Consensus no more?

Financial Markets Regulatory Outlook 2020

Swiss Addendum

Swiss Addendum - Introduction

The annual assessment from Deloitte's EMEA Centre for Regulatory Strategy explores trends and specific regulatory themes that will shape the financial services industry in 2020. This year's edition includes topics such as LIBOR / SARON transition, climate risk, cyber resilience, prevention of financial crime and market access. The Swiss Financial Market Supervisory Authority (FINMA) inaugural public Risk monitor report[1] echoes the European view. The local regulator cites these topics as "critical risks" facing the Swiss financial services industry.

After a decade of global regulatory reforms defined by the financial crisis and misconduct issues, the regulatory environment is now changing profoundly. The international consensus on regulatory reform is fraying. Political appetite for globalisation is retreating, and trade tensions are mounting. Technological change and social concerns, including environmental sustainability, are rising on regulators' agendas. That said, the precise direction in which regulation will head is not yet clear. All are likely to have a profound impact on the medium term regulatory outlook.

In this addendum to the EMEA Regulatory Outlook for 2020 we highlight our strategic challenges and key cross-sector regulatory themes most relevant for the local market.

Conclusion

To sum up, financial institutions cannot lean back in 2020 with multiple regulations coming in to force and the regulatory perimeter expanding into new fields, teething problems can be expected. FINMA's supervisory focus[2] will lie on: the negative interest rate risk management, financial crime prevention risk management, readiness for abolition of LIBOR benchmark interest rates, cyber risk management and on environmental, social and governance issues, including climate risks. Significant economic and demographic changes over the last decade demand different types of financial services products and will challenge both market participants and regulators to evolve and keep pace. So while the post-crisis wave of regulatory change may be subsiding, financial services firms should not expect supervisory scrutiny to abate as we move into 2020. We hope that this year's outlook from our Regulatory Centres will both inform and stimulate discussion in a continually changing environment.

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1 FINMA Risk Monitor Report 2019, December 2019 - Published by the Swiss Financial Market Supervisory Authority
2 FINMA Risk Monitor Report 2019, December 2019 - Published by the Swiss Financial Market Supervisory Authority

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To put the cross sector regulatory themes into context we should consider the wider economic trends driving changes in the financial services sector including the economic landscape, expedited digital transformation, increasing regulatory fragmentation at a global level and increasing regulatory supervision.

Swiss economic landscape
While the recent Swiss Government Expert Group headlines[3] (Group, Autumn 2019) revised slightly downwards the expectations for the Swiss Economy for the end of 2019. Growth slowed down in 2019 to approximately 1% with slight rebound expected for 2020 to approximately 1.5%. This is balanced by low unemployment, inflation rates, however upward pressure on the Swiss franc, a sustained negative interest rate environment and the risk of a domestic real estate bubble create challenging economic conditions for the Swiss financial services sector, where the resilience of business models will continue to be tested.

Political uncertainty remains regarding Switzerland's relationship with the EU and also to some extent the impact of Brexit. A worsening of the EU relationship in particular could impact Swiss market access, ability to service EU based clients and also the attractiveness of Switzerland as a business location.

Digital transformation
Businesses continue to drive digital and AI programs to harness the benefits of technological innovation, to deliver enhanced client experience and improve profitability. The Swiss National Bank predicts this trend will continue with FinTechs disrupting the local market and further evolving to be competitors to the traditional banks and their digitalization strategies.[4]

Swiss policy makers and regulators have been leading with a focus on blockchain and cloud, however in line with their counterparts elsewhere, will continue to be challenged by the need to respond to the pace and scale of technological change. For example, the risks associated with increasing use of artificial intelligence (AI), the impact of innovation on operational resilience and cyber security, and digital ethics will be at the forefront of the financial services regulatory debate. Further, growing evidence that ineffective implementation of technological change can increase cyber vulnerabilities and operational disruption in the financial sector is also attracting regulatory scrutiny. These trends will have repercussions for firms' ability to use data to innovate, enhance their cross-border resilience, and deliver value and security to their clients.

Regulatory fragmentation
Global firms will face higher complexities and costs as regulatory standards across jurisdictions diverge in both timing and substance. The issue of market fragmentation was highlighted by the G20 as an area of concern in 2019, and the Financial Stability Board has an important ongoing programme of work in this area.[5]

3 Press release 17 September, Federal Department of Economic Affairs, Education and Research EAER, State Secretariat for Economic Affairs SECO, Economic Policy Directorate Short Term Economic Analyses
4 Swiss National Bank 2019 publication: Umfrag zu Digitalisierung und FinTech bei Schweizer Banken
5 FSB Report on Market Fragmentation, June 2019, Financial Stability Board, https://www.fsb.org/wp-content/uploads/P040619-2.pdf

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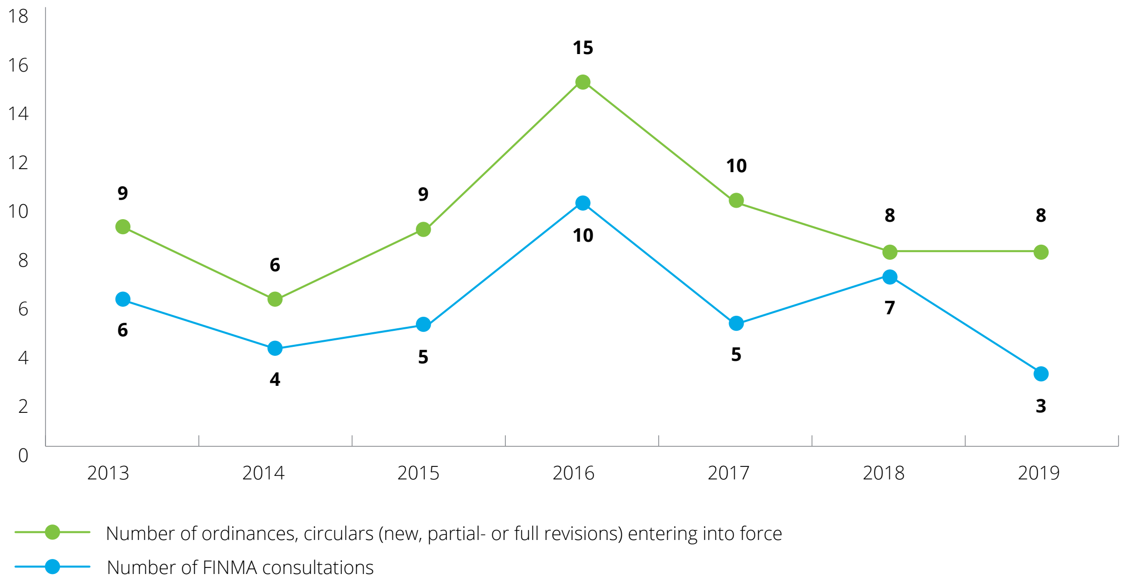
While we do not expect these forces to play out fully in 2020 we think they nevertheless provide important context and financial services firms need to be prepared to respond to these trends.

Increasing focus on supervision

While Switzerland's current domestic regulatory environment mirrors global trends with the pace of regulatory policy change slowing, compared to the recent past, in 2020 we expect financial services firms, especially banks, to have some respite from the huge regulatory implementation agenda that has characterised the last decade. But even if the post-crisis regulatory demands are reducing, the regulatory outlook for 2020 is far from beginning. While the more traditional regulatory themes remain top of FINMA's (Swiss Financial Market Supervisory Authority) agenda, heightened supervisory focus on risk management, financial crime prevention and cross border compliance will continue to build regulatory pressure.

Fig. 1: *Decreasing instances of 'new' Swiss regulations coming in to force following the regulatory response to the 2009 global financial crisis.*

The pace of regulatory policy change is slowing if we look at the number of ordinances, circulars proposed and entering into force (new, partial – and full revisions) over the last 5 years.



Source: FINMA website and annual reports

Cross Sector Themes

IBOR

The 2020 edition covers a mix of cross-sector and sector-specific issues of strategic significance for all financial services firms operating in EMEA, including topics such as IBOR transition, climate risk, cyber resilience, the adoption of AI models, and much more besides.

We explore five of these themes further as they are of particular significance for the Swiss FS industry:

- LIBOR / SARON transition
- Climate change and sustainability
- Operational and cyber resilience
- Crypto-assets
- Financial crime prevention

LIBOR / SARON transition (3.1 IBOR (p. 16) in EMEA Financial Markets Regulatory Outlook)
Interest rate benchmarks play a key role in global financial markets. In 2014 the FSB made recommendations to reform interbank offered rates (IBORs) in response both to cases of attempted manipulation and to the decline in liquidity in key interbank unsecured funding markets. While Switzerland has already proposed an alternative, in the form of SARON (Swiss Average Rate Overnight), discontinuation of LIBOR (GBP) benchmarking remains a challenge: many key currencies e.g. GBP, USD and JY do not have an alternative and financial products still reference LIBOR for the setting of interest rates. Firms can expect a particular Swiss regulatory focus on three key risk areas: legal, valuation, operational readiness and are therefore urging institutions to address challenges in time ahead of the end of 2021 deadline. The discontinuation of LIBOR will have major repercussions due to the high transaction volumes involved and the wide-ranging technical interlinkages and represent a significant financial stability risk.

Recent FINMA-mandated self assessments show that the majority of banks are still well behind schedule in their efforts to prepare for the replacement of LIBOR. In addition, the slow progress has been limiting the adoption of alternative benchmark interest rates so far. Given the degree of risk arising from the continued reliance on LIBOR, regulated firms should expect

> "The discontinuation of LIBOR / SARON transition will have major repercussions due to the high transaction volumes involved and the wide-ranging technical interlinkages and represent a significant financial stability risk."

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increasing scrutiny of their transition efforts as the end of 2021 approaches. However, we expect the likely outcome of the transition to be the coexistence of multiple rates for a limited set of products and time, and some divergence in fallback arrangements.

Climate Change and Sustainability (3.2 Climate change and sustainability (p. 20) in EMEA Financial Markets Regulatory Outlook)
So far, investors rather than regulation have been the main drivers of sustainable finance. Boosted by the global political focus on climate change and the Green (Liberal) movement gaining support in the 2019 Swiss national elections, however, sustainability is on the agenda of all federal institutions, including the Federal Department of Finance and the Swiss National Bank. Regula Rytz, president of the Green party, in an interview published by Neue Zuercher Zeitung specifically called out the role of the financial sector with regards to climate change stating: "We have to hold the financial centre more accountable," "Do not invest any longer in coal or fossil energy."[6]

FINMA recently joined the central banks and supervisors Network for Greening the Financial System, to better leverage global knowledge for managing financial risks of climate change. The recent FINMA Risk Monitor cites climate change as a "key risk" for 2020. In addition, the European Commission amended MiFID to incorporate sustainability aspects, e.g. the requirement to assess ESG preferences as part of clients' investment objectives and risk tolerance in order to recommend suitable products.

We expect to see the regulatory perimeter expansion continue in 2020, financial institutions are grappling with what this means for their own business activities and investment offerings and looking to find an angle where this can be used to drive competitive advantage in a period of increasing cost pressures.

> "There is an increased focus of FINMA and other central banks and supervisors to find solutions for managing financial risks of climate change."

[6] NZZ.ch: Grünen-Präsidentin Regula Rytz meint: "Die älteren Generationen haben die Probleme vor sich hergeschoben" 29.11.2019 Michael Schoenenberger, Michael Surber

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Operational and cyber resilience – Implementation of the Financial Services Act (FIDLEG, FINIG) and introduction of cloud based services
(3.2 Operational and cyber resilience (p. 23) in EMEA Financial Markets Regulatory Outlook)
The Financial Services Act including FINSA (and in German FIDLEG) and FINIG, the Swiss counterparts of MiFID II and AIFMD are entering into force beginning of 2020 with extended transition periods.[7]

FIDLEG is regulating the overall financial services including: providing general information to clients, segmenting clients by conducting appropriateness and suitability tests (retail, professional, institutional segments), different rules of conduct depending on segment, setting best execution principle, documentation rules, segmenting products into risk-classes, providing BISs and prospectuses, monitoring rules.[8]

FINIG is summarizing licensing requirements, supervisory rules, creates prudential supervisory regime for specific asset manager categories, that previously have not been subject to it and defines eligibility requirements among others for licenses, legal forms, risk management, operative internal controls.[9]

Looking back at the legislative framework for MiFID II, which went live in 2018, late information and unstructured implementations harm operational performance. FIDLEG is expected to be ratified with a comfortable transition period. This should prevent the risk of urgent short-term fixes resulting in operational stress and higher than necessary costs however this will still be a challenge for a number of firms to align their EU and local Swiss programs.

In March 2019 the Swiss Bankers Association published the "Cloud Guidelines", a non-binding "guide to secure cloud banking". Key topics are the cloud governance, data protection and confidentiality, access for authorities and courts and performance of

"While the regulatory framework for MiFID II is comparable to the new requirements under FIDLEG and FINIG, implementation effort should not be underestimated."

7 Information to FIDLEG and FINIG, FINMA, 2018, https://www.finma.ch/de/bewilligung/fidleg-und-finig/
8 FIDLEG – Beyond MiFID II experiences, Deloitte, 2018, https://blogs.deloitte.ch/banking/2018/07/fidleg-beyond-mifid-ii-experiences.html?utm_medium=email&utm_campaign=Daily%20Banken%20Banques%20Banking&utm_content=Daily%20Banken%20Banques%20Banking+CID_008cd7e71e384a52ab917e58a9857440&utm_source=Campaign%20Monitor%20email&utm_term=FIDLEG%20%20Beyond%20MiFID%20II%20experiences
9 Information to FIDLEG and FINIG, FINMA, 2018, https://www.finma.ch/de/bewilligung/fidleg-und-finig/

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a proper audit. One of the main concerns of Swiss banks in this area remains the U.S. Cloud Act.

In this respect the guidelines give only limited advice and recommend a risk assessment supported by the provider. Banks are well advised to consider these non-binding recommendations when making use of cloud services.

Prevention of financial crime – Amendments to Anti-Money Laundering Regulation (3.9 Financial Crime (p. 41) in EMEA Financial Markets Regulatory Outlook
The AML Ordinance has been revised to incorporate the new fintech licencing category, launched in 2018. This new amendment summarizes the requirements for (future) FinTech licence holders, about global monitoring of money-laundering, terrorist financing risks, legal, reputational risks, also setting risk management measures. The obligations due to the institutions' size are less stringent than those for banks.[10]

After the introduction of further revisions to AMLO-FINMA in line with recent FATFA country review findings effective 1 January 2020, further revision of the AMLA are anticipated for 2021 (earliest). Advisors will have a new reporting duty in addition to the already existing compliance rules with due diligence obligations.

Reporting duty and the right to report will be differentiated and included in an ordinance. Another addition will be that financial intermediaries will be able to cancel a business relationship, in case they do not receive any answer in 1.5 months after sending a report to the Money Laundering Reporting Office Switzerland.[11]

"In response to a number of major international money – laundering cases with connections to Switzerland in recent years, Switzerland is strengthening its defence for money laundering and terrorist financing with heightened regulatory expectations."

[10] FINMA revises its Anti-Money Laundering Ordinance, FINMA, 2018, https://www.finma.ch/en/news/2018/07/20180718-mm-gwv-finma/
[11] Federal Council adopts dispatch on amending Anti-Money Laundering Act, 2019, Federal Department of Finance, https://www.efd.admin.ch/efd/en/home/dokumentation/nsb-news_list.msg-id-75603.html

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Crypto assets – Blockchain and Distributed Ledger Technology (3.8 Crypto assets (p. 38) in EMEA Financial Markets Regulatory Outlook)
There is no specific regulation to Crypto currencies in Switzerland. However, the Government follows a principle-based approach and FINMA has published a number of helpful guidance papers and offers concrete advice upon request. On 27.11.2019 the Federal Council announced, based on a report and public consultation, that no specific technology act will be created.

Swiss parliament is expected to address the proposal for the first time in 2020 Q1. Realistically the changes to the law can not be expected before 2022.[12]

The work of the Global Financial Stability Board (FSB) in this area will continue with a consultation expected in April 2020[13] regarding the introduction of so-called global "stablecoins" and aims to evaluate the challenges to the regulatory community, including for financial stability. At the same time, it could bring benefits to the financial system and wider economy. This will be of great interest to all working in this sector.

While there is no specific federal law, the below are three key areas of upcoming change:

- General application of AML principles to all crypto trading platforms
- Licence-requirements for DLT trading platforms and acceptance of significant amounts of crypto values
- Clarifications on the application of FinSA and FinIA to DLT and the respective assets.

12 Federal Council wants to further improve framework conditions for DLT/ blockchain, The Federal Council, 2019, https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-77252.html
13 FSB 2020 Workplan https://www.fsb.org/2019/12/fsb-sets-out-2020-work-programme/

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Other emerging Swiss regulatory focus topics

Gender Equality (3.4 Culture, governance and accountability (p. 26) in EMEA Financial Markets Regulatory Outlook)
In Switzerland, modification of law on stock companies (Aktienrecht) expected to enter in to force in 2021 will introduce gender quotas for large listed companies amongst its many other changes. Also, an amendment of the Gender Equality Act will step into effect on the 1st of July 2020. The new section will have an obligation for employers to conduct an internal equal pay assessment – and have it reviewed and verified by an external independent party, an audit firm or a dedicated organization.[14]

Scrutiny of the resilience of firms' business models to the changing risk environment
In this regard, FINMA has outlined expectations to increase regulatory scrutiny in relation to sustainable profitability in a low interest rate environment and also business models which are showing significant growth in the mortgage market. This focus is not restricted to the banking sector, in asset management, FINMA will undertake in-depth analysis of the risk management of real estate funds in particular. In the insurance area, FINMA will conduct a stress test with a view to gaining an insight into the impact of properties and mortgages held in investment portfolios on the solvency of insurance companies.

In the medium term, FINMA has also identified other prevalent risks which will all be subject to regulatory scrutiny and monitoring in the future in light of the changing economic landscape and society wide trends. These changes cover diverse topics including: impediments to Swiss cross-border market access; an ageing society; the increasing individualisation of insurance (based on big data); and risks for wealth management in a market with falling values of financial instruments.[15]

Across Europe, the following five trends will continue to influence Swiss firms active in the EU market and more information is available on these topics in the full report:

- **Culture, governance, and accountability** – Supervisors will prioritise banks' governance and culture but will progressively extend their focus to other sectors.
- **Good customer outcomes** – Conduct regulators will increasingly focus on the outcomes consumers receive, in addition to processes and controls around the design, sale and distribution of FS products.
- **AI governance and model risk management** – FS and cross-sector authorities across Europe are starting to look closely into the governance and model risk management challenges arising from material AI models, and the implications for their regulatory and supervisory objectives.
- **Regulating firms' use of consumer data** – Competition, consumer protection, privacy, and ethical considerations will shape public policy in response to firms' use of consumer data and We expect "value for data" to become an area of increasing regulatory focus

[14] Federal Act on Gender Equality, the Federal Council, https://www.admin.ch/opc/en/classified-compilation/19950082/index.html
[15] Focus areas presented include risks highlighted by FINMA in its first time publication of its risk monitor, Risk Monitor, FINMA, 2019, https://www.finma.ch/en/documentation/finma-publications/reports/risikomonitor/

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- **Stress testing** – Supervisors are increasingly shifting their focus to qualitative aspects of stress testing, such as control frameworks or model validation; and to macroprudential policy. For-banking, consideration is being given to the ap-propriate complexity of the stress testing exercise and the balance of responsibilities between banks and supervisors.

Banking Themes

Banking regulatory developments of note for 2020

Finalised Basel III reforms – **"Basel IV"** (4.1 Banking (p. 48) in EMEA Financial Markets Regulatory Outlook)

Basel III's finalized regulatory standards aim to restore credibility in the calculation of risk-weighted assets and enhance comparability of banks' capital ratios. Main features from the Fundamental Review of the Trading Book (FRTB) on the Basel Committee's Market Risk Policy are revisions to capital calculations affecting all risk types, higher leverage ratio requirements for G-SIBs and the introduction of a more robust risk-sensitive output floor. Implementation date for most of the reforms estimated for beginning of 2022 and Bank's in particular face continued capital pressure. 2020 will see many banks focus on liquidity management as the they prepare for the introduction of the Net Stable Funding Ratio (NSFR) and the interplay with the existing Liquidity Coverage Ratio (LCR).

Regime for small banks – FINMA implemented a more proportionate supervisory approach, by making certain regulations simpler for institutions, which are small, liquid and well capitalised, for instance they can be exempted from RWA calculations.[16]

SBA guidelines

Guidelines from the Swiss Bankers' Association (SBA) are also stepping into effect in 2020. The Agreement between the SBA and banks (VSB 20) is modifying some due diligence rules for banks: lowering the threshold for spot transaction contracting party identification, reducing the deadline for gathering missing information in case of account openings.[17]

The SBA guidelines, recognized by FINMA, on mortgages for investment properties bring tightening requirements regarding the loan-to-value ratio and amortization. Owner occupied residential properties are not affected and FINMA recommends that banks voluntarily also apply the stricter capital and amortisation requirements to loans for buy-to-let properties.

The Swiss National Bank (SNB) reviewed the Na-

> "The SBA guidelines, recognized by FINMA, on mortgages for investment properties bring tightening requirements regarding the loan-to-value ratio and amortization."

16 FINMA implementing small banks regime, FINMA, 2019, https://www.finma.ch/en/news/2019/11/20191127-mm-kleinbankenregime/
17 VSB 20, Swiss Banking, https://www.swissbanking.org/de/medien/news/vsb-20-revidierte-standesregeln-im-bereich-der-geldwaeschereibekaempfung

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tional Bank Ordinance (NBO) when adjusting the basis for calculating the negative interest on sight deposits held at the SNB. Repo transactions with non-banks will no longer be subject to minimum reserve requirements; previously only repo transactions with banks were exempted. Securities lending transactions will also no longer be counted towards the calculation of minimum reserves as they are very similar to repo transactions in terms of their economic effect.

Modified regulations to accounting-valuations and coverage, introduction of additional value adjustments approaches for banks in different supervisory categories are also coming in 2020.[18]

[18] Value adjustments for default risks: new approaches, FINMA, 2019, https://www.finma.ch/en/news/2019/03/20190315-mm-rechnungslegung-banken/

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