do not incur any significant interest rate risks outside their trading portfolio - will therefore be required to apply the stipulated provisions in full, at both individual and group level.

Interest rate risks

Measurement, management and monitoring of the interest rate risks

This new circular fixes the minimum requirements for the measurement, management and monitoring of rate risks which must be satisfied by the establishments concerned. In addition to these basic requirements, a series of organizational directives are designed to ensure effective supervision of the rate risks incurred by each establishment. However, Circular 99/1 does not lay down any special equity requirements to cover the interest rate risk.

The scope of application of the circular covers all items in the banking portfolio. In practical terms, this means that all the items which do not meet the conditions for a trading portfolio within the meaning of Art. 14 letter e BO must be taken into consideration. The system of measurement chosen by the bank must be capable of aggregating all the rate risks incurred.

The rate risk management process is part of the overall procedure for management of the risks faced by banking establishments. It is therefore imperative for the general risk policy to be carefully defined. A consistent risk policy may be regarded as the essential foundation of integrated risk management and supervision.

Circular 99/1 sets out a veritable framework for management of the interest rate risks and focuses on three key elements:

Table

The sources and effects of interest rate risks

Sources of interest rate risks

Repricing risk
(contains yield curve risk)

Basis risk

Optionality risk

Effects of interest rate risks

Primary effects

Income effect
(Earnings perspective)

Value effect
(Economic value perspective)

Secondary Effects
(influence primary effects)

Structure effect

Quality effect

Commission effect

In identifying the interest rate risks, one must differentiate between the sources and the effects of risks. The sources of the risks are generally maturity mismatches of assets and liabilities. These lead to the income and economic value effects.

- definition and identification of the rate risk, measurement and limitation of this risks;
- organization, internal audit and external audit;
- information system comprising internal reporting and the system for external announcements.

Definition, identification, measurement and limitation of the rate risks

These four factors must enable the financial institutions to apply appropriate principles and methods to determine their exposure and measure the risks incurred against the limits fixed by the Board of Directors.

There are three main sources of rate risks:

- the risk of an interest rate review which occurs when the structure of claims and commitments is not identical;
- the basis risk which flows from imperfect correlation of interest rates, despite similar characteristics concerning rate revision conditions;
- the risk of implicit optional clauses which flows from positions comprising optional clauses.

These three risk sources can engender five effects of which the impact on earnings and the impact on assets are regarded as primary effects which can be quantified; on the other hand, the structural effect and the impact on solvency are secondary effects that are hard to quantify. The impact on commission profits is another relevant factor.

Interest rate risk measurement within the meaning of Circular 99/1 signifies in the first instance a quantification of the impact of interest rate changes on anticipated income (income effect) and on the economic value of equity (effect on assets). In this context, the Federal Banking Commission (FBC) requires risk measurements to take account of normal and crisis scenarios. The banking establishments themselves must define their scenarios in the light of their own situation because the circular does not define them.

Implementation of the statutory requirements for rate risk measurement essentially involves the following stages which in practice are not clearly defined in relation to each other:

- acquisition and preparation of data;
- definition of interest rate change scenarios;
- definition of measurement procedures and their implementation.

In practice, the financial institutions will very often use packages which are/will be offered on the market. However, it must be stressed that the use of a standard solution does not release the management concerned from the need to take basic decisions on the measurement, management and supervision of interest rate risks. But the recourse to such a solution can permit effective implementation of the decisions.

A coherent system of limits must be determined as a function of the measurement methods used and applied. It must take account of the market value (effect on assets) and on par values (effect on income).

Organization, internal and external audits

The circular stipulates that the establishment must have an adequate organization to ensure appropriate risk management. It leaves the necessary discretion to set up an organizational procedure appropriate to the needs of each establishment, which are largely dependent on the nature and complexity of the positions and activities.

The organization is based on three pillars:

- the body responsible for **high level management** which is in charge of the risk policy and its implementation;
- **the operational management**, which implements the risk policy and issues directives for that purpose;
- the specialized units responsible for **internal auditing** of interest rate risks which, as the name implies, measure and monitor risks.

Each entity must accept the responsibilities incumbent upon it and a communication flow must be put in place for this purpose.

The desire of the Federal Banking Commission to strengthen the central role and responsibility of the Board of Directors in the monitoring of risks must be emphasized.

These three pillars are supplemented by the internal audit and external audit, which are responsible for checking the rate risk management process overall and the adequacy of the reporting system and the adherence to the monitoring requirements and limits.

At least once each year, the external audit body must certify compliance with the provisions of Circular 99/1.

Information system comprising internal reporting and the system for external announcements

The circular explicitly requires the establishments to have an information system which ensures adequate monitoring of risks and enables the appropriate persons to be immediately alerted when the risk exposure exceeds the limits authorized by the highest management body. Its stipulates the minimum content of this information.

Announcements to the Swiss National Bank (SNB) must also be made quarterly on the forms provided for this purpose. These announcements must reach the SNB within six weeks. By this system, the Federal Banking Commission intends to lay down sufficient conditions to enable the establishments which present risk exposures in excess of the average for all banks to be identified.

The new provisions on equity to cover market risks took effect on 31 December 1997 with a transitional period of two years expiring on 31 December 1999.

Market risks

Time-limit

In its letter of 10 September 1999, the FBC fixed the procedure for application of these new provisions, i.e. requiring the bank or the securities trader to forward to the FBC:

- within ten days of the entry into force of the new provisions, but no later than on **10 January 2000**, an announcement accompanied by the confirmations, commentaries and views of its audit body on the specific application of the new provisions;
- for the banks which have opted for the criterion date of 31 December 1999 the form for the «calculation of capital adequacy» must be submitted by **the end of February 2000**; this is the closing date for presentation of the preliminary announcement.

Standardized method

To satisfy the requirements laid down for the application of the standardized method, the banks must set up an internal organization to ensure:

- compliance with the requirements to guarantee data integrity. The banks must prove that they have reliable documented procedures, which have been verified and approved by the internal bodies responsible. The latter must guarantee that all the transactions are recorded in full, correctly and in due time, that the market parameters are adequate and up-to-date and fixed by a body which is independent from the front office and that the data are correctly evaluated and prepared for the purpose of risk measurement;
- correct and appropriate application of the procedures laid down in this directive to determine the capital adequacy for the coverage of interest rate, exchange, share price, primary commodity and option risks;
- compliance with the legal and technical conditions permitting a daily

aggregation of all significant positions at group level when the capital adequacy requirements for the market risks on a consolidated basis are not determined in a cumulative manner but result from the use of the technique of aggregation of all positions existing within the group (see table).

Simplified method

The simplified method can only be applied to interest rate and equity risks; the standardized method must be used for exchange risks, primary commodity and option risks.

To satisfy the requirements laid down for the application of the simplified method, the banks must set up an internal organization, which will show:

- compliance with the requirements to guarantee data integrity and the requirements are identical to those of the standardized method;
- adequacy and correct application of the procedures to determine the capital adequacy to cover exchange, primary commodities and option risks;
- assurance of permanent compliance with the limit values for the use of the simplified method by means of the policy on risks, structure of the limits and risk verification.

Note: currency transactions can very quickly exceed the thresholds permitting use of the simplified method and in this case application of the standardized method is essential.

Table

Capital adequacy requirements on a consolidated basis according to the standardized method

When all the legal entities of a group apply the standardized method, the conditions for technical procedures permitting daily aggregation of all the significant positions recorded with different legal entities must be certified.

In the event of a positive certification, the capital adequacy requirements for market risks on a consolidated basis may be calculated by the standardized method. A consolidated balance sheet or a consolidated trading portfolio must be drawn up. The calculation of requirements is then made for each category of risks: shares, rate instruments, currencies, gold and primary commodities on the basis of the consolidated balance sheet and the consolidated trading portfolio.

When this attestation cannot be given, the capital adequacy requirements for market risks on a consolidated basis prescribe cumulative requirements for each legal entity. The requirements must be determined separately for each legal entity and for each risk category: equities, rate instruments, currencies, gold and primary commodities. The positions shown in the accounts for the different legal entities cannot be mutually compensated when calculating the net positions and capital adequacy requirements.

The structure of banks is becoming increasingly complex. The supervisory authorities are therefore having to draw up principles for the supervision of financial conglomerates

Supervision of financial conglomerates

Rapidity of structural changes in the banking and financial sector

Like all the other branches of the economy, the financial sector has also undergone far-reaching changes in recent years and decades. Even if there are still banks which, in the simplest case, are established as regional businesses and supply only traditional banking services, an increasingly large number of financial establishments

- manage a network of branches and are developing nationally
- supply the whole range of services of a universal bank
- work across national borders to participate in the process of globalization
- are becoming financial conglomerates in the sense that they are diversifying into other financial domains such as insurance.

The main causes of this trend are economic liberalization, technical innovations and merger processes.

A financial conglomerate is a group of companies under central control which play an active or exclusive role in at least two of the three central activities of the financial sector, namely (1) banking, (2) securities trading and (3) insurance.

Supervisory authorities

One of the main tasks of the banking and financial supervisory authorities at national and international levels resides in the establishment of the general principles fixing rules of behaviour for a particular type of activity and cooperation between authorities and also the designation of an authority to coordinate supervision on a consolidated basis.

As a function of the main type of activity, the general elements of supervision will be those applicable to banking and financial conglomerates or insurance conglomerates; however, this supervision may in some cases be applied in an identical or analogous manner.

Principal common elements

1. Authorization

Before engaging in any business activity, banks, securities traders, investment funds and insurance companies must obtain permission to practice from the authority designated for this purpose. The same applies, as a general rule, to any extension of activity that may be envisaged.

2. Organization/behavioural rules

Conglomerates are required to act in such a way as to protect their customers and contribute to the sound running of the activity sector concerned.

The managers must take responsibility for guaranteeing compliance with general rules of conduct and ensuring the introduction of reliable procedures for reporting information to the supervisory authorities.

3. Consolidated accounts

Presentation of the consolidated group accounts is governed by various statutory and regulatory texts and by specific directives of the supervisory authorities.

4. Audit

In the context of the consolidated supervision of financial conglomerates, the role of the audit body is enhanced to the extent that it must verify and deliver reports comprising a number of certificates on a consolidated basis.

Faced with an authority which, like the Federal Banking Commission, acts as coordinator of a group, the task of the audit body also extends beyond the frontiers. For that purpose, the audit body must put in place appropriate audit directives with increased physical presence of the responsible auditors in the countries where the entities falling within the consolidated scope of supervision are situated, so as to be able to discharge its obligations when it comes to draw up its reports.

Special elements

1. Risk distribution

The credits granted to a customer or group of customers must be taken into consideration so as to guarantee at all times adequate diversification in compliance with the statutory and regulatory requirements. It is in the interest of the group to be able to ascertain and limit the commitments of a customer or group of customers to all the companies of the group so as to prevent the occurrence of a major risk.

By way of example, entities subject to the rules of consolidated supervision in Switzerland must respect the provisions on risk distribution both indi-

vidually and on a consolidated basis (Art. 21m BO).

When a bank belongs to a banking and financial group which is subject to consolidated supervision that is regarded as appropriate, the risk positions of the group member companies may be excluded if a number of conditions are satisfied (Art. 21a, para. 2 BO). More stringent or less stringent requirements may also be decided by the FBC (Art. 22 BO).

2. Information flows
When a bank belongs to a group whose parent company is itself supervised by a supervisory authority for the banks or financial markets, a number of items of information and documents, which are not accessible to the public but are needed for consolidated supervision, may be forwarded to the foreign supervisory authority under certain cumulative conditions; in case of doubt, the decision shall be taken by the FBC (Art. 4 quinquies LB).

Direct verifications

The new Art. 23 septies, para. 3 LB (see also Art. 38 LBVM) shows the practical scope of consolidated supervision at group level.

The examination must ascertain whether an entity:

- has an appropriate organization;
- assesses, limits and supervises in an appropriate manner the risks incurred in the context of its activities;
- is directed by persons who offer all the guarantees of impeccable activity;
- satisfies capital adequacy and risk distribution requirements;
- correctly performs its obligation of reporting to the supervisory authorities.

International proceedings

Confronted with the globalization and interpretation of different services, the international prudential bodies have defined the fundamental principles of international supervision (*see table*).

Table

International proceedings

Basel Committee:
Fundamental principles for effective banking supervision (September 1997)

Joint Forum:
Supervision of Financial Conglomerates (February 1999)

EEC:
Council Directive 92/30 on the Supervision of credit establishments on a consolidated basis
(April 1992 currently being modified)

ECBS:
Core principles of the International Conference of Banking Supervisors (October 1998)

OICV/IOSCO:
International Securities Trade Organization: Framework for Supervisory Information about Derivatives and Trading Activities (September 1998)

IAIS:
International Association of Insurance Supervisors: General Supervisory Principles (1997).

The entry into force of the LBA has considerably widened the range of persons and companies covered by the statutory provisions. The law no longer relates only to banks, stock exchanges, securities traders, investment funds and insurance companies, but now also covers all persons pursuing activities in the financial sector, in particular asset managers, brokers and stockbrokers. These are the operators designated by the LBA as financial intermediaries.

Implementation of the LBA: the situation regarding self-regulating bodies (SRB)

Innovations of the LBA

The Federal Law on the Control of Money Laundering in the Financial Sector extends to non-banking financial intermediaries, the due diligence obligations applied for many years by the banks pursuant to the specific prudential rules (Circular FBC 98/1) and to rules emanating from the profession (Agreement on the Swiss bank's code of conduct with regard to the exercise of due diligence (CDB 98) issued by the Swiss Bankers Association). The LBA has been designed to fill the gaps in the Swiss legal environment in the area of control of money laundering. The LBA is a general law which defines the field of application and obligations of financial intermediaries. It must therefore be supplemented by implementing directives and supervisory measures. The law gives private law bodies the possibility of defining the implementing procedures, regulations and fixing the scope of verification of financial intermediaries (principle of self-regulation). These two conditions apply more particularly to non-banking financial intermediaries, because the latter are not governed by special laws establishing supervisory authorities and are not grouped together under umbrella associations which could be given responsibility for verifying application of the law.

System applied in Switzerland

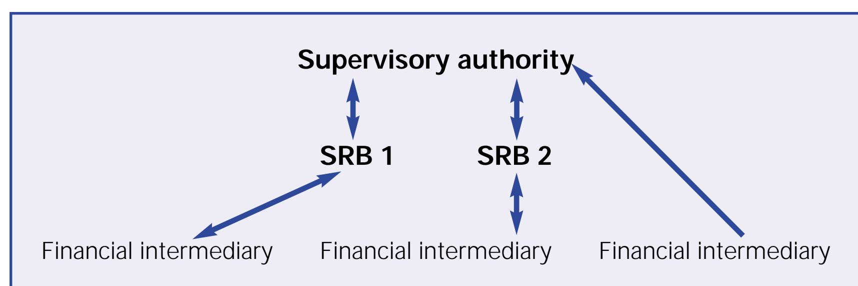
Following consultation of the parties involved, the legislator finally chose to delegate application of the law to the professionals themselves rather than providing for an organization at State level. This solution undeniably had the advantage of leaving greater flexibility to private law bodies which were therefore free to become organized as they wished within the requisite legal framework. This fixes as a rule for the financial intermediaries the need to be governed by a self-regulating body (SRB) which monitors their compliance with the provisions for control of money laundering. For that purpose, they may either affiliate to SRBs created for this purpose by the professional circles concerned or be directly regulated by the supervisory authority for the control of money laundering. The law therefore provides for a sequence of verifications because financial intermediaries are verified by their respective SRBs which are themselves supervised by the controlling authority. In the event of direct dependence on the supervisory authority, the intermediate level consisting of SRBs is simply eliminated.

The law stipulates 1 April 2000 as the deadline for financial intermediaries to affiliate to the SRB of their choice.

Financial intermediaries who decide to be directly dependent on the supervisory authority must previously apply for authorization to engage in business. In their daily activities, they are then subject to control by the supervisory authority for the prevention of money laundering in respect of the obligations of due diligence of financial intermediaries. This solution is particularly onerous for the State which therefore prefers the SRB solution.

The professional circles concerned were allowed until 31 March 1999 to set up and notify SRBs to the supervisory authority. In November 1999, only seven SRBs had been recognized, i.e.:

- Verein zur Qualitätssicherung im Bereich der Finanzdienstleistungen VQF (Association for Quality Assurance in Financial Services)
- SRO Post, internal audit
- SRB Audit Chamber
- SRB CFF, internal audit
- SRO Verband Schweizerischer Vermögensverwalter (VSV) (Association of Swiss Asset Managers)



- Organismo di Autodisciplina dei Fiduciari del Cantone Ticino, Lugano (Self-Regulation Organization of Auditors in the Canton of Ticino, Lugano)
- SRB Swiss Federation of Attorneys-at-Law and Swiss Federation of Notaries.

Banks, securities traders and investment fund managers remain subject to supervision by the FBC, while insurance institutions are still dependent on the Federal Office for Private Insurance.

Structures and internal regulations of SRBs

SRBs determine their internal structures at their own discretion. However, the supervisory authority requires them to have an audit body, to set up an appropriate organization and to create a number of posts (delegate for information answerable to the supervisory authority and responsible for investigation and repression of fraud). It also advises them without obligation to set up an arbitration tribunal.

SRBs are also required to adopt an internal regulation which will have the same role for the affiliate members as the convention on the obligation of due diligence for banks. A model regulation drafted by the supervisory authority is used and fixes the minimum requirements, in particular for due diligence obligations. The SRBs may develop this regulation and adjust it to the specific needs of the profession represented by them. Finally, the internal rules are presented for the approval of the supervisory authority.
The SRBs must also define the conditions of admission of their members. The latters make out an application for membership for which a model form is supplied by the supervisory authority. The SRBs keep a central index listing their affiliated members, excluded members and financial intermediaries whose application for membership has been rejected.

Tasks of the SRBs

The SRBs must adopt a regulation which stipulates for the attention of their members the requirements laid down in the LBA provisions. Their task then consists of training financial intermediaries and their employees on the matter of laundering and of making sure that all their members correctly apply the law and internal regulation. These verifications may be performed internally or delegated to an external auditor. Once each year, the SRBs present a report to the supervisory authority on tests made and observations on that occasion (see Art. 27, para. 2 LBA).

Tasks of the supervisory authority

The supervisory authority is dependent on the Federal Finance Administration. It has been set up to guarantee supervision of all financial intermediaries active in Switzerland either directly or via an SRB to guarantee correct application of the law.

It approves SRBs and the internal regulations drawn up by them, supervises their activities by means of the annual report submitted to it and verifies implementation of the internal rules.

Penalties

Penalties for failure to respect laws and internal regulations may be imposed by the SRBs and in the most serious cases by the supervisory authority.

As the SRBs are organized under private law, they remain free to choose the sanctions taken against offending members. The most severe penalty is the exclusion of the recalcitrant financial intermediaries who must then join another SRB or accept direct control by the supervisory authority.

In the event of a dispute, the SRB appoints one or more persons responsible for examining the matter and, where appropriate, imposing penalties. If the statutes of the SRB so provide, decisions taken may be brought before an arbitration tribunal consisting of members of the SRB who do not exercise any other function.

The LBA provides for a number of sanctions to ensure application of the law. The exercise of an asset management activity without affiliation to an SRB and without authorization of the supervisory body and failure to accept a decision of the supervisory body are punishable by a fine or in the most serious cases by winding up the financial establishment concerned.

Conclusion

Most financial intermediaries would probably find it advantageous to join an SRB. This affiliation is the simplest administrative procedure and also the most economical way of satisfying the requirements of the law. The formation of an SRB by financial intermediaries active in the same branches enables account to be taken of the specific features and interests of the branch concerned.

Circular FBC 96/2 "Preliminary information following the close of the financial year" of 19 September 1996 is cancelled and replaced by Circular FBC 99/3.

Preliminary information

By its Circular FBC 96/2, the FBC stipulated the information to be made available to the supervisory authority within a time-limit of sixty days.

Compared to that circular (FBC 96/2) the new circular FBC 99/3 introduces the following modifications:

- the data of preliminary information are also requested on a consolidated basis and are now collected and processed for statistical purposes by the Swiss National Bank (SNB) and then forwarded to the FBC;
- the declaration concerning holders of qualified or controlling shareholdings must be forwarded directly to the FBC;
- the announcement of the ten biggest debt positions is no longer part of the preliminary information but integrated into the bank or stock market audit report.

The bank audit institutions are required to subsequently verify, as part of the ordinary audit, the indications contained in the preliminary information. Adequate notification must be given of any significant divergence. This revised information must be forwarded to the FBC within seven months pursuant to the new circular.

This circular takes effect on 31 December 1999 and will apply to all closings of account from that date.

The FBC has adapted its directives on provisions governing the statement of accounts (DSA-FBC). The adaptations relate primarily to the following points:

1. **recording of transactions before the trade date or settlement date;**
2. **valuation of the trading portfolio by the fair value principle**
3. **en pension repurchase**

DSA-FBC

Adjustments to the directives on the statement of accounts (DSA-FBC) dated 14 December 1994

On 28 October 1999, the FBC amended this circular when the consultation period had expired. The amendments can be summarized as follows:

- The entry in the balance sheet of cash transactions which have not yet been performed may be made according to the trade date and settlement date principle. The method used must be published in the Annex to the annual accounts and applied uniformly over a period of time (*see table 1*).

- The trading portfolio may be valued by the fair value principle if all the stipulated requirements are respected (*see table 2*). Compliance with these requirements must be attested by the bank audit body.

- Details have been set out on the three accountancy possibilities available for repurchase transactions.

These amendments take effect on 31 December 1999. They must be applied for the first time to the annual accounts as at 31 December 2000.

Table 1

Some definitions

Principle of trade date accounting
Assets acquired (sold) in spot transactions are stated under (deleted from) the corresponding asset heading on the trade date. The payment commitment (payment claim) is entered in the balance sheet at the same time.

Settlement date accounting
Between the trade date and the settlement date, the securities substituted for the purchased (sold) assets are stated in the balance sheet under « Other assets » or « Other liabilities ». On the settlement date, the securities concerned are entered under (deleted from) the relevant assets heading. At the same time the corresponding commitments (claims) are stated in the balance sheet.

Concept of fair value
Fair value represents the amount at which a security may be traded or a debt settled between appropriate independent commercial partners. Where a liquid and price-efficient market exists, the valuation may be based on the market price. In the absence of such a market, the fair value is defined on the basis of a valuation model.

However, a transitional period expiring on 31 December 2004 has been allowed for the uniform application of the principle of the conclusion or settlement date at group level.

Table 2

Cumulative conditions for application of the «fair value»-method

1. internal models take account of all significant risks;
2. elements taken into account in the internal models are full and appropriate;
3. internal models and the elements taken into account are reliable, based on scientific foundations and applied uniformly;
4. the verifications required by the ASB applicable to risk management in trading and use of derivatives are effective, in particular in respect of verification of models, of valuation and of the daily result account by the internal risk supervision body which is independent of trading;
5. traders, the independent auditor and the risk manager have to be close to the market and familiar with it.

Circular FBC 98/4 «Short-term interbank receivables» took effect on 1 January 1999. In it, the FBC fixed the conditions on which the 8% risk weighting may be applied.

Interbank receivables

Short-term interbank receivables

The maximum limit of 25% of available equity (Art. 21a, para. 1 BO) is reached very quickly for short-term interbank receivables.

By this circular, which took effect on 1 January 1999, the FBC fixed at 8% the risk weighting rate in the risk distribution field for the following short-term receivables:

- short-term receivables on the major Swiss banks and cantonal banks benefiting from the State guarantee;
- short-term receivables of RBA group bankers on the central bank.

For the cantonal banks which do not benefit from a total cantonal guarantee (Geneva and Vaud), the transitional period during which short-term receivables may be weighted at the rate of 8% expires on 31 December 1999.

With effect from 1 January 2000, the 25% weighting rate will have to be applied to these two cantonal banks.

By letter of 15 November 1999, the FBC laid down the procedure for notifications relating to the change of year (year 2000 problem).

Year 2000

Year 2000 problem/notifications relating to the year change

Organizations and establishments covered by the FBC are required to submit to it, without delay, notifications using an appropriate form concerning the current status and problems encountered for the critical period 31 December 1999 to 5 January 2000.

The notifications must be made:

- daily (see table);
- immediately if a major difficulty is encountered by a particular institution;
- at group level when the FBC is responsible for consolidated supervision;
- at their own level or at that of partial consolidation in Switzerland for subsidiaries and branches of foreign establishments;
- by service providers if a separate announcement is made for the benefit of its members. In the latter case, these establishments do not have to make the corresponding announcement subject to their own situation status.

In the event of failure to provide situation reports, despite the fact that the means of communication are functioning normally the FBC may have to take certain measures.

Information may be obtained by registration and payment of a fee to the Central Command Centre Interbank in Zürich (CCCI). When problems are reported, the CCCI may provide suitable information on action to be taken.

Table

Daily notifications

date	by 10 a.m.	by 4 p.m.
1 January	• Establishments with a balance sheet total in excess of CHF 5 billion. • Swiss Exchange SWX	
2 January	• Establishments with a balance sheet total in excess of CHF 5 billion. • Swiss Exchange SWX	• All establishments*
3 January	• Establishments with a balance sheet total in excess of CHF 5 billion • Swiss Exchange SWX	
4 January	• Establishments with a balance sheet total in excess of CHF 5 billion. • Swiss Exchange SWX	• All establishments*
5 January	• Establishments with a balance sheet total in excess of CHF 5 billion. • Swiss Exchange SWX	

**including establishments which must report by 10 a.m.*

Capital adequacy requirements are a central feature of the supervisory system.

In view of their importance, the supervisory authorities must regularly examine capital adequacy.

Equity

Equity constitutes a «security buffer» enabling the supervisory authorities to have sufficient time to take appropriate measures to solve the problem that might be created by losses recorded as a consequence of a significant fall of the markets or a loss in value of the credit and shareholding portfolio.

However, compliance with the equity requirements is not an absolute guarantee of either the financial strength of an establishment or the stability of the banking system as a whole.

The current prudential arrangements laying down the minimum requirements are based on the ratio stipulated by the Basel Committee (Cooke ratios). These ratios measure the credit risk and the market risk.

In June 1999, consultations on a reform of these ratios began. This reform relates essentially to the following three pillars:

- The requirements will depend, as they do at present, on a standardized method for weighting the elements to be taken into consideration with the possibility of calling upon specialized agencies for the rating of sovereign debtors, banks and corporate borrowers.

  Banks which have sophisticated systems may use their own internal rating systems.

- The reform tends to ensure concordance of capital adequacy and internal procedures to assess the risks incurred by banks and a new «quantitative/qualitative» balance.

- The third central feature of the reform is emphasis on financial information to be supplied to third parties, notably the equity structure, risk exposure and equity requirements. For that purpose, market discipline is needed.

This reform reveals certain weaknesses, essentially through its separate risk approach, incomplete and summary reporting of risks without reference to their real level. Moreover, equity as such does not automatically have a disciplining effect.

On the contrary it may have an impact on the economic agents, for example by encouraging them to exploit differences which exist between the real economic risk of a portfolio and measurement of this risk in terms of regulatory ratios. The requirements may also affect the overall credit volume at macro-economic level.

Other alternative techniques currently under discussion might also lead to a review by the bodies responsible for managing this problem of the approach adopted.

According to the «pre-commitment»-approach, a banking establishment would be responsible, on the basis of the internal methods used, for determining in advance its capital requirement (market risk). If its basis turns out to be inadequate, sanctions will be imposed after the event. However, the nature of the sanctions is difficult to regulate.

Another approach combining the simplicity of the «pre-commitment» and the benefits of the internal models (base-plus approach) might also be adopted. This approach allies intervention by the regulatory authorities who determine absolute requirements and the responsibility of the establishment for fixing the amount of the pre-commitment. However, this approach is reserved for certain banks which have an effective quantitative model and an adequate supervisory environment.

Current banking and financial legislation does not cover currency traders who play an important role on the financial market. A Committee is currently examining their status.

Currency traders

The term transferable securities means standardized transferable securities which are liable to be circulated in large numbers, i.e. paper securities, security rights and currencies structured and broken down in the same way and offered to the public or sold to more than twenty customers, provided that these securities are not specially created for certain contracting parties.

The currency trade is not covered by the supervision exercised by the Federal Banking Committee over banks, traders and transferable securites and investment funds. Only the use of structured currency derivatives satisfies the conditions for liability.

The Zufferey Committee has accordingly been mandated by Federal Councillor Kaspar Villiger to examine the status of these intermediaries acting on the banking and financial market and to make proposals. The operators concerned must be affiliated to a self-regulating organization stipulated by the new law on money laundering by 31 March 2000 at the latest.

In the meantime and to enable these intermediaries to show that they contribute to the good repute of the Swiss financial centre, we believe that the application of the three following general principles should guide this type of activity which is not at present governed by prudential rules i.e.:

1. «Know your client»: procedures comparable to the requirements for any regulated activity constitute the basis of every activity. Compliance with them satisfies the expectations and obligations of the statutory and self-regulation norms newly applicable to these intermediaries. The activity of new electronic channels, such as the Internet, in no way changes respect for this principle.

2. Every currency trader should apply by analogy the principles of loyalty applicable to other traders (prohibition of division, correct application of exchange rates).

3. Every currency trader should set up a suitable procedure to enable the history of a transaction to be traced at any time by analogy with the obligation to keep a journal.

The financial institutions must respect the individual rights of third parties and the principles of fair and undistorted competition in their advertising. In addition, certain action must be taken if the financial institutions do not wish to be unexpectedly placed under the supervision of a foreign authority. Compliance with the recommendations of IOSCO (International Organization of Securities Commissions) is compulsory.

Advertising on the Internet

Advertising in general

Like advertising on other media, Internet advertising must not contain any statements which may infringe the individual rights of third parties and the principles of fair and undistorted competition. In particular, no incorrect, misleading, unnecessarily injurious or even racist statements may be circulated.

Advertising for financial services

In Switzerland:

The financial institutions must respect the above general principles. In addition, the banks which have signed the Convention on the Restriction of Advertising in Consumer Credit Business (see Circular No. 1101 D of the Swiss Bankers' Association of 16 December 1993) must respect the provisions of that Convention.

Abroad:

The activities of the financial institutions are regulated and subject to official supervision in many countries. With Internet advertising, the question arises as to whether the global impact of the Internet does not create an obligation for authorization in other countries.

For the time being, there are no binding international rules on which the financial institutions may base their work in this area. Therefore, legislation and practice would, in principle have to be verified in each individual country or at least in the principal countries concerned. The IOSCO recommendations published in September 1998 on the use of the Internet in the financial sector contain important directives as they are supported by many Member States of IOSCO, in which the principal countries including Switzeralnd are represented.

Pursuant to the IOSCO recommendations, Internet advertising might require a financial institution to be placed under the supervision of a particular foreign authority if:

- the information is targeted on a particular country (e.g. stating local contact persons or the local currency);
- offers from that country are also accepted or advertising is offered actively to potential investors, e.g. by E-mail.

The financial institution may prevent its subordination to supervision by a foreign authority according to the IOSCO recommendations if:

- a clear and visibly placed disclaimer is used (a disclaimer worded in general terms such as «this offer is not being made in any jurisdiction in which the offer would or could be illegal» will not be sufficient) and
- reasonable measures are taken to exclude investors from certain countries from the service offer (e.g. by screen-out procedures which require web visitors to state information on their country of domicile and then refuse access to the web site for certain countries; or by screening the addresses of the persons who take up the offer).

Respect for the above rules enables the legal risks associated with Internet advertising to be significantly reduced.

Topic of the next issue:

eBusiness Customer Relationship Management (CRM) in Financial Services

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