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Monday, March 30, 2015

Top 10 risk and compliance management related news stories and world events that (for better or for worse) shaped the week's agenda, and what is next

Dear Member,

CAT is a really interesting project.
Commissioner Luis A. Aguilar said:

"In January 2005, the New York Stock Exchange's ("NYSE") average speed of execution for small, immediately executable orders was 10.1 seconds.

More recently, the average speed has accelerated to a half a second or less."

Looks good! What's the catch?

Commissioner Luis A. Aguilar continued: "This speed can bring benefits as it allows for quicker executions and delivery of market data.

However, it can also wipe out billions of dollars in just a few minutes, such as when the Flash Crash in May 2010 caused $1 trillion to evaporate in just 20 minutes, before making a partial recovery; and, when Knight Capital

suffered a $460 million trading loss over a 45-minute period in August 2012 that resulted from a computer malfunction.

The new technology has enabled the growth of a very fragmented trading environment and encouraged the proliferation of so-called "dark pools."

To that end, even though the SEC is not a self-funded agency, like many of its counterparts, the Commission is devoting significant amounts of its limited resources to enhancing the agency's data gathering and analytics.

These initiatives are important if the Commission is to properly keep track of, among other things, the activities of over 25,000 regulated entities, the approximately 9,400 publicly-traded companies that file reports with the SEC, and the 15,000-16,000 tips, complaints, and referrals we receive per year.

In particular, the Commission has been working to capture data and automate its analytical capabilities to allow our staff to proactively identify areas of risks, emerging trends, and fraudulent activity.

These initiatives will allow the staff to spot issues in ways we were not able to do before the crisis.

One of the most significant data collection rules that the Commission has adopted is the requirement for a Consolidated Audit Trail ("CAT").

CAT, when operational, will be the world's largest data repository of securities transactions.

Read more at Number 3 below.

We have an interesting point of view in the European Union. Steven Maijoor, ESMA Chair, said:

"As you are well aware, MiFID II introduces a new, ambitious transparency framework applicable to non-equities.

For ESMA, the most challenging task we face at the moment is obtaining and analysing the data needed to set the liquidity and transparency thresholds, because of two reasons:

1) These markets are currently not transparent and so the data available is necessarily limited and of varying quality, and

2) The vast scale and resource-intensive nature of the exercise.

One of the elements that has attracted greater attention is transparency for bonds. Since transparency is linked to the notion of liquidity, which is not prevalent in European bond markets, the number of bonds that will be transparent is very small: less than 10%."

Steven Maijoor also speaks about "an industry culture not sufficiently oriented to behave in clients' best interest, and insufficient management of situations of conflicts of interest affecting the way services are provided to clients."

Read more at Number 6 below.

Welcome to the Top 10 list.

Best Regards,

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Number 1 (Page 8)

BIS
Oil and debt

Dietrich Domanski, Jonathan Kearns, Marco Jacopo Lombardi and Hyun Song Shin

The total debt of the oil and gas sector globally stands at roughly $2.5 trillion, two and a half times what it was at the end of 2006.

The recent fall in the oil price represents a significant decline in the value of assets backing this debt, introducing a new element to price developments.

In common with other episodes of retrenchment induced by rapid declines in asset values, greater leverage may have amplified the dynamics of the oil price decline.

Number 2 (Page 23)

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mr Mario Draghi, President of the European Central Bank, before the Hearing at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels

«We also moved to a new building which we officially inaugurated last week; we unveiled our new 20 euro banknote; and in a milestone towards even greater transparency of our decision-making procedures, we published on 19 February for the first time the accounts of a monetary policy meeting of the Governing Council of the ECB.

In the remainder of my remarks, I will explain some important aspects of the extended asset purchase programme and present a first assessment of its effects.»

Number 3 (Page 30)

Preparing for the Regulatory Challenges of the 21st Century

Commissioner Luis A. Aguilar
Georgia Law Review Annual Symposium
Financial Regulation: Reflections and Projections
University of Georgia, Athens, Georgia

«During my tenure as an SEC Commissioner, our country's economy has experienced extreme highs and lows.

In fact, the country experienced the worst financial crisis since the Great Depression, followed by the current period of significant economic growth where the stock market has grown by around 165% from the low point of the financial crisis.

I have had a front-row seat to all of this, as I became an SEC Commissioner just weeks before the financial crisis hit our nation.»

Number 4 (Page 46)

A Few Observations on Shareholders in 2015

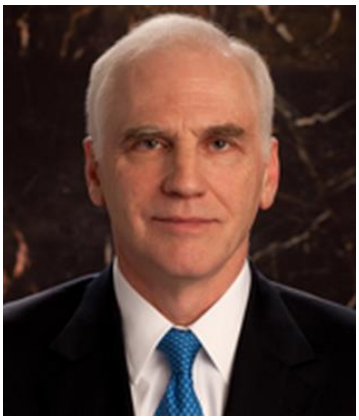
Chair Mary Jo White
Tulane University Law School 27th Annual
Corporate Law Institute
New Orleans, Louisiana

« There are different views on what is meant by "shareholder activism," but just the word "activism" triggers an adverse reaction from many companies.

Reflexively painting all activism negatively is, in my view, using too broad a brush and indeed is counterproductive.

To me, the term activism captures the range of efforts by investors to influence a company's management or decision-making.»

Number 5 (Page 58)



Application of enhanced prudential standards to bank holding companies

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC

«In my testimony this morning I will try to provide, from a regulator's perspective, some context for the committee's consideration of this subject by explaining how the Federal Reserve has differentially implemented prudential regulations based on the size, scope, and range of activities of banking organizations, as well as how we have organized our supervisory portfolios.»

Number 6 (Page 67)

MIFID/MIFIR- CSD hearing before ECON

Steven Maijoor, ESMA Chair,

«Let me first comment on MIFID2/MIFIR, which is the most significant piece of Level 2 regulation that ESMA has undertaken since its establishment.»

Number 7 (Page 74)

Monetary Policy Lessons and the Way Ahead

Vice Chairman Stanley Fischer
At the Economic Club of New York, New York, New York

«For over six years, the federal funds rate has, effectively, been zero.

However it is widely expected that the rate will lift off before the end of this year, as the normalization of monetary policy gets underway.»

Number 8 (Page 85)

Welcoming remarks

Jaime Caruana, General Manager of the BIS, at the Second BIS Research Network meeting on "Macroeconomics and global financial markets", Basel,

«The BIS Research Network was set up last year as part of our effort to serve as a bridge between central banks and academics to tackle some of the most pressing conceptual and empirical questions facing central banks today.»

Number 9 (Page 89)

SEC Headquarters, Washington, DC

SEC Suspends Trading in 128 Dormant Shell Companies to Put Them Out of Reach of Microcap Fraudsters

The Securities and Exchange Commission announced it has suspended trading in 128 inactive penny stock companies to ensure they don't become a source for pump-and-dump schemes.

Number 10 (Page 91)

EIOPA Advice to the European Commission Equivalence assessment of the Swiss supervisory system in relation to articles 172, 227 and 260 of the Solvency II Directive

By letter of 25 February 2014, the European Commission requested EIOPA to update the equivalence advices for Switzerland and Bermuda (under articles 172, 227 and 260 of the Solvency II Directive) and Japan (under Article 172 of the Solvency II Directive) that EIOPA provided in October 2011.

Number 1

BIS
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Dietrich Domanski, Jonathan Kearns, Marco Jacopo Lombardi and Hyun Song Shin

The total debt of the oil and gas sector globally stands at roughly $2.5 trillion, two and a half times what it was at the end of 2006.

The recent fall in the oil price represents a significant decline in the value of assets backing this debt, introducing a new element to price developments.

In common with other episodes of retrenchment induced by rapid declines in asset values, greater leverage may have amplified the dynamics of the oil price decline.

The high debt burden of the oil sector also complicates the assessment of the macroeconomic effects of the oil price decline because of its impact on capital expenditure and government budgets, and due to the interaction with a stronger dollar.

From mid-2014, the price of crude oil fell substantially after hovering at historically high levels around $100 for four years.

In spite of the expected boost to household incomes and corporate profits globally, an intense debate has unfolded about what lower oil prices imply for the outlook across economies.

A new element that can help shed light on this question is the high level of debt of the oil sector.

The debt borne by the oil and gas sector has increased two and a half times over, from roughly $1 trillion in 2006 to around $2.5 trillion in 2014.

As the price of oil is a proxy for the value of the underlying assets that underpin that debt, its recent decline may have caused significant financial strains and induced retrenchment by the sector as a whole.

If the adjustment takes the form of increased current or future sales of oil, it may amplify the fall in the oil price.

Similarly, if the need to service debt delays a pullback in production, a lower price may act more slowly to balance supply and demand.

More broadly, assessing the macroeconomic impact of lower oil prices becomes more complicated.

The resultant decline in capital expenditure will be sharper for more indebted firms, and tighter credit conditions for all firms will reverse the debt-financed investment boom.

The fiscal impact of the oil price decline will be felt more acutely in countries where debt issuance by state-owned oil companies has facilitated the transfer of profits to the government.

This special feature explores the link between oil and debt.

It is organised as follows.

The first section discusses the recent fall in oil prices.

The second documents the increase in leverage in the oil-producing and related sectors.

The third analyses oil firms' responses to lower oil prices against the backdrop of high debt.

The fourth explores the broader economic and financial ramifications of the collapse in the price of oil. The last section concludes.

The fall in the price of oil

As typically occurs with abrupt price changes, commentators and policymakers have scrambled to rationalise the recent fall in oil prices.

Strong growth in US oil production is an important part of the explanation: since early 2009 it has risen more than 70%, equivalent to almost 4 million barrels per day, with the bulk of the increase coming from shale oil.

Overall, however, the growth of oil production has not been especially rapid.

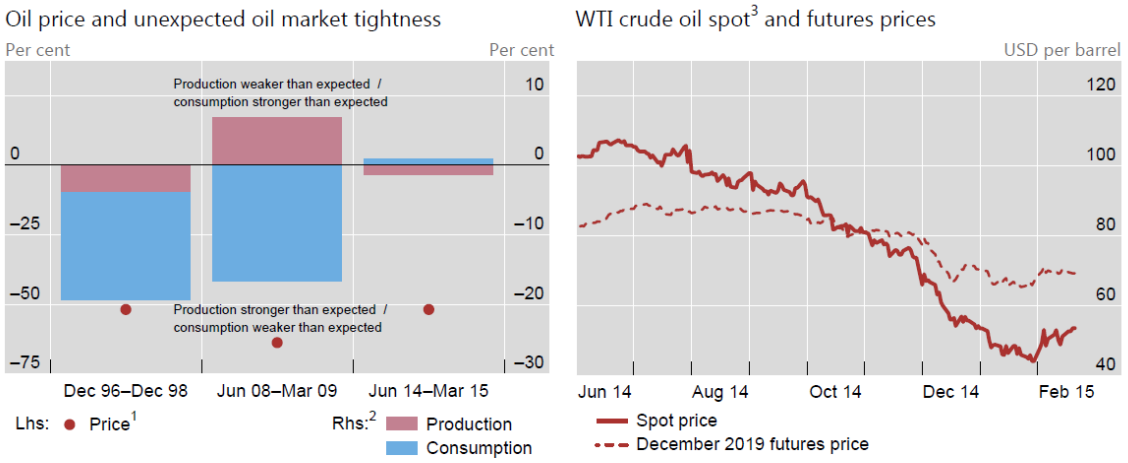
The decline in prices has also been attributed in part to demand-side developments: slower economic growth in Asia and Europe has reduced

current and expected future oil consumption (see IEA (2015) for a detailed analysis of supply and demand trends).

However, shifts in production and consumption seem to fall short of a fully satisfactory explanation of the collapse in oil prices.

Current estimates of the growth of oil production and oil consumption since mid-2014 have deviated little from earlier forecasts (Graph 1, left-hand panel).

Shifts in production and consumption fall short of explaining oil price dynamics — Graph 1



[1] Change in quarterly average Brent crude oil spot price. [2] Cumulative deviation of growth from expectation at the start of the episode. [3] Cushing West Texas Intermediate (WTI), US market close time.

Sources: US Energy Information Administration; Bloomberg; BIS calculations.

This contrasts starkly with the last two periods of comparable oil price declines in 1996 and 2008: these episodes were associated with sizeable reductions of oil consumption and, in 1996, with some expansion of production.

While the recent oil production and consumption figures are estimates that can be revised, the absence of sharp declines in other commodity prices and industrial production also suggest that the fall in the oil price is not attributable to a large contraction in oil consumption which is not yet reflected in the data.

Rather, the steepness of the oil price decline since mid-2014 and the clustering of very large day-to-day price declines are reminiscent of an asset market, whose dynamics reflect not only shifts in market participants'

expectations about fundamentals but also binding financial constraints that condition firms' responses.

As regards expectations about fundamentals, prices fell along the whole futures curve after OPEC's decision in November 2014 to maintain production levels in response to falling prices. Long-dated futures prices, which had been relatively stable during the preceding fall in the spot price, dropped by about $15 in the two weeks after the OPEC meeting (Graph 1, right-hand panel).

Commentators have identified this as change in expectations about equilibrium prices because of a persistent change in supply conditions.

Oil market participants apparently saw OPEC's decision as a signal that it is no longer prepared to act as swing producer in the face of rapidly rising non-OPEC production.

As regards financial constraints, the price decline occurred against the backdrop of much higher debt levels of oil producers.

By analogy with the housing market, when the underlying assets of a leveraged sector fall in value, the strain imposed by the price decline induces retrenchment - for instance, by trying to sell more of the asset backing the debt.

Oil is not housing, but analogous actions such as hedging may exert additional downward pressure on the underlying asset.

The remainder of this article explores in more detail the mechanisms through which the substantial increase in leverage of the oil industry took place, and the forces that are unleashed when that leverage starts to unwind.

The build-up of oil-related debt

The greater willingness of investors to lend against oil reserves and revenue has enabled oil firms to borrow large amounts in a period when debt levels have increased more broadly due to easy monetary policy.

Since 2008, companies in the oil sector have borrowed both from banks and in bond markets.

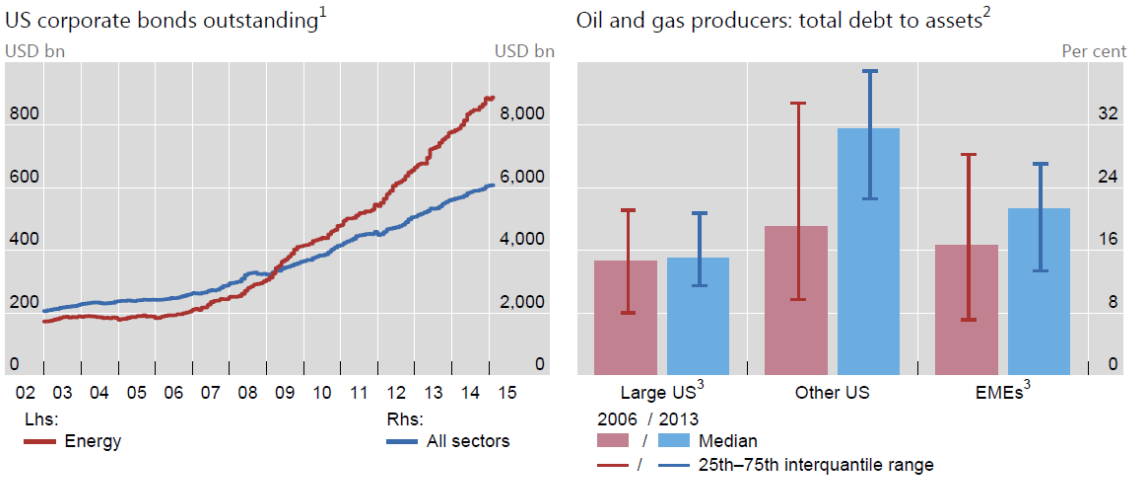
Issuance of debt securities by oil and other energy companies has far outpaced the substantial overall issuance by other sectors (Graph 2, left-hand panel).

Oil and gas companies' bonds outstanding increased from $455 billion in 2006 to $1.4 trillion in 2014, a growth rate of 15% per annum.

Energy companies have also borrowed heavily from banks.

Syndicated loans to the oil and gas sector in 2014 amounted to an estimated $1.6 trillion, an annual increase of 13% from $600 billion in 2006.

Debt and leverage have increased sharply in the energy sector — Graph 2



[1] Face value of Merrill Lynch high-yield and investment grade corporate bond indices. [2] Integrated oil, gas and exploration/production companies. [3] Companies with total assets in 2013 exceeding $25 billion.

Sources: Bloomberg; Thomson Reuters Worldscope; BIS calculations.

Overall, the stock of debt of energy firms has risen even faster than that of other sectors.

Debt issued by oil and other energy firms accounts for about 15% of both investment grade and high-yield major US debt indices, up from less than 10% just five years earlier.

A substantial part of the increased borrowing has been by state-owned major integrated oil firms from emerging market economies (EMEs).

From 2006 to 2014, the stock of total borrowing (syndicated loans and debt securities) of Russian companies grew at an annual rate of 13%, that of Brazilian companies 25% and that of Chinese companies 31%.

Borrowings of companies from other EMEs increased by 17% per annum.

The increase in the leverage of EME companies contrasts with the stable leverage of comparable-sized large firms in the United States (Graph 2, right-hand panel).

These EME companies have substantial existing production and therefore revenue.

In many cases, their borrowing has coincided with large dividend payments to their sovereign owners.

Hence, their behaviour appears similar to that of large, cash-rich firms in other sectors that have used very easy borrowing conditions in international markets to increase equity returns.

US oil companies have also borrowed heavily.

They account for around 40% of both syndicated loans and debt securities outstanding.

Much of this debt has been issued by smaller companies, in particular those engaged in shale oil exploration and production.

Indeed, while the ratio of total debt to assets has been broadly unchanged for large US oil firms, it has on average almost doubled for other US producers - including smaller shale oil companies.

These firms borrowed heavily to finance the expansion of production capacity, often against the backdrop of negative operating cash flow.

Indeed, shale investment accounts for a large share of the increase in oil-related investment.

Annual capital expenditure by oil and gas companies has more than doubled in real terms since 2000, to almost $900 billion in 2013 (IEA (2014)).

Producers' responses to lower oil prices

The combination of falling oil prices and higher leverage can lead to financial strains for oil-related firms.

First, the price of oil underpins the value of assets that back these firms' debts.

Lower prices will tend to reduce profitability, increase the risk of default and lead to higher financing costs.

Indeed, spreads on energy high-yield bonds widened from a low of 330 basis points in June 2014 to over 800 basis points in February 2015, much more than the increase for total high-yield debt (Graph 3).

Second, a lower price of oil reduces the cash flows associated with current production and increases the risk of liquidity shortfalls in which firms are unable to meet interest payments.

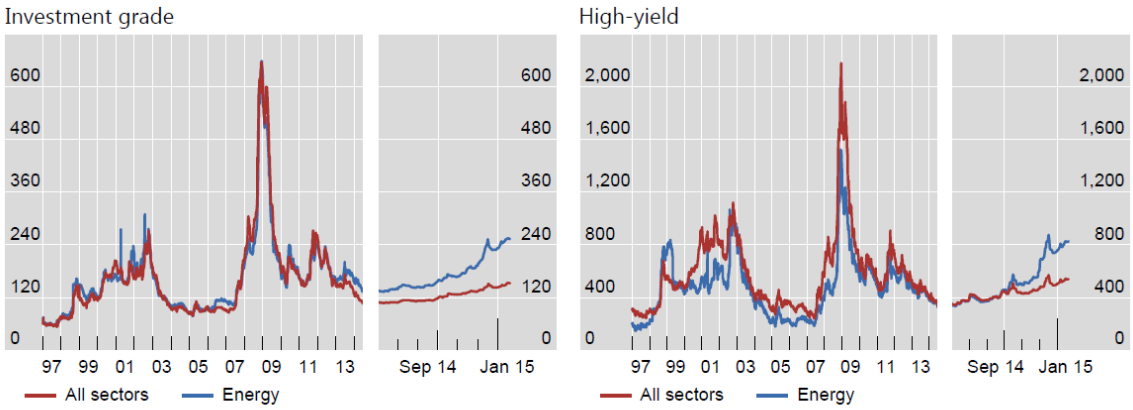
Such strains may affect the way firms respond to lower oil prices in two main ways.

The first is by adjusting investment and production.

Where a substantial portion of investment is debt-financed, higher costs and tighter lending conditions may accelerate the reduction in capital spending.

Credit spreads point to increasing risks in the energy sector

US corporate bond indices; option-adjusted spread over Treasury notes, in basis points — Graph 3



Source: Merrill Lynch.

Highly indebted firms could even be forced to sell assets, including rights, plant and equipment.

As regards production, highly leveraged producers may attempt to maintain, or even increase, output levels even as the oil price falls in order to remain liquid and to meet interest payments and tighter credit conditions.

Second, firms with high debt levels face stronger imperatives to hedge their exposure to highly volatile revenues by selling futures or buying put options in derivatives markets, so as to avoid corporate distress or insolvency if the oil price falls further.

The overall impact of these responses on oil price dynamics is two-sided. On the one hand, cutbacks in the capital expenditure of oil firms (or announcements thereof) would tend to lift oil prices through (expectations of) future lower supply.

Asset sales should be price-neutral.

On the other hand, if financial constraints keep production levels high and result in increased hedging of future production, the addition to oil sales would magnify price declines.

In the extreme, a downward-sloping supply response of increased current and future sales of oil could amplify the initial decline in the oil price and force further deleveraging.

Assessing the possible role of such an induced increase in supply during the current market downturn is an empirical question which will be tackled in the remainder of the section.

Recent developments in oil capital spending and production appear consistent with the responses laid out above.

Many companies have already announced reductions in capital spending of 30% or even 50%.

Companies with less cash flow from existing production, and larger interest payments from existing high debt, will be most constrained in financing ongoing investment.

In particular, for smaller US firms, including many shale oil firms, capital expenditures have exceeded cash flows from oil sales by wide margins (Graph 4, left-hand panel).

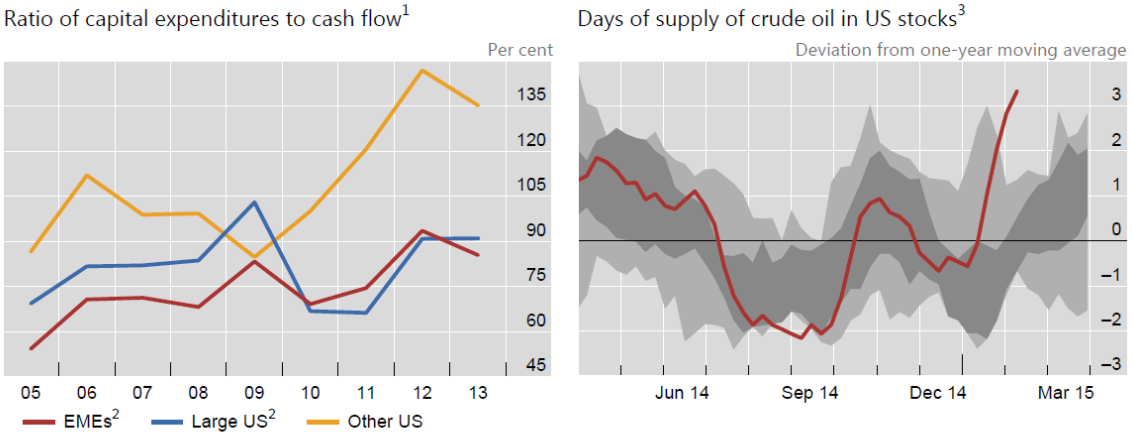
Indeed, the US shale rig count has fallen sharply in recent months.

At the same time, oil production has remained strong. In the United States, estimates of oil stocks have increased quite markedly in recent months on the strength of production growth and some softening of demand (Graph 4, right-hand panel).

Production typically responds with a lag to lower prices as existing wells continue to produce even when prices fall given their large fixed costs and lower marginal costs.

However, the combination of a lower rig count with continued strong production in spite of the short life of shale wells may reflect more selective exploitation of productive wells by producers to meet cash flow needs.

Debt and ample oil supply will constrain oil producers — Graph 4



[1] Median across integrated oil, gas and exploration/production companies in each category. [2] Companies with total assets in 2013 exceeding $25 billion. [3] Calculated as current crude oil stock level divided by refinery inputs of crude oil (as a proxy for demand) averaged over the most recent four-week period. The dark (light) grey range depicts the minimum and maximum values registered over the period 2009–13 (1984–2013) in the corresponding weeks of the calendar year.

Sources: US Energy Information Administration; Thomson Reuters Worldscope; BIS calculations.

More notably, increased hedging by oil producers seems to have been associated with downward pressure on oil prices more recently.

The short positions of "merchants" in organised derivatives markets as reported by the US Commodities and Futures Trading Commission (CFTC), a proxy for this hedging activity, have increased by about 70 million barrels since August 2014.

The left-hand panel of Graph 5 plots the association between increases in short positions and changes in the oil price.

This relationship is mildly positive (but not statistically significant) during the period of relatively stable prices between January 2010 and May 2014, but it turns negative after June 2014.

And, in contrast to the earlier episode of falling oil prices in 2008, when the slope of the regression line was also negative, the relationship is statistically significant for the most recent period.

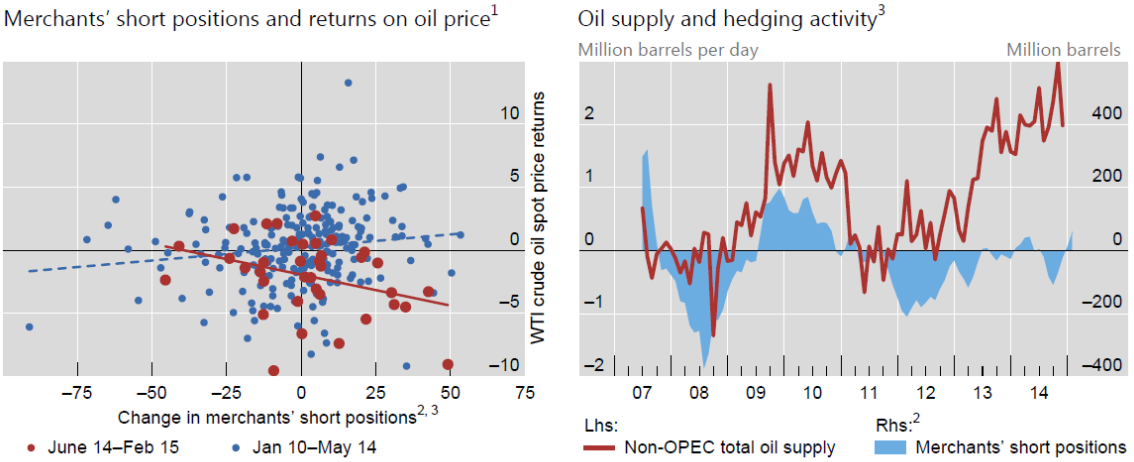
Since July 2014, producers have sold additional oil in the futures market amidst declining prices - that is, the supply response has been downward-sloping.

This could well reflect the role of leverage, although a more in-depth investigation would be needed to establish whether it is indeed leverage that explains the difference from 2008.

Position-taking in organised derivatives markets provides only a partial picture of oil producer hedging.

Producers also rely on tailor-made derivatives contracts (over-the-counter (OTC) contracts) provided by swap dealers for hedging.

Oil producers seem to have changed their hedging behaviour — Graph 5



[1] Weekly data (five-day moving average for oil price). The solid regression line indicates statistical significance at a 95% confidence level; the dotted line indicates no statistical significance. [2] Futures and options short open positions on WTI light sweet crude oil traded at the NYMEX, in millions of barrels. [3] Twelve-month changes.

Sources: CFTC; Datastream.

There is some, albeit indirect, evidence that producers have increasingly hedged through swap dealers over the past few years.

Between 2007 and 2012, changes in CFTC-reported short positions of merchants broadly tracked shifts in oil production (Graph 5, right-hand panel), suggesting that hedging kept pace with extraction activity.

In contrast, the surge in production in 2013 - mostly of US shale oil - was not matched by an increase in merchants' short positions in the CFTC data. Instead, short positions of swap dealers almost doubled (Graph 6, left-hand panel).

However, during the period of falling oil prices from mid-2014, short positions of swap dealers fell sharply.

These shifts in short positions of swap dealers raise questions about possible broader changes in oil derivatives markets that may have affected the availability and cost of hedging.

Swap dealers are an important part of the oil derivatives ecosystem.

They comprise specialised commodity traders (including trading affiliates of some large oil producers) as well as subsidiaries of major banks.

Some of the latter are, in turn, major providers of commodity investment products such as exchange-traded funds (ETFs) and mutual funds.

The demand for energy-backed investment products provided a natural match to producer hedging needs.

This changed with outflows from energy investment products beginning in 2013 (Barclays (2015)), which may have forced swap dealers to cover their exposures vis-à-vis producers by taking short positions in the open market.

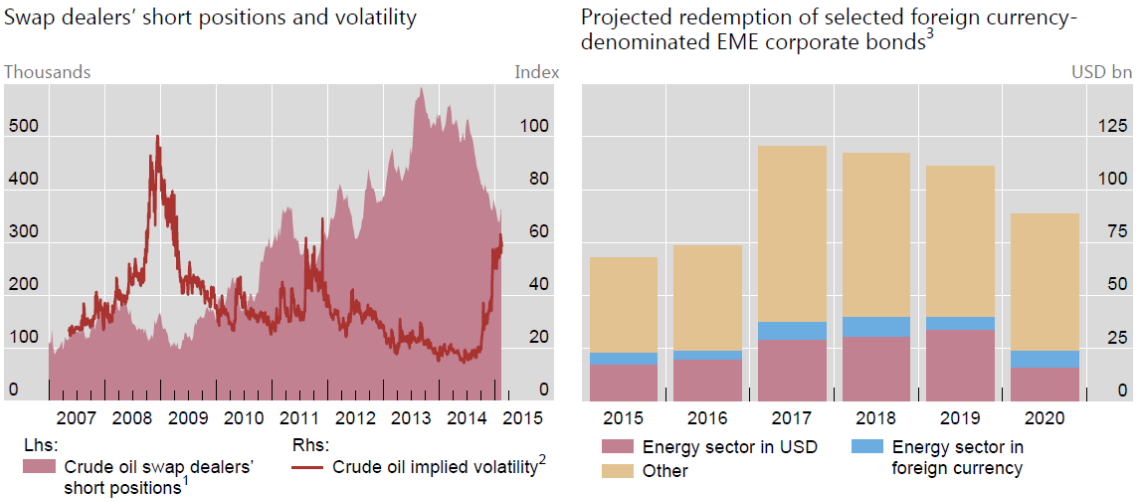
Finally, liquidity in oil derivatives markets may have deteriorated.

Financial intermediaries have reduced market-making capacity post-crisis in response to market pressure and more stringent regulation (Fender and Lewrick (2015)).

And, as with other market-makers, commodity swap dealers will aim to reduce positions when volatility increases (Graph 6, left-hand panel).

Oil derivatives trading is no exception to the risks arising from the withdrawal of such "fair weather liquidity".

Energy bonds account for a larger share of bond markets — Graph 6



[1] Futures and options short open positions on WTI light sweet crude oil traded at the NYMEX, in thousands of contracts. [2] CBOE Crude Oil Volatility Index. [3] Summed across Brazil, Bulgaria, Chile, China, Colombia, the Czech Republic, Estonia, Hong Kong SAR, Hungary, Iceland, India, Indonesia, Korea, Latvia, Lithuania, Malaysia, Mexico, Peru, the Philippines, Poland, Romania, Russia, Singapore, Slovenia, South Africa, Thailand, Turkey and Venezuela.

Sources: CFTC; Datastream; Dealogic.

Broader economic repercussions

The previous section explored how high debt levels could affect the response of producers to falling oil prices.

While far from being conclusive, there is some support for the view that leverage is affecting production and hedging decisions of oil producers.

Related to this, there are broader questions about the impact of oil sector debt on the financial system and the wider economy.

From the perspective of market functioning and financial stability, the large outstanding debt of the oil sector focuses attention on how that debt is intermediated.

Both banks and bond markets play an important role in providing credit to oil-related firms.

As regards banks, anecdotal evidence points to risk-shedding that is similar to other episodes of sharply declining values of collateral assets.

In particular, US banks have reportedly cut back short-term credit lines to shale oil companies, or demanded additional collateral.

Perhaps even more important is the behaviour of long-term fixed income investors.

Being able to absorb losses in the short term, long-term investors in debt securities have often been considered a stabilising influence on financial markets.

However, recent experience suggests that even long-term investors have limited appetite for losses and may join in any selling spree.

A sell-off of oil company debt could spill over to corporate bond markets more broadly if investors try to reduce the riskiness of their portfolios.

The fact that debt of oil and gas firms represents a substantial portion of future redemptions underlines the potential system-wide relevance of developments in the sector (Graph 6, right-hand panel).

The high debt level of the oil sector also complicates the macroeconomic assessment of lower oil prices, for at least three reasons.

First, any amplifying effect of high leverage on capital expenditure in the oil sector could have knock-on effects on investment in other sectors.

As discussed in Banerjee et al (2015), uncertainty and expected profitability are major determinants of investment.

Retrenchment in the oil sector could therefore affect the outlook and spending in energy-related sectors, but also in other sectors of economies or regions that are heavily dependent on oil production.

Second, the impact of the oil price collapse on government fiscal revenue can be large.

In several countries, oil-related revenue accounts for a substantial proportion of the government budget, and the financial strains posed by the oil price decline for highly leveraged state-owned oil companies will impose more acute fiscal constraints on government spending.

Some countries have hedged their fiscal commitments by entering into formal hedging transactions.

For instance, Mexico's Oil Income Stabilisation Fund (FEIP) has an explicit hedging programme using option contracts in oil for one year.

However, pressure on fiscal revenues will be felt if hedges expire before oil prices recover.

Finally, oil companies in some EMEs seem to have increased leverage in order to finance dividend payments to governments (Graph 4, left-hand panel).

Sustaining such payments has become much more costly.

Third, there is a potential interaction between the oil price collapse and exchange rate movements.

As noted already, many firms in the oil sector are non-US (often EME) firms that have nevertheless borrowed in dollars.

Currency mismatches in their cash flows may be smaller than for other sectors to the extent that oil revenues are in dollars.

Even so, oil companies located in EMEs may be perceived to be more risky and find access to new foreign currency borrowing more difficult than those in advanced economies.

Given that EME oil firms have increased their borrowing sharply over the past decade, they could be particularly susceptible to tighter credit conditions.

Conclusions

This article has explored the interaction between oil prices and high debt levels of oil companies.

There is some evidence that higher leverage has affected the response of oil producers to lower prices and, eventually, oil price dynamics.

Oil sector leverage also complicates the assessment of the macroeconomic implications of lower oil prices.

Many of the findings are tentative, and quantifying the financial and macroeconomic significance of the mechanisms discussed remains a topic for future research.

That said, the discussion highlights two issues that are of relevance beyond the energy sector.

First, the oil-debt nexus illustrates the evolving risks in the financial system.

Rapidly rising leverage creates risk exposures in the non-financial corporate sector that may be transferred across the global financial system.

Similarly, rising leverage puts a greater premium on the liquidity of the markets for the assets that back debt.

Both developments underscore the need to better understand the functioning, behaviour and interaction of markets and intermediaries.

Second, the build-up of debt in the oil sector provides an example of how high debt levels can induce new linkages between individual markets and the wider economy.

Such interaction needs to be taken into account in assessments of the economic implications of falling oil prices.

Number 2

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mr Mario Draghi, President of the European Central Bank, before the Hearing at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels

Mr Chairman,
Honourable Members of the ECON committee,
Ladies and Gentleman,

I am happy to be back to this committee for my first regular hearing at the European Parliament in the year 2015.

A lot has happened since we last met in November last year.

With Lithuania, the euro welcomed its 19th member.

On 22 January we announced our intention to extend our asset purchase programmes to buying public sector securities; we started the purchases on March 9.

We also moved to a new building which we officially inaugurated last week; we unveiled our new 20 euro banknote; and in a milestone towards even greater transparency of our decision-making procedures, we published on 19 February for the first time the accounts of a monetary policy meeting of the Governing Council of the ECB.

I know this has always been a topic very dear to your committee.

In the remainder of my remarks, I will explain some important aspects of the extended asset purchase programme and present a first assessment of its effects.

I will then, as the coordinators have asked me to do, elaborate on the link between price stability and financial stability and will speak briefly about the macroprudential tools the ECB has now at its disposal.

Economic outlook and monetary policy

The most recent data and survey evidence show that growth is gaining momentum.

The basis for the economic recovery in the euro area has clearly strengthened.

This is due to in particular the fall in oil prices, the gradual firming of external demand, easy financing conditions driven by our accomodative monetary policy, and the depreciation of the euro.

These more positive developments are also reflected in the recent ECB staff projections.

Compared with the projections from December, the outlook for 2015 and 2016 has been visibly revised upwards by 0.5 and 0.4 pp., respectively.

We expect inflation in the euro area to remain very low or negative in the months ahead, because the recent fall in oil prices will continue to influence the figures until later in the year.

However, inflation rates are expected to start increasing gradually towards the end of the year.

They will be supported by aggregate demand, by the impact of the lower euro exchange rate and by the recovery of oil prices from their current troughs in the years ahead.

The latest ECB staff projections foresee average inflation at 0.0% in 2015, rising to 1.5% in 2016 and 1.8% in 2017.

A key factor for a full recovery of the euro area economy and ensuring that inflation does not remain too low for too long will be the extra stimulus that the Governing Council decided to introduce in January under the ECB's expanded asset purchase program.

This decision was premised on two considerations.

First, the momentum supporting the economic recovery was viewed as too weak and fragile to give us sufficient confidence that inflation would return to levels closer to 2% over a policy relevant medium-term horizon.

Second, the expansive potential of the monetary policy measures that had been decided between June and October was seen as uncertain.

This was because they were largely dependent on banks' own decision to borrow Eurosystem funds and lend them on to their customers.

The cumulative uptake under the first two targeted long-term refinancing operations stood at around €212.4 billion.

Therefore, the monetary impulse had to be reinforced and needed to be quantitatively more predictable and controllable to put the economy and the outlook for price stability on a firmer footing.

On 9 March, we started purchasing public-sector securities as part of our expanded asset purchase programme, which also comprises interventions in the ABS and covered bond markets.

Overall, our asset purchases will amount to €60 billion per month.

The pace of purchases so far puts the overall program on track to reach a total of €60 billion in March. At this point in time we see no signs that there will not be enough bonds for us to purchase.

Feedback from market participants so far suggests that implementation has been very smooth and that market liquidity remains ample.

Our interventions have accelerated a trend that had been evident since some time.

A steady process of re-integration across financial markets and jurisdictions had been under way since the summer of 2012.

What is new today, however, is that lower interest rates in capital markets are increasingly being transmitted through the entire financial intermediation chain.

Lower funding costs for banks have started to influence the cost of borrowing for households and companies.

As bank lending rates are being reduced, new investment projects - previously considered unprofitable - become attractive.

In the short-run, this should sustain the demand for credit and investment.

Indeed, the banks covered in our Bank Lending Survey confirm that the easing of lending conditions is progressing hand-in-hand with a resurgent demand for credit to finance business investment.

In the longer-term perspective, this will increase potential output.

We intend to carry out our purchases at least until end-September 2016, and in any case until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term.

The Governing Council will take a holistic perspective when assessing the path of inflation.

It will evaluate the likelihood for inflation not only to converge to levels that are closer to 2%, but also to stabilize around those levels with sufficient confidence thereafter.

When doing this assessment, the Governing Council will follow its monetary policy strategy and concentrate on inflation trends, looking through any surprise in measured inflation (in either direction) if judged to be transient and with no implications for the medium term outlook for price stability.

The positive results of our new purchase programme should not distract other stakeholders from delivering their contribution to put the economy back on track.

Fiscal policies should support economic growth, while ensuring debt sustainability.

A full and consistent implementation of the Stability and Growth Pact is key for confidence in our fiscal framework.

Moreover, structural reforms should be implemented promptly and with determination.

The combination of improved economic structures and sound fiscal policies indeed has the potential to make our monetary policy more effective by encouraging economic actors to take advantage of improved financing conditions and increase investment.

Price stability and financial stability

Let me now turn, as suggested by the ECON coordinators, to the interaction between price stability and financial stability.

Price stability is, as you know, the primary objective of the ECB and the Eurosystem.

And achieving price stability is a necessary condition for financial stability.

Clearly, unstable inflation developments can distort a wide variety of macroeconomic and financial fluctuations, to the extent that these distortions become harmful for the economy.

For example, unstable inflation developments could complicate pricing of assets and blur the signals from relative asset price adjustments with detrimental effects on resource allocation.

However, price stability is not a sufficient condition of financial stability.

The last crisis proved that financial stability can be at risk even at times when price stability is achieved.

And monetary policy decisions also affect expectations and a wide range of asset prices.

Our monetary policy measures are necessary to achieve our primary objective of maintaining price stability.

But we are nevertheless aware that they may have unintended side effects on the financial system.

For example, asset prices may increase to levels that are not justified by fundamentals, while periods of low yields and volatility may invite excessive risk taking by financial investors.

In turn, such developments can act as an amplifying mechanism for any eventual financial instability.

At the same time, financial stability is a precondition for the efficient conduct of monetary policy.

To be successful in delivering price stability, monetary policy relies on the effectiveness of the monetary transmission mechanism.

In this context, a stable and non-fragmented financial system is important for the smooth transmission of monetary policy signals.

We are monitoring closely any potential risks to euro area financial stability, including those from excessive risk taking.

Currently these risks are contained.

And should they emerge, macro-prudential policy would be best suited to address them.

Recently, indeed some national authorities in the euro area have decided to implement such measures that go in the direction of preventing financial stability risks from emerging at national level.

Regarding macro-prudential oversight of banks in the euro area, this is shared between national authorities and the ECB.

The ECB may top-up specific national macro-prudential measures if it considers these insufficient to mitigate systemic risks.

The ECB and the national authorities have at their disposal macro-prudential instruments for the banking sector, as provided in the Capital Requirements Directive and Regulation (CRD IV/CRR).

These include capital buffers, such as the countercyclical capital buffer, systemic risk buffer and capital surcharges for systemic institutions.

Additional measures may also be used to improve banks capital and liquidity position, limit their large exposures or increase capital requirements for certain asset classes, such as interbank and real estate exposures.

To make the most effective use of these instruments and strengthen the stability of the financial system, the ECB and national authorities regularly exchange information on macro-prudential policies.

Processes for formal notifications to the ECB by national authorities regarding intended measures have already been activated.

Overall, the ECB will help to identify potential financial stability risks and foster a coordinated stance for macro-prudential policies among euro area Member States.

Conclusion

Let me conclude by saying that I have always very much valued the exchange with your house both as an exercise of our accountability obligations and as a source of inspiration.

I am therefore very much looking forward to our debate and hope that we will now have time to discuss some of the matters for which time was too short at the plenary debate.

Thank you for your attention.

Number 3

Preparing for the Regulatory Challenges of the 21st Century

Commissioner Luis A. Aguilar
Georgia Law Review Annual Symposium
Financial Regulation: Reflections and Projections
University of Georgia, Athens, Georgia

Thank you, Professor [Carol] Morgan, for that kind introduction. It is a great honor to be here at the Georgia Law Review's Annual Symposium. Before I begin my remarks, however, let me issue the standard disclaimer that the views I express today are my own, and do not necessarily reflect the views of the U.S. Securities and Exchange Commission ("SEC" or "Commission"), my fellow Commissioners, or members of the Commission's staff.

In the spirit of today's Symposium, entitled "Financial Regulation: Reflections and Projections," I plan to reflect back over the events that have taken place during my years as a Commissioner and then make a few projections as to future trends.

During my tenure as an SEC Commissioner, our country's economy has experienced extreme highs and lows.

In fact, the country experienced the worst financial crisis since the Great Depression, followed by the current period of significant economic growth where the stock market has grown by around 165% from the low point of the financial crisis.

I have had a front-row seat to all of this, as I became an SEC Commissioner just weeks before the financial crisis hit our nation.

As a result, I witnessed first-hand just how fragile our capital markets can be, and the need for a robust and effective SEC to protect them.

First, let me provide a snapshot of what went on.

I was sworn-in as an SEC Commissioner on July 31, 2008.

Within a few weeks, on September 15, 2008, Lehman Brothers filed for bankruptcy.

To give you a sense of its rapid decline, within 15 days, its share price went from $17.50 per share to virtually worthless.

The demise of Lehman Brothers is often seen as the first in a rapid succession of events that led to an unimaginable market and liquidity crisis.

These events included:

- Substantial economic damage to a number of storied financial institutions;

- A crisis that engulfed the money market industry;

- The freezing up of the short-term capital markets; and

- The discovery of a long list of Ponzi schemes as cash became in short supply, the most famous of which was the Bernie Madoff Ponzi scheme.

Any one of these events would have been a significant market event, but taken together we had a financial system on the verge of collapse.

A discussion of all that went wrong could fill several volumes of the Georgia Law Review.

Needless to say, the ensuing turmoil shook the global economy to its core and exposed the weaknesses of many regulatory regimes—both in the United States and abroad.

Eventually, it became abundantly clear that years of lax attitudes, deregulation, and complacency about the virtues of strong regulation contributed significantly to the financial crisis.

The events of the financial crisis substantially affected the Commission, as the primary regulator of the U.S. capital markets.

It is no exaggeration to say that the SEC's continued existence was in doubt.

In fact, in early 2009, there were reports that the White House and the U.S. Department of Treasury were considering a plan that would reduce the

SEC's authority to protect investors, and transfer this authority to a new federal "super cop."

I was a new Commissioner at the time, and the Commission, as well as our country, faced an avalanche of unprecedented issues.

I marveled at the timing of my arrival at the SEC.

Looking back, I thought about my long career as a partner at several nationally recognized law firms, as the General Counsel, Head of Compliance, and Executive Vice President for one of the world's largest and most successful asset management firms, and as the President of one of its broker-dealers.

And now I found myself at the SEC, faced with the possibility that we would be asked to turn off the lights and close the doors for the very last time.

Fortunately, Congress and the White House realized that the SEC played an essential and necessary role.

In fact, the Dodd-Frank Act expanded the SEC's authority and jurisdiction.

As a result, during my tenure, a refocused SEC has tackled head-on a wide variety of complex issues.

Indeed, the years following the financial crisis have been one of the most active periods in SEC history.

Much of this work involved taking an honest assessment of our shortcomings, which resulted in significant internal restructurings, including reorganizing the Enforcement Division, creating a new division to focus on economic analysis and risk assessment, and revamping our inspection and examination program.

Moreover, during this same time period, the Commission has entered into one of its most active periods in promulgating new rules. In fact, the Commission has voted on almost 250 rulemaking releases during my tenure.

Most of the Commission's new rules rightly focused on addressing flaws in our own capital markets.

For example, some of these rules sought to remedy the conflicts of interest that led credit rating firms to knowingly give their highest ratings to a slew of investments that were extremely risky, and which turned out to be worthless, or close to it.

Other rules address the poor disclosures for the asset-backed securities markets that were at the epicenter of the 2008 market turmoil.

Of course, the Commission has also proposed and/or adopted a wide range of other regulatory requirements across the expanse of the capital markets—impacting equity and option exchanges, broker-dealers, investment advisers, and hedge funds—to name just a few.

Many of these rulemakings have been groundbreaking.

Still, even with all of this activity, the Commission remains behind on many of its mandates under the Dodd-Frank Act, the more recent JOBS Act, and other important initiatives.

The Commission still has much work to do.

In addition to the focus on the domestic market, the Commission is also working internationally to address the dangers arising from the growth and interconnectedness of the global financial markets, and the reality that risks from less-regulated overseas markets can ultimately come to our shores.

The Commission's efforts continue across a wide range of regulatory initiatives, any of which are worthy of an in-depth discussion.

Today, I plan to project forward and focus on certain fundamental challenges facing the Commission that will cut across several important regulatory responsibilities, and demonstrate the need for the Commission to evolve and adapt to changing times.

In particular, I will focus on:

- First, how the SEC should prioritize its use of data and technology to become a more effective regulator; and

- Second, how the global nature of the crisis illustrates the increasingly interconnected nature of the global economy and underscores that the SEC faces a future of needing to work globally to protect American investors.

The Evolving Capital Markets and the Need For High-Quality Information

First, I want to discuss how the Commission is evolving into a more informed regulator through various data gathering and technology driven initiatives.

Today, our capital markets are more sophisticated, larger, faster, and more technologically driven than at any time in history.

This rapid change requires that a regulator be able to quickly spot risks, identify emerging trends, and understand how new financial products and evolving market conditions are impacting investors and the capital markets as a whole, both here and abroad.

For example, within the past few years, high-tech, automated trading has come to dominate the world's capital markets.

This reliance on technology has resulted in a market structure increasingly characterized by high-speed trading executed at many different trading venues.

To illustrate this point, in January 2005, the New York Stock Exchange's ("NYSE") average speed of execution for small, immediately executable orders was 10.1 seconds.

More recently, the average speed has accelerated to a half a second or less.

This speed can bring benefits as it allows for quicker executions and delivery of market data.

However, it can also wipe out billions of dollars in just a few minutes, such as when the Flash Crash in May 2010 caused $1 trillion to evaporate in just 20 minutes, before making a partial recovery; and, when Knight Capital suffered a $460 million trading loss over a 45-minute period in August 2012 that resulted from a computer malfunction.

The new technology has enabled the growth of a very fragmented trading environment and encouraged the proliferation of so-called "dark pools."

As evidence of this development, in 2005, NYSE executed approximately 80% of the consolidated share volume of listed stocks.
Today, NYSE's share of volume is less than 24%.

Where we once had just a handful of brick-and-mortar securities exchanges, like NYSE, there are now 18 national securities exchanges and perhaps as many as 40 to 50 dark pools where trades are executed, mostly through automatic, electronic networks.

Estimates show that, in 2012, automated trading accounted for about 50-75% of the volume traded on all of the exchanges each day.

It is no secret that the Commission is struggling to keep up with these market and technological developments while trying to assess whether these evolutionary changes benefit or detract from our capital markets.

In fact, just last summer, Chair White announced that the SEC would "comprehensively review and address core market structure policy issues, such as the overall fairness of trading in high-speed markets [and] changes in the number and nature of trading venues...."

As a further step, the Commission recently established an advisory committee to provide a formal mechanism through which it can receive input on market structure issues.

In fact, the first meeting of this committee is scheduled for May 13, 2015.

The Need for Timely, Accurate, and Complete Data and Information

No one can doubt that effective oversight of the capital markets requires that the SEC be well-informed.

However, one of the most difficult challenges facing the SEC today is the lack of information, particularly at a time when the capital markets' reliance on the newest and most advanced technology to generate and process information keeps increasing exponentially.

The Commission's lack of access to critical data was laid bare by the Flash Crash.

It took the staffs of both the SEC and CFTC over four months to get the data and analyze the events of those fateful 20 minutes in May 2010, when the prices of many U.S. equities experienced extraordinarily rapid and extreme swings.

The Commission's need for data is even more acute, as markets are continuing to grow more complex and fragmented.

Moreover, the lack of access to critical data goes beyond market structure and cuts across the Commission's responsibilities including enforcement, corporate disclosures, and the asset management industry.

The financial crisis, and its aftermath, made clear that the SEC needed far more information to effectively supervise a number of important market sectors—such as money market funds, hedge funds, derivatives activities (including credit default swaps), municipal advisors, credit rating agencies, and others.

Efforts to Obtain Critical Data and Information

To that end, even though the SEC is not a self-funded agency, like many of its counterparts, the Commission is devoting significant amounts of its limited resources to enhancing the agency's data gathering and analytics.

These initiatives are important if the Commission is to properly keep track of, among other things, the activities of over 25,000 regulated entities, the approximately 9,400 publicly-traded companies that file reports with the SEC, and the 15,000-16,000 tips, complaints, and referrals we receive per year.

In particular, the Commission has been working to capture data and automate its analytical capabilities to allow our staff to proactively identify areas of risks, emerging trends, and fraudulent activity.

These initiatives will allow the staff to spot issues in ways we were not able to do before the crisis.

One of the most significant data collection rules that the Commission has adopted is the requirement for a Consolidated Audit Trail ("CAT").

CAT, when operational, will be the world's largest data repository of securities transactions.

CAT should improve the oversight of the markets by allowing the Commission to identify and address potential risks before they metastasize into larger problems.

CAT will also be a game-changer with respect to combatting securities fraud, which is more difficult to identify due to market fragmentation and the rise of electronic trading.

While we're waiting for CAT to be implemented, the SEC is developing tools to utilize data in new ways.

First, in 2013 the SEC staff rolled out a data collection initiative entitled Market Information Data Analytics System, or as we call it, MIDAS.

It is designed to collect publicly available market information, such as commercial feeds of market quotes and data from national exchanges.

On any given day, MIDAS collects about one billion trading records from each of the national equity exchanges

The SEC staff is utilizing MIDAS to provide market structure information to the public and to help the staff develop better insights into the capital markets.

Nonetheless, the system does have some significant constraints.

In particular, it only collects publicly available information and it does not provide information regarding the lifecycle of a trade, the various components of a trade, the identities of parties involved in the trade, or any of the off-exchange trade and order flow information.

These are gaps that an operational CAT should address in the future.

Beyond better utilizing public data, the SEC is using several data-analytic tools to assist its enforcement investigations.

For example, the Enforcement Division is using a sophisticated, data-driven, proprietary analytical program, called Aberrational Performance Inquiry, to identify and investigate hedge funds and financial advisory firms with suspicious returns.

In Fiscal Year 2014, the Enforcement Division brought its eighth case, as a result of this initiative.

Similarly, the Division's Automated Bluesheet Analysis Project, which was started in 2011, continues to be an effective and proactive tool to detect

suspicious trading patterns and relationships among traders who attempt to profit through illegal insider trading.

In addition, working with the Division of Economic and Risk Analysis, or DERA, the Enforcement Division is also using a tool called the Accounting Quality Model ("AQM"), which helps the staff determine whether an issuer's financial statements stick out from the pack in a way that requires further review.

Furthermore, in response to criticisms about the Commission's ability to process the tips, complaints and referrals ("TCR") received, the SEC upgraded its technology to make it easier and more user-friendly for the public to submit tips, as well as to provide the SEC staff with the automated ability to access and analyze real-time data.

The Commission now has an automated centralized information system for tracking, analyzing, and reporting on the handling of tips and complaints.

This program assures that no tip will be neglected, a problem the SEC had faced in the past.

The Commission recognizes that data gathering is only the start. It also should be able to effectively use and analyze the data.

To that end, the Commission is improving the transparency and the overall usefulness of some of the disclosure information it receives, by requiring data tagging.

The idea is simple: data tagging allows investors, regulators, and market participants to organize and analyze massive amounts of data and information more efficiently by associating pieces of information with keyword tags.

The ultimate result is that data tagging improves the retrieval, searchability, and analysis of relevant market data by the SEC staff and the public alike.

The focus on data tagging began in earnest in 2009, when the Commission adopted its so-called "smart disclosure" rules to require interactive data tagging for the financial statements of public companies; the risk/return information of mutual funds; and certain information provided by credit rating agencies.

But it's not just the SEC that benefits from data tagging.

To further enhance transparency of this data, the Commission's public website now contains organized data sets of quarterly and annual data from XBRL-tagged financial statements filed with the Commission.

These data sets should help the public and interested users more easily consume large amounts of data for comparison and analysis.

Moreover, the SEC staff has developed analytical tools to use this tagged data to identify and investigate possible enforcement matters.

Finally, another example of the benefits of collecting real-time data information can be found with respect to money market funds.

The financial crisis made clear that the information being received by the Commission was too stale to be of regulatory use.

When a prominent money market fund "broke the buck," and other funds came under pressure, we simply did not have the data at hand to determine what other funds could "break the buck."

Accordingly, the Commission promulgated a rule to require money market funds to provide monthly disclosures of their investment portfolios.

This new data has proven invaluable, as it allows the Commission to put its finger on the pulse of these funds, and better monitor their activities.

For example, this new data allowed the SEC staff to monitor closely whether and how money market funds were adjusting their holdings during the Eurozone crisis in 2011.

In particular, this data allowed the staff to determine that money market funds were not—as had been widely speculated—overexposed to Irish banks and other European securities during the Eurozone crisis.

These are all positive steps forward.

The Commission is now using data and technology in ways it had not done before the crisis.

The demonstrable results are that the SEC staff is able to review and analyze information more efficiently and effectively.

But, it is not enough and there is much more to be done. As I project into the future, the SEC must push forward with its efforts to embed interactive data in more of its regulatory filing requirements.

As one example, as a result of the Dodd-Frank Act, the SEC is promulgating new rules that require additional corporate governance information to be provided in proxy statements, including matters involving executive compensation.

These rules should include, where appropriate, data tagging requirements that would enable this information to be reviewed and analyzed more efficiently by the Commission staff and investors alike.

Data Collection and Analysis: A Work In Progress

Ultimately, enhanced data gathering and technological developments can help the Commission fulfill its mission of protecting investors, fostering capital formation, and ensuring the market is fair, orderly, and efficient.

However, to accomplish those goals, Congress will need to provide the SEC with sufficient and reliable funding to utilize cutting-edge technologies.

In addition, the SEC requires funding to hire staff with specialized skill sets to analyze the data and improve the agency's ability to assess risk, conduct examinations, and detect and investigate fraud.

Simply stated, to be an effective regulator, the Commission must have a vast repository of vital data from market transactions, public companies and regulated entities, in a format that the staff can easily use, search, and compare.

The Commission requires systems that can efficiently manage this volume of information and allow the information to be reviewed and analyzed more effectively by the Commission staff and the public.

We're getting there, but we're not there yet —not by a long shot.

At the end of the day, whether or not the SEC will be an effective regulator in the years to come will depend on its ability to obtain and efficiently analyze full, accurate, and timely data as to market activity and all the companies we oversee.

The Globalization of Securities Regulation

Let me now turn to another growing challenge—and that is the growing globalization of securities regulation.

Technological advances that have impacted the domestic securities markets have also significantly affected the global securities market and have accelerated the movement of capital across international borders.

Over the past 20 years, the global securities market has grown in both size and sophistication—and as the global markets grow, Americans have a greater ability to invest in securities markets around the world.

This increase in investment opportunities has been facilitated, in part, by advances in technology that provide investors—through their desktops and smart phones—with access to nearly limitless investment opportunities worldwide.

These developments require that the SEC think more globally and recognize that its registrants will increasingly be global players, that fraud perpetuated at home can be initiated by those who have never set foot in the United States, and that a market meltdown can have global origins and ramifications.

Consequently, as I project forward, the protection of American investors will require that the SEC increase its efforts to communicate, coordinate, and cooperate with its international counterparts, something that is easier said than done.

The differences between civil and common law jurisdictions, the variances in cultures and traditions, and the dissimilarities in local laws and how they are enforced pose serious challenges.

Oftentimes, the applicable law is a patchwork of separate and localized regulations that, at best, result in a fragmented, uncoordinated, and sometimes conflicting system of regulations, and, at worst, can result in a "race-to-the-bottom."

Fostering a Global Environment for Combating Fraud

An important aspect of international cooperation, of course, is addressing cross-border fraud.

In fiscal year 2013, for example, almost 20% of the SEC's enforcement cases involved foreign persons and entities.

Moreover, the Commission expects future cases to continue to have international elements.

To effectively investigate and prosecute these cases, the Commission will need cooperation from our international partners.

To that end, the Commission has entered into over 130 information-sharing arrangements with foreign regulators and law enforcement agencies.

In addition, the SEC conducts a wide variety of technical assistance programs to train our international regulatory and law enforcement partners on enforcement and examination topics.

In Fiscal Year 2014 alone, the SEC trained more than 2,300 regulatory and enforcement officials from around the world.

Recent statistics underscore the growing need for mutual cooperation in cross-border enforcement.

A quick look at the SEC's recent international enforcement cases include numerous cases in the areas of insider trading, market manipulation, foreign bribery, and other securities fraud cases.

This growing trend requires a good deal of international cooperation in order to prosecute these cases successfully.

In Fiscal Year 2014, for example, the SEC made about 735 requests for international assistance, and, in turn, received approximately 460 requests for assistance from foreign regulators.

In addition, the SEC often provides access to its files to foreign regulators and uses its compulsory powers to assist foreign investigations.

Regrettably, these international efforts are not what they should be. Although some international partners have been helpful, there are too many times that when the SEC calls for help, we find only silence, or worse, there are regulatory obstacles put in the SEC's path.

These obstacles and challenges included a foreign regulatory authority's lack of broad powers to investigate, litigate, or sanction violations; lack of

regulatory independence from political and industry influences; and the lack of resources dedicated to international cooperation.

Additionally, several foreign jurisdictions have privacy laws, blocking statutes, and other laws restricting or limiting the disclosure of certain information required in enforcement investigations and regulatory examinations.

Moreover, even when the SEC succeeds in obtaining remedies in federal district courts or administrative proceedings for a cross-border fraud, enforcing those judgments and orders still poses challenges.

For instance, one important tool for the SEC to punish wrongdoers is its ability to seek monetary penalties.

The power to impose penalties enhances the effectiveness of the Commission's enforcement program by more effectively deterring individual and corporate violators.

However, the weight of legal authority in foreign jurisdictions tends to favor the denial of court judgments and administrative orders that impose fines or penalties.

The impact of cross-border fraud on American investors is further exacerbated by the Supreme Court decision in Morrison v. National Australian Bank, Ltd. that limits the anti-fraud provision of the Exchange Act, Section 10(b), to claims that relate to frauds on an American stock exchange or that involve security transactions in the United States.

The end result is that, as the internet and the growth in foreign capital markets facilitate the ability of American investors to directly deploy their money around the globe, their ability to seek redress in the United States is being limited, while their ability to be harmed is not.

Accordingly, the Commission must consider, first, what it can do to prevent, detect, and mitigate the domestic impact of fraud originating from a foreign jurisdiction; and, second, what it can do to foster global efforts to combat fraud and enhance market integrity.

But, as I said before, this is easier said than done.

The challenge regulators face in pro-actively preventing fraudulent activity is demonstrated by the Public Company Accounting Oversight Board's

("PCAOB") difficulty in inspecting PCAOB-registered firms that reside abroad.

As you may know, in order to audit financial statements of companies publicly-traded in the United States, accounting firms are required to register with the PCAOB and subject themselves to regular inspections.

This is not limited to accounting firms based in the United States, and, in fact, more than 900 of the approximately 2,300 firms registered with the PCAOB are located outside the United States.

Thus, for the PCAOB to be effective, it must be able to inspect all registered firms no matter where they reside—truly a global effort.

Unfortunately, the PCAOB has faced significant regulatory obstacles to its inspections in a number of international jurisdictions.

In various European Union ("EU") member states, there was a long delay before the PCAOB was even allowed to inspect registered accounting firms, oftentimes as a result of state sovereignty claims, privacy or personal data concerns, or other local law considerations in these countries.

Fortunately, within the last few years, the PCAOB has made progress in overcoming some of these regulatory obstacles to global inspections.

Notwithstanding this progress, however, the difficulties continue today, as the PCAOB still is unable to conduct inspections of approximately 175 registered accounting firms in 11 EU member countries, as well as in China, Hong Kong, and Venezuela.

These obstacles persist, despite the important regulatory objective of the PCAOB's inspections in providing investors with reliable and accurate financial statements.

Ultimately, these regulatory obstacles pose a threat to all investors, whether in the U.S. or abroad, who cannot be assured that companies with foreign operations in these countries will be subject to audits that meet the requisite independence and high-quality professional standards.

The PCAOB's experience shows how difficult it is to develop cross-border oversight but, on the other hand, the progress that has been made shows it's possible.

As we look to the future and project forward, it is clear that, as companies increasingly have foreign operations, the SEC will need to address how best to extend its enforcement reach and supervisory oversight over global operations and transactions.

The success or failure of those efforts will determine if the SEC will be an effective regulator in the future.

Conclusion

Clearly, the past few years have been challenging.

By many accounts, a large number of investors lost significant amounts of money and simply left the capital markets.

Fortunately, since then, there are signs of an economic recovery and that some investors are returning to the market.

Nonetheless, we must learn from the past to project into the future.

It is important to keep in mind that change is a constant in our capital markets, and the exact nature and impact of that change will be difficult, if not impossible, to predict.

For instance, the dangers and risks of cyber-attacks and the impact of high-frequency trading are developments no one expected just a few years ago.

As we project forward, it is impossible to predict with certainty the challenges ahead. I do believe, however, that the country requires a well-informed and well-funded SEC to protect American investors—from both domestic and international activities.

While the world keeps changing, and while the SEC will need to change with it, the one constant I hope will not change is the commitment of the SEC staff to protecting investors and the markets.

As we project forward, a strong SEC is the only way to be prepared for the future.

Thank you for having me here today.

Number 4

A Few Observations on Shareholders in 2015

Chair Mary Jo White
Tulane University Law School 27th Annual Corporate Law Institute
New Orleans, Louisiana

Introduction

Thank you, Faiza [Saeed], for that kind introduction. I am honored to be here at Tulane's 27th Annual Corporate Law Institute. As usual, you have gathered an incredibly distinguished group to discuss cutting-edge issues in M&A.

Today, I will share a few observations on three specific areas: the current state of shareholder activism; the shareholder proposal process; and fee-shifting bylaws.

I know your next two panels take up aspects of these important topics, but I think the space is lively and big enough for all of us to comment.

The Current Activism Landscape

There are different views on what is meant by "shareholder activism," but just the word "activism" triggers an adverse reaction from many companies.

Reflexively painting all activism negatively is, in my view, using too broad a brush and indeed is counterproductive.

To me, the term activism captures the range of efforts by investors to influence a company's management or decision-making.

Some of it is constructive. In certain situations, activism seeks to bring about important changes at companies that can increase shareholder value.

Now, some of you may find the juxtaposition of the word "activism" with "shareholder value" does not comport with your sense of reality.

Some of you also believe that activists are not interested in increasing long-term value for shareholders and other stakeholders.

Still others will assert that activists are simply short-term traders looking to make a quick dollar.

I did say this was a lively topic with many different views.

Activism is used to achieve a variety of outcomes: board seats or control of the board; an acquisition or spin-off of a non-core or unprofitable line of business; or a share buyback.

Negotiations between an activist and a target company may take place privately, or an activist may choose to go public.

An activist may also begin a campaign behind the scenes, but go public if it believes it is not being heard or making enough progress.

Any of these approaches, if used in the right circumstances, can be compatible with the kind of engagement that I hope companies and shareholders can foster.

Increasingly, companies are talking to their shareholders, including so-called activist ones.

That, in my view, is generally a very good thing. Increased engagement is important and a growing necessity for many companies today.

The activism landscape in 2015 continues to evolve.

While activists traditionally focused on small and significantly underperforming companies, many of them today are also targeting larger issuers that are not necessarily poor performers.

Campaigns also appear to be experiencing greater success.

Activist investors secured at least one board seat in roughly 73% of all proxy fights in 2014, up from the previous year's record of 63%.

And the campaign objectives appear to be shifting, with breakups, a review of strategic alternatives, and corporate control transactions featuring more prominently, and governance issues arising less frequently.

Hedge funds are playing a much more prominent role in this space and their size and influence are growing; interesting, new players are joining their ranks.

The total assets under management for such funds has been pegged at more than $120 billion in 2015 — a roughly 30% jump from 2014.

Their growing presence has undeniably changed the corporate landscape.

But is that good or bad, or both?

As you know, an intense debate is taking place in the business, legal and academic communities as to whether activism by hedge funds and others is a positive or negative force for U.S. companies and the economy.

Some believe that activism of all stripes is essential to effect necessary management and board changes at underperforming companies while others contend that certain activism results in short-term gains at the expense of companies and shareholder value in the long run.

Competing economic studies have helped fuel the debate by asserting that activism leads to either increased or decreased long-term economic well-being for targeted companies.

One study, for example, found that activist campaigns are followed by improved operating performance during the five-year period after the campaign, while another study observed that activists' impact on operating performance is, at best, "very unclear."

It is an interesting and important debate, but our role at the SEC is not to determine whether activist campaigns are beneficial or detrimental in any given circumstance.

Rather, the agency's central focus is making sure that shareholders are provided with the information they need and that all play by the rules.

Our staff in the Division of Corporation Finance typically gets involved once an activist campaign becomes public, be it by way of a proxy fight or other non-routine proxy solicitation, a tender offer, or pertinent disclosure in an investor's beneficial ownership reports.

The staff reviews materials related to these campaigns to facilitate compliance with the applicable disclosure requirements so that

shareholders receive the information necessary to make an informed investment or voting decision.

No matter how contentious the relationship is between the activist and the company, or how high the stakes, all parties, including activists and management, are obligated under the federal securities laws to provide shareholders with timely, clear, complete and accurate disclosures about the subject matter and their interests.

All parties should make their obligations under the federal securities laws a high priority.

For example, parties should be mindful of the requirements under Regulation 13D-G to file their initial and amended beneficial ownership reports on a timely basis, and provide accurate and complete disclosure about their plans or proposals, rather than recite boilerplate that obfuscates their true intentions or their coordination with other investors.

The concern about inaccurate and incomplete beneficial ownership reports is not theoretical.

Just last week, we brought actions against eight individuals and entities — including officers, directors and major shareholders — for failing to update their 13Ds to reflect material changes, including a series of significant steps to take the companies private.

Activists and companies should also pay special attention to Exchange Act Rule 14a-9 — the prohibition against making material false and misleading statements or omissions in proxy solicitations — as they make their cases for or against change in their fight letters and other communications under the federal proxy rules.

While I appreciate the importance of allowing the parties to fully debate the issues in what may be adversarial situations, they should be careful not to make claims or accuse others of wrongdoing without an adequate factual foundation.

While I am on the topic of disclosure, it was implicated in an interesting way in a recent takeover bid this past year — a bid with which you are likely familiar.

In that bid, we saw a unique pairing of a strategic bidder and an activist hedge fund in which the parties took novel and, for some, controversial steps that generated significant interest.

Initially, the hedge fund publicly sought to call an informal meeting of the target company's shareholders and filed a proxy statement with the Commission for a solicitation in connection with such a meeting, which it referred to as a "shareholder referendum" — a mechanism not provided for in the company's bylaws.

The objective was to seek shareholder support in favor of a non-binding resolution to request that the target's board promptly engage in good faith negotiations about an acquisition of the company.

Some questioned whether a shareholder has the ability to call a meeting of shareholders outside of a company's bylaw framework, hold a non-binding vote by way of a proxy solicitation, and file a purported proxy statement under the proxy rules.

Specific questions were raised about whether communications relating to such a shareholder referendum should be allowed to be filed as soliciting materials under the Commission's proxy rules.

The concern was that doing so could give the disputed materials a form of official imprimatur.

All fair questions.

SEC rules do not specifically address shareholder referendums. And it is state law and a company's corporate instruments that provide the rules for shareholder meetings and specify what are proper matters for shareholder action.

Whether a shareholder referendum is a form of proper corporate action under state law is thus a question best left to state legislatures and the courts.

For our part, the Commission has long taken steps to facilitate shareholders communicating with one another.

Our federal proxy rules, which quite broadly define the term "solicitation," provide procedural protections that support the exercise of voting rights granted under state law.

To fully effectuate that objective, the staff has a longstanding practice of accepting and looking at all filings, even if it is unclear whether the filing was required under our rules as a "solicitation."

Whenever a filing is made, we expect it to fully comply with the applicable disclosure requirements, and filers assume potential liability under the federal securities laws.

The staff's goal in such a situation is to ensure that the filing complies with the applicable rules and that shareholders are provided with complete and accurate material information.

The alternative in this context would be for the referendum to go forward under the radar, without public disclosure, without SEC staff oversight, and without the protection of our rules.

Ultimately, the shareholder referendum I mentioned was abandoned and the hedge fund called a special meeting of the target company's shareholders pursuant to the company's bylaws.

We do not know whether other activist shareholders will try the shareholder referendum approach in future campaigns.

If they do, you can expect the SEC staff to perform its oversight role of ensuring that investors receive timely, complete and accurate disclosure.

Even though the SEC staff does not act as a "merits or behavior referee," parties should still take a hard look at their actions and rhetoric and consider whether they are engaged in a constructive dialogue and facilitating a constructive resolution.

I recognize, of course, that highly sophisticated strategies have come to dominate proxy fights and takeover bids; I have been involved in them as a private sector lawyer.

And it is not my intent to threaten the vibrancy of anyone's practice area.

But I do think it is time to step away from gamesmanship and inflammatory rhetoric that can harm companies and shareholders alike.

Fortunately, by some accounts, companies and activists are starting to make positive progress, as they increasingly engage with each other and negotiate outcomes that seem more mutually beneficial.

* * *

Rule 14a-8 Shareholder Proposals

Shareholders obviously do not have to resort to a proxy contest to engage with companies. They can and often do engage through the SEC shareholder proposal process.

Exchange Act Rule 14a-8 enables shareholders meeting certain requirements to have their proposal included in a company's proxy materials.

And shareholders often take advantage of this option. By one count, over 400 shareholder proposals were voted on at U.S. companies in 2014.

The total number of shareholder proposals submitted to companies was undoubtedly much higher as this tally does not reflect the proposals that may have been submitted and withdrawn as a result of negotiations between companies and their shareholders, or that may have been excluded under our shareholder proposal rule.

This proxy season, there has been special interest in the shareholder proposal and staff no-action process.

I played a role in that.

The initial event that sparked interest was the staff's decision in December on a no-action request by a company to exclude from its proxy materials, under Rule 14a-8(i)(9), a shareholder proposal seeking proxy access, on the grounds that it directly conflicted with a proposal subsequently made by the company.

Many other companies have received similar shareholder proposals, and, after the initial no-action letter was granted, they made similar arguments in seeking no-action letters from the staff to exclude the proposals.

One shareholder proponent raised questions about the proper application of our rules and sought reconsideration of the staff's initial decision to issue a no-action letter.

Others raised questions as well.

After reviewing the proposals, counterproposals and competing arguments, I was not comfortable that I or the staff had sufficient opportunity to

consider the questions and concerns that were raised about how to interpret the term "directly conflicts" under Rule 14a-8 in the particular context presented.

So, I requested that the staff review the appropriate application of the provision and report to the Commission on its findings.

In light of the pending review, the Division of Corporation Finance decided not to express a view on the provision during the current proxy season.

The staff's review is ongoing, and it would not be appropriate to talk about the specifics of the proposal or staff responses. But I would like to make a few comments about our shareholder proposal rule and the no-action process generally.

Every year, the staff receives approximately 300-400 requests to exclude shareholder proposals under Rule 14a-8.

A team of staff members reviews these requests and provides a response to assist both companies and shareholders in complying with the rule.

While the staff strives for consistency and correctness in the administration of this process, their informal responses are neither "precedent" nor binding on the Commission or a court.

And, over time, views and interpretations may evolve, and changes may be reflected in guidance, interpretation, or rule changes if necessary.

While the staff works tirelessly to review and respond to all requests consistently and in a timely manner, they have the discretion to decline to review requests for no-action letters.

It is, and should be, rare for the staff to decline to review a request, but it does happen, as it did this proxy season.

There has been considerable discussion — and some not insignificant consternation — about my direction to the staff to examine the application of Rule 14a-8(i)(9) and the staff's subsequent decision to decline this season to review requests asserting that rule as a basis for exclusion.

I recognize that my direction and the staff's decision has raised new questions and resulted in a change in how some companies were expecting to address some shareholder proposals this season.

While any frustrated expectations are regrettable, my request was driven by a deeper concern that the application of (i)(9), as originally interpreted by the staff, could result in unintended consequences and potential misuse of our process.

The purpose of the review is to think carefully about the application of the rule and a variety of related questions.

Keith Higgins, our Director of the Division of Corporation Finance, recently discussed a number of these questions.

By way of example, if a management proposal is made in response to a shareholder proposal on the same subject matter, does that end the inquiry — and the company may exclude the shareholder proposal because it "directly conflicts" with management's proposal?

What if the proposals have the same subject matter, but the terms differ?

What if management's proposal could be viewed as a proposal that, if adopted, may purport to provide shareholders with the ability to do something, such as call a special meeting or include a nominee for director in a company's proxy materials, but that, in fact, no shareholder would be able to meet the criteria to do so?

If a company excludes a shareholder proposal because it conflicts with the company's own proposal on the same subject matter, should the company have to disclose to its shareholders the existence of the shareholder proposal?

What if the company's competing proposal was offered only in response to the shareholder's proposal — should the company have to disclose its motivations for its own proposal?

I am looking forward to the results of the staff's review on these and other questions.

In impartially administering the rule, we must always consider whether our response would produce an unintended or unfair result. Gamesmanship has no place in the process.

* * *

Fee-Shifting Bylaws

Changing focus a bit, I would like to briefly mention one more issue that appears to be getting some initial traction in the issuer community — fee-shifting bylaws.

A great deal of debate has taken place about bylaw and charter provisions that shift the company's costs in shareholder litigation to the plaintiff shareholder if the shareholder loses or is not entirely successful on all claims.

Just for context, the so-called "American rule" is that each party in litigation generally bears its own costs.

In shareholder derivative actions, however, courts can require that a company pay the attorneys' fees of a successful shareholder out of the proceeds of any judgment or settlement.

This is designed to incentivize a shareholder to bring suit where the costs could be high and the individual return may be small but shareholders as a whole could benefit.

Under the federal securities laws, Section 11(e) of the Securities Act also allows, in the court's discretion, the imposition of costs and attorneys' fees against either party whose suit or defense is found to have been without merit, including in class actions.

In May 2014, the Delaware Supreme Court ruled that a fee-shifting provision in a bylaw could be valid under Delaware law, although it left open the questions of whether the manner in which the provision was adopted or the circumstances under which it would be invoked could make the bylaw unenforceable.

Thereafter, more than 40 companies adopted some form of similar fee-shifting provisions.

Concerns have been expressed that such bylaws could stifle shareholder actions against companies because the provisions are one-sided and only apply to shareholders who lose, including, in some situations, those who lose any part of their claim.

Recently, the Delaware Corporation Law Council recommended that the Delaware General Corporation Law be amended to expressly prohibit

companies from including fee-shifting bylaws for claims brought against officers and directors for violation of their state law duties, but no action has been taken to date.

There have been calls for the Commission to intervene in some way, including possibly participating by way of an amicus brief in an appropriate case to advance possible pre-emption and/or public policy arguments.

While I am not commenting today on such calls or the merits of any particular argument, I will say that the SEC and courts have long recognized that the ability of shareholders to bring an action under the federal securities laws provides them with an important remedy that can complement our enforcement actions.

Our staff is thus keeping a very close eye on the evolving developments, and I am too.

Specifically, our staff is focused on making sure the disclosures in company filings about its fee shifting provision — and the implications of such provisions — are clear.

If a company chooses to adopt a fee-shifting provision, it should clearly communicate to shareholders the specific features of the provisions and its effect on shareholders' ability to bring a claim.

Shareholders should be fully informed of a company's efforts to affect their ability to seek redress so that the issue can be considered in voting and investment decisions.

I am concerned about any provision in the bylaws of a company that could inappropriately stifle shareholders' ability to seek redress under the federal securities laws.

All shareholders can benefit from these types of actions.

If the Commission comes to believe that these provisions improperly hinder shareholders' exercise of their rights, it may need to weigh in more directly in this discussion, as it did with indemnification under the Securities Act.

Conclusion

Let me stop here.

What I have been advocating a bit today is a more open, constructive and balanced approach between companies and their shareholders.

Companies should continue toward greater engagement with their owners, and carefully listen to their views.

Activists should act responsibly and according to the rules.

The strategic creativity of lawyers on either side may not always best serve the public interest. Upending the traditional roles of management, boards, and shareholders should not be the objective.

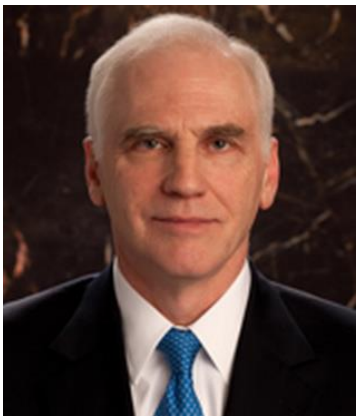
Companies need their management and boards focused on their "jobs" so they can deliver shareholder value and contribute to the economic growth and innovation on which our country has always depended.

But resisting all change, stonewalling every overture or ignoring the views of shareholders is also not acceptable or productive.

Constructive engagement should be everyone's goal.

Thank you. Enjoy your conference.

Number 5



Application of enhanced prudential standards to bank holding companies

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC

Chairman Shelby, Ranking Member Brown, and other members of the committee, I appreciate the opportunity to testify on the threshold in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) for application of enhanced prudential standards to bank holding companies.

In my testimony this morning I will try to provide, from a regulator's perspective, some context for the committee's consideration of this subject by explaining how the Federal Reserve has differentially implemented prudential regulations based on the size, scope, and range of activities of banking organizations, as well as how we have organized our supervisory portfolios.

In both our supervisory and regulatory practices, we are pursuing a tiered approach to prudential oversight.

Regulatory differentiation in the Dodd-Frank Act

Traditionally, statutes creating prudential regulatory requirements or authorities generally took what might be termed a unitary approach.

That is, the statutes simply made a particular requirement or authority applicable to banks or banking organizations generally, with few clear distinctions based on the characteristics of the regulated entities.

The federal banking agencies did adopt some regulations with requirements that applied only to larger institutions.

And, as I will describe a bit later, through supervisory practice they administered some statutory requirements differently based on the size of banks and the scope of their activities.

But the starting point was a more or less similar set of statutory requirements.

The Dodd-Frank Act explicitly broke with this traditional approach by creating prudential requirements that vary with the size or systemic importance of banking organizations.

Of particular importance is the Dodd-Frank Act emphasis on financial stability, both in markets generally and with respect to the largest financial firms, which had been associated with market perceptions that they were too big to fail.

The law created some new authorities for financial regulators and instructed regulators to use authorities they already had to put in place regulations to contain systemic risk.

As to regulations applicable to individual firms, the Dodd-Frank Act creates thresholds for various prudential regulations at asset sizes of $1 billion, $10 billion, and $50 billion.

Of special note is that section 165 of the Dodd-Frank Act requires the Federal Reserve to establish enhanced prudential standards for bank holding companies with total assets of $50 billion or more and other financial firms designated as systemically important by the Financial Stability Oversight Council.

Among other areas, these standards include capital, liquidity, risk management, resolution planning, and single-counterparty credit limits.

Of particular significance is the section 165 requirement that these enhanced standards increase in stringency depending on the size, interconnectedness, role in credit intermediation, and other factors specified in the law.

In addition to these enhanced, graduated standards, section 165 requires that firms with greater than $50 billion in assets be subject to annual supervisory stress tests.

The Federal Reserve has implemented the section 165 requirement of graduated stringency for enhanced prudential standards by creating what are, in effect, three categories within the universe of banking organizations with $50 billion or more in assets.

As required by statute, all firms within this universe are subject to basic enhanced standards.

Firms with assets of between $50 billion and $250 billion are subject only to these basic enhanced standards.

Firms with at least $250 billion in assets or $10 billion in on-balance-sheet foreign assets are also subject to more stringent requirements, including the advanced approaches risk-based capital requirements, the supplementary leverage ratio, the countercyclical capital buffer, and the full-scope liquidity coverage ratio.

Finally, the eight U.S. bank holding companies that have been designated as global systemically important banking organizations will be subject to an additional set of regulatory requirements.

An enhanced supplementary leverage ratio, equally applicable to all eight firms, has already been adopted.

We are also working on two requirements that will vary in stringency even among these eight firms, based on their relative systemic importance.

One is the set of risk-based capital surcharges for which we issued a notice of proposed rulemaking late last year.

The other, on which we anticipate issuing a notice of proposed rulemaking in the coming months, is a long-term debt requirement designed to support effective orderly resolution processes.

In sum, the stringency of the Federal Reserve's prudential regulations increases in proportion to the systemic importance of the banking organizations.

With this tiered approach to regulation, the Federal Reserve aims not only to achieve the Dodd-Frank Act goal of mitigating risks to U.S. financial stability, but to do so in a manner that limits regulatory costs and the expenditure of supervisory resources where not needed to promote safety, soundness, and financial stability.

Tiered regulatory and supervisory experience

The Federal Reserve also takes a tiered approach to supervision.

We organize the firms we supervise into portfolios based predominately, although not exclusively, on asset size.

We have four such groups:

(1) community banking organizations, which are generally those with $10 billion or less in total assets;

(2) regional banking organizations, which have total assets between $10 billion and $50 billion;

(3) large banking organizations, which have total assets over $50 billion but are not among the largest and most complex banking organizations; and

(4) firms overseen by the Large Institution Supervision Coordinating Committee (LISCC), which are the largest and most complex banking organizations.

As with tiered regulation, our tiered supervision is intended to take into account differences in business models, risks, relative regulatory burdens, and other salient considerations.

Where specific regulatory goals for the different portfolios vary, the supervisory programs reflect those differences.

And even where the goals are similar across portfolios, supervisory programs should nevertheless take account of the differences among the firms in the four portfolios.

In general, we shape our supervisory expectations for each portfolio by considering the increase in safety and soundness that we are likely to achieve through a specific practice or requirement, in light of the regulatory costs for the banking organizations in the portfolio and the impact that the stress or failure of those institutions would likely have on credit intermediation, the deposit insurance fund, and financial stability.

So, for example, there are heightened expectations with regard to corporate governance for large banking organizations that are not applied to regional or community banking organizations.

Among other areas, the Federal Reserve expects the boards of directors of these larger firms to set direction and oversight for revenue and profit generation, risk management, and control functions; to ensure that senior

management has the expertise and level of involvement required to manage core business lines, critical operations, banking offices, and other material entities; and to maintain a corporate culture that emphasizes the importance of compliance with laws, regulation, and consumer protection.

While strong corporate governance is important at all banking organizations, it is vital at large banking organizations, given that their systems and operations are typically much broader and more complex than those of the smaller-scale and more localized regional and community banking organizations.

While asset size is the principal determinant of the general supervisory program for a banking organization, other factors are taken into account as appropriate.

For example, if a regional banking organization were to become involved in activities typically undertaken only by larger banking organizations, we might add to that firm's supervision an expectation or practice drawn from the large banking organization portfolio.

Moreover, in determining which banking organizations belong in the LISCC portfolio, the Federal Reserve has focused on the risks to the financial system posed by individual firms - size has not been the dispositive factor.

For example, three large banking organizations are not in that portfolio, even though they have larger balance sheets than the processing- and custody-focused bank holding companies that are in the LISCC portfolio.

The stress or failure of these large, essentially regional banking organizations could have a serious effect on credit intermediation across a significant part of the country and, in some situations of generalized stress, might have consequences for the financial system as a whole.

However, we judge that the functions of the two processing- and custody-focused LISCC firms implicate systemic concerns to a greater extent than the substantial balance sheets of the larger regionals.

The role of statutory thresholds

As I hope by now is apparent, the Federal Reserve has done considerable work to tailor our supervision of banking organizations by reference to their size, business model, and systemic importance.

Similarly, using the statutory discretion granted us, and frequently in cooperation with other regulatory agencies, we have also tailored the application of certain statutory requirements to different groups of banks.

The question of statutory thresholds is thus a fairly narrow one: Does a threshold specify a cut-off point that is appropriate for mandatory application of a particular regulatory requirement, taking into account whatever discretion is given to the implementing regulatory agencies?

In answering this question, it is first worth noting the case for establishing such statutory thresholds.

In the past, Congress has at times not simply given the banking agencies authority to engage in a particular form of prudential regulation, but has required that they do so.

Capital regulation and prompt correction action are two examples.

Not coincidentally, I think, congressional action followed banking crises that revealed possible shortcomings in the regulatory and supervisory structures that had existed preceding the crisis.

In requiring certain kinds of prudential regulation, Congress was in effect protecting against memories of those problems fading and the consequent possibility of supervisory relaxation, which might allow for a recurrence of similar banking problems in the future.

The creation of mandatory thresholds for certain enhanced prudential standards is an important advance in the traditional congressional role of specifying a set of mandatory regulations.

This statutory structure recognizes the substantially divergent risks presented to the economy and the financial system by the potential stress or failure of banking organizations of different sizes and with different activities, while preserving considerable discretion for the banking agencies in implementing those regulations.

Here again, statutory enactment of mandatory measures for banking organizations of a certain size or systemic importance serves as a form of safeguard against the erosion of prudential oversight that could occur were predominant reliance to be placed on the details of firm-specific supervision, which are sometimes hard for the public to discern.

Removal or change of such thresholds, as with generally applicable prudential requirements, will thus require congressional action and an occasion for considered public debate on the merits of such change.

Experience to date, however, suggests that there are some statutory thresholds that might bear reexamination.

One pertains to the applicability of some Dodd-Frank Act provisions to community banks.

For example, the Volcker rule and the incentive compensation requirements of section 956 of the Dodd-Frank Act are directed at concerns generally present only with larger institutions, but the Volcker rule by its terms applies to all banking organizations, and the incentive compensation provisions apply by their terms to all banking organizations with $1 billion or more in assets.

The banking agencies have done their best to tailor the application of these rules to smaller banks and, indeed, to make clear the limited extent to which they should affect those banks.

However, some compliance effort on these rules is still needed at community banks.

Raising the asset threshold for these two requirements to $10 billion would eliminate this compliance burden, the cost of which is probably not worth whatever incremental prudential benefits might be gained at these small banks.

Even in the relatively unusual circumstance in which a practice at a smaller bank might raise safety and soundness concerns, the supervisory process would remain available to rectify any problems.

The second threshold that is worth discussing is the $50 billion level established by section 165 of the Dodd-Frank Act.

As noted earlier, the import of this threshold is to require enhanced prudential standards and supervisory stress testing for banking organizations whose assets exceed that amount.

As also noted, the Federal Reserve has tailored those standards in accordance with the increasing stringency requirement of section 165, so that they are more flexible for institutions closer to the $50 billion

threshold and most demanding for the eight firms of global systemic importance.

It has been somewhat more difficult to customize supervisory stress testing. While some elements of the test, such as the market shock and single-counterparty default scenarios, are applied only to larger firms, the basic requirements for the aggregation and reporting of data conforming to our supervisory model and for firms to run our scenarios through their own models do entail substantial expenditures of out-of-pocket and human resources.

This can be a considerable challenge for a $60 billion or $70 billion bank.

On the other side of the ledger, while we do derive some supervisory benefits from inclusion of these banks toward the lower end of the range in the supervisory stress tests, those benefits are relatively modest, and we believe we could probably realize them through other supervisory means.

These are the factors that lay behind my suggestion last year that it might be worth thinking about the level of this threshold, which I understand to be a purpose of today's hearing.

That said, I want to emphasize a few points.

First, consideration of potential increases in the threshold for mandatory prudential measures should not remove the discretion of the banking agencies to require additional measures - including such things as more capital or liquidity - for specific firms or groups of firms in appropriate circumstances.

That is, while it is sensible to limit mandatory measures for classes of firms where most banks in that class are unlikely to present a particular kind of risk, it would be very ill-advised to preclude supervisors from requiring such measures of firms where that risk may become more of a concern.

Second, any consideration of raising the threshold to take account of the factors I mentioned earlier should not extend to removal of the application of enhanced standards and other rules to the largest banking organizations.

As senators and regulators have discussed many times before in this committee, the tasks of combatting the reality and the perception of too big to fail, and of vulnerabilities in broader financial markets, are crucial and ongoing.

Conclusion

The innovation in the Dodd-Frank Act that requires tiered regulation is central to our shared goals of protecting financial stability and ensuring the availability of credit.

Smaller banks do not pose risks to financial stability, though they can suffer collateral damage when stress builds throughout the financial system.

And, while enhanced prudential standards are important to ensure that larger banks can continue to provide credit even in periods of stress, some of those same enhancements could actually inhibit credit extension by rendering the reasonable business models of middle-sized and smaller banks unprofitable.

The Federal Reserve will continue to use statutory authorities to calibrate our regulation and supervision to the risks posed by the different classes of banks, avoiding a one-size-fits-all approach.

We and, I believe, many others are committed to the dual goals of protecting systemic stability and fostering the efficient intermediation of credit by the overwhelming majority of American banks that do not pose systemic or far-reaching risks.

Thank you. I would be pleased to take any questions you may have.

Number 6

MIFID/MIFIR- CSD hearing before ECON

Steven Maijoor, ESMA Chair,

Dear Members of the European Parliament, Ladies and gentlemen,

I am delighted to have been invited by the Chair and Members of ECON to present the work of ESMA on the delegated acts and implementing measures under MiFID 2 /MIFIR and CSDR.

MIFID2/MIFIR

Let me first comment on MIFID2/MIFIR, which is the most significant piece of Level 2 regulation that ESMA has undertaken since its establishment.

As you know, part of this undertaking is making every effort to ensure that the consultation is as wide and open as possible and that all stakeholders are heard.

We have also updated periodically the Parliament on how the Level 2 measures advanced.

Let me first comment on the Markets area and I will concentrate on three substantive matters (non-equity transparency, commodity derivatives, and microstructure).

Non-equity transparency

As you are well aware, MiFID II introduces a new, ambitious transparency framework applicable to non-equities.

For ESMA, the most challenging task we face at the moment is obtaining and analysing the data needed to set the liquidity and transparency thresholds, because of two reasons:

1) These markets are currently not transparent and so the data available is necessarily limited and of varying quality, and

2) The vast scale and resource-intensive nature of the exercise.

One of the elements that has attracted greater attention is transparency for bonds.

Since transparency is linked to the notion of liquidity, which is not prevalent in European bond markets, the number of bonds that will be transparent is very small: less than 10%.

ESMA proposed a classification of liquidity based on a "class of bonds" concept, built around issuance size.

We are aware of the limitations this entails and the concerns it raises both in the sell- and the buy-side and we are in the process of assessing which changes would be needed.

Commodity derivatives

Our work in relation to commodity derivatives is another hive of activity. The EU is going into new, unchartered territory by implementing the most extensive position limits regime in the world.

ESMA is mindful of the responsibility it has here to set a methodology which balances a unified approach with sufficient flexibility to avoid stifling markets, particularly illiquid ones, and new contracts.

However, in the commodities world it is not just the instruments themselves which will be subject to new regulation.

Commodity firms will have to either curtail some of their 'speculative' trading activity or become authorised under MiFID II, since the exemptions they benefited from under MiFID I are substantially narrowed.

Consequently, the ancillary activity exemption and the thresholds ESMA will set is the focus of interest.

ESMA's aim, in this regard, is to follow a principle of fairness: the exemption is intended to benefit commercial users and producers of commodities but to capture those firms which undertake pure financial trading that is not related to the hedging of their commercial operations.

With that in mind, we will review the thresholds established in the Consultation Paper.

Market Microstructure

In the area of market microstructure, the two "stars" of our proposals are the tick size table and the market making obligations.

ESMA started to conduct, quite early in the process, a significant evidence-based analysis of the interactions between the size of the tick, the incidence of HFT, and the efficiency and depth of the market.

We have kept three basic principles during this process:

1) That competition between venues should not be based on the size of the tick they apply

2) That an adequate relation should be found between the tick and the spread of each share, and

3) That both liquidity and price should be relevant for the determination of the tick size.

We remain convinced of those principles and we are working on how the proposal could be further improved or fine-tuned.

In relation to market making obligations, it is important to stress that we received the task of developing the details of a regime that brings new obligations for a number of firms that are quoting with algorithms.

Inevitably, this will bring big changes to market practices and many stakeholders are aware that their activity will need to adapt accordingly, which is the natural result of Level 1.

We have based our proposals on the concept of incentivising market making, not forcing it, when market conditions deteriorate but requiring a minimum significant presence when market conditions are normal.

After covering these three topics, I would like to mention two procedural points.

Flexibility to intervene in the regulatory process

I have already pointed out to this Committee that the Union has rightly adopted the principle of maximum harmonisation on these matters, with a single EU rule enforced by national supervisors.

However, when a brand new regime like this comes into place, the regulator needs to be extremely vigilant to monitor the unintended impacts in the first months and years of the new regime and be able to conduct adjustments.

However, neither national authorities, nor ESMA have any tool to take quick action should that occur.

Therefore, it will be essential that in the first years after the go-live of MiFID II, ESMA and the EU institutions keep a close dialogue and explore the mechanisms to address regulatory adjustments in a flexible and agile manner.

Implementation timing and effort

I would like to finish the Markets area by stressing how huge an effort the post-regulatory phase will require, for everyone involved, including supervisors, market participants and infrastructures.

The rules will be final only towards the start of 2016, and there will be just 1 year to put in place IT systems, procedures, templates, databases, formats, and reporting.

Although significant resources are being used both in the public and the private sector, it will be a very significant challenge to have all the systems implemented and running by January 3rd of 2017.

Investor Protection

Let me now move to the investor protection side.

MiFID II provides a framework that will support investment firms to act in the best interest of their clients, by improving governance and organisational requirements for firms, strengthening conduct of business rules regulating the relationship with all categories of clients, and introducing new powers to supervisors at national and EU level.

ESMA's technical advice sent to the Commission on 19 December last year is in line with these overarching objectives.

It proposes to the Commission to adopt several measures that will further contribute to the protection of investors across the European Union.

These measures tackle problems which became even more evident during the crisis.

Just to mention a few of them: an industry culture not sufficiently oriented to behave in clients' best interest, and insufficient management of situations of conflicts of interest affecting the way services are provided to clients.

The areas covered by ESMA's technical advice aim, therefore, at proposing more granular measures which range from governance and organisational aspects to specific conduct of business obligations.

All these measures aim at ensuring better design of products, enhanced services to clients, more complete and clear information about their investments, proper management of conflicts of interest, better assessment of the suitability of products recommended to clients, an improved framework to achieve best execution, strengthened protection of investors' assets and a fair and efficient treatment of their complaints.

I would like to stress that the final technical advice submitted to the Commission was the result of a thorough process of stakeholders' consultation and we think it strikes a delicate balance between different views expressed by a wide range of stakeholders, including representatives of investors and the financial industry.

In parallel with the work on the technical advice and the technical standards required to ESMA, we are also working on guidelines mandated by MiFID II.

It is worth mentioning the guidelines on complex products, on knowledge and competence of staff and, jointly with the other ESAs, guidelines on cross-selling, and management bodies.

The common work with the other ESAs brings me to another comment that I consider very relevant in the perspective of investor protection.

In particular, I would like to emphasise that, while MiFID II certainly is an important piece of legislation for the protection of investors, it is not the only one.

In order to ensure the protection of investors irrespective of the product they buy and to avoid regulatory arbitrage, it is of the utmost importance that the legislative framework regulating different products and sectors is aligned.

The adoption of the PRIIPs regulation was an important step in this direction.

CSDR

Let me in the remainder of my contribution talk briefly about CSDR. ESMA has been drafting more than 30 measures under CSDR.

Despite the challenging timeline and the complexity of matters at hand, here we have also consulted extensively: we have held two full consultations, received spontaneous input, and discussed all important issues with stakeholders in several roundtables.

We have done this in very close cooperation with central banks.

The overall input to our Consultation Paper was quite positive and showed progress from the earlier Discussion Paper.

As regards settlement discipline, notably penalties and buy-in, there are still important challenges.

Cash penalties and buy-in are the most difficult topics.

They raise complex technical issues and stakeholders provided significant comments to the consultation paper.

The main points for buy-in relate to who should execute the buy-in when the transaction is not cleared by a CCP or executed on a trading venue.

The CSD? Its participants?

The trading counterparties? Level 1 is unfortunately unclear here and leaves to ESMA the definitions of “the details”.

ESMA proposed that the settlement system, being the CSD and participants, should be the framework in which the buy-in should apply.

Some CSDs and banks are pushing for the buy-in to be executed at trading level: by the clients, or the clients of the clients, of the participant.

They claim, which seems a fair point, that if they face the risk of the cost of the buy-in, they will demand guarantees and collateral to their clients to cover that risk, rendering the system more expensive, which seems contrary to the objective of the Regulation.

However, if the launch of the buy-in is left to the discretion of the ultimate clients, who will be in many cases outside the Union and outside the reach of EU supervisors, this will cause obvious enforceability problems which may render the whole buy-in regime inapplicable.

ESMA is, therefore, facing here an interesting conundrum, which is our current priority.

Let me finally spend a few words on the main point on penalties raised during the consultation.

For illiquid instruments, borrowing costs are not an appropriate indicator to set the penalties, as the instruments are simply not available for borrowing.

Therefore, setting a penalty rate on the basis of the borrowing cost may ultimately dis-incentivise trading in those instruments rather than having a deterrent effect on fails, so ESMA is considering this comment and assessing how to best reflect it in its final approach.

Thank you for your attention.

Number 7

Monetary Policy Lessons and the Way Ahead

Vice Chairman Stanley Fischer
At the Economic Club of New York, New York, New York

For over six years, the federal funds rate has, effectively, been zero.

However it is widely expected that the rate will lift off before the end of this year, as the normalization of monetary policy gets underway.

The approach of liftoff reflects the significant progress we have made toward our objectives of maximum employment and price stability.

The extraordinary monetary policy accommodation that the Federal Reserve has undertaken in response to the crisis has contributed importantly to the economic recovery, though the recovery has taken longer than we expected.

The unemployment rate, at 5.5 percent in February, is nearing estimates of its natural rate, and we expect that inflation will gradually rise toward the Fed's target of 2 percent.

Beginning the normalization of policy will be a significant step toward the restoration of the economy's normal dynamics, allowing monetary policy to respond to shocks without recourse to unconventional tools.

I would like to take this occasion to look back on some lessons learned during our time at the effective lower bound on the interest rate, and also to look forward.

Monetary Policy since the Crisis

Let me first take a step back in time.

Prior to the crisis, the financial system was more fragile than we realized.

Key vulnerabilities included excessive leverage, overdependence on short-term funding, and deficiencies in credit ratings, underwriting standards, and risk management.

Importantly, interconnections across financial institutions heightened the risk of contagion through cascading losses.

Some of these interconnections emerged from the use of complicated financial instruments that created seemingly safe and liquid assets.

At the time, it was common to say that risk was being dispersed and allocated to those best able to bear it.

But rather than distributing risk widely, these instruments concentrated risk on the balance sheets of a relatively small number of highly levered financial institutions.

As a result, as the subprime crisis developed, market participants pulled back from risk taking, leading to deleveraging spirals and fire sales.

The damage spread across the globe.

Following the collapse of Lehman Brothers on September 15, international trade collapsed as panic and financial connections transmitted distress across borders.

Of course, the economy's vulnerabilities did not stem from the private sector alone: in the public sector, gaps in the regulatory structure allowed important financial institutions to escape comprehensive supervision, and regulators were insufficiently focused on the stability of the system as a whole.

The Federal Reserve responded aggressively to the crisis.

By the end of 2008, the Federal Open Market Committee (FOMC) had reduced the target federal funds rate from 5-1/4 percent to, effectively, zero.

The Fed also acted forcefully as the lender of last resort--in its traditional role of providing short-term liquidity to depository institutions, and also by providing liquidity directly to borrowers and investors in key credit markets.

In addition, the worldwide scope of the crisis called for concerted international action.

Because of the global nature of dollar funding markets, the Fed authorized dollar liquidity swap lines with major central banks, beginning in December 2007.

In October 2008, central bankers coordinated reductions in policy rates and the Group of Seven agreed to use all available tools to prevent the failure of systemically important financial institutions.

The next month, the Group of Twenty announced a broad common strategy, including fiscal expansion.

These steps likely prevented a second Great Depression, but they were not sufficient to avoid a severe global contraction.

In the United States, with the federal funds rate at its effective lower bound by the end of 2008, the FOMC judged that it could not provide much additional accommodation via its conventional tool--reducing the federal funds rate.

Instead, the FOMC used two unconventional tools: large-scale asset purchases and enhanced forward guidance.

To varying extents, foreign central banks have also been using these tools.

The Fed's asset purchases did not have the conventional aim of increasing reserve balances to pull down short-term rates.

Rather, purchases of longer-term securities lowered longer-term yields through portfolio balance effects.

The evolution of our asset purchases reflected a learning process for policymakers.

In the early programs, the FOMC specified the expected quantities of assets to be acquired over a defined period.

In contrast, with QE3 (the most recent round of quantitative easing, implemented from September 2012 to October 2014), the FOMC announced that we would continue to purchase securities at a certain

monthly pace until the outlook for the labor market improved substantially in a context of price stability.

Later, the FOMC noted that the pace of purchases was also data dependent, allowing the pace to be revised based on its assessment of progress toward its long-run objectives.

With the federal funds rate near zero and the Fed creating and adjusting new asset purchase programs, it became difficult for the public to anticipate how the FOMC would likely conduct monetary policy and respond to changing economic conditions.

Thus, the FOMC began to rely heavily on enhanced forward guidance to communicate its intentions. Forward guidance works in part because it also constrains the flexibility of decisionmakers when the time comes to make their future decisions.

Nonetheless, a number of potential costs might be associated with unconventional tools.

When interest rates are extremely low, risks to financial stability might grow.

In addition, elevated securities holdings could reduce the Fed's income and remittances to the U.S. Treasury when rates eventually rise.

Further, the Fed's quantitative easing appeared significantly to affect foreign asset markets, and to have contributed to a surge of capital inflows to emerging-market economies (EMEs).

Our asset purchase programs were even called a "currency war."

However, eventually, most EMEs seemed glad to receive those flows. Interestingly, the asset purchases recently announced by the European Central Bank (ECB) appear to be putting downward pressure on longer-term interest rates in the United States.

In addition, the ECB's policy should increase growth in Europe, which will be beneficial for U.S. exports.

Although some of these benefits may be offset by the recent appreciation of the dollar, much of that increase likely reflects other factors including the relatively strong performance of the U.S. economy.

Looking back, there is ample evidence that supports the view that the Fed's asset purchases contributed to a stronger U.S. recovery, by raising the prices of the assets purchased and close substitutes, as well as those of riskier assets.

Our experience also shows that forward guidance helped better align market expectations of Fed policy with the Committee's policy intentions.

In brief, unconventional policies helped bring down long-term yields both by reducing term premia and by lowering the expected path of future short-term rates.

The Recovery from the Financial Crisis

Despite monetary stimulus, the recovery from the financial crisis has been even more sluggish than we had expected.

The slow recovery provides more evidence that severe financial crises have long-lived effects, as Reinhart and Rogoff, and others, have documented.

The gradual pace of the recovery has likely reflected both demand and supply factors.

With respect to aggregate demand, the economy faced several important headwinds: efforts by households and businesses to rebuild their balance sheets, persistently tight credit conditions, the extreme weakness of the housing sector, the significant drag from fiscal policy in the years from 2011 to 2013, and the growth slowdown in Europe and other parts of the world.

Turning to aggregate supply, it appears that productivity growth has slowed.

One notable manifestation of slow productivity growth is that last year, unemployment fell significantly further than we had anticipated as of the start of the year--a pattern that occurred in the prior four years as well--whereas gross domestic product growth fell short of our expectations, as it had in three of the four prior years.

However, productivity is extremely difficult to predict.

For my part, I believe that the enormous gains in human welfare that the information technology explosion seems to be generating are likely to

continue, and will perhaps eventually return measured productivity growth to its long-run historical pace.

Conditions for Liftoff

Although the recovery has been slow, there has been significant cumulative progress.

An increase in the target federal funds range likely will be warranted before the end of the year.

Liftoff should occur when the expected return from raising the interest rate outweighs the expected costs of doing so.

In deciding when that time has come, we will continue to monitor a wide range of information regarding labor market conditions, inflation, and financial and international developments.

We anticipate that it will be appropriate to raise the target range when there has been further improvement in the labor market and we are reasonably confident that inflation will move back to our 2 percent objective over the medium term.

Policy Normalization

Full normalization of monetary policy would allow the Fed to rely on its traditional policy framework of adjustments to the federal funds rate.

However, as long as our balance sheet remains sizable, we will not be able to implement monetary policy with our traditional tool of repurchases.

It is important that, when we change the rate for the first time in a long time, we are certain that we have the operational tools to control the federal funds rate--and, accordingly, we have developed and tested new operational tools to control the federal funds rate.

As discussed in the FOMC's statement titled Policy Normalization Principles and Plans, which was published following the September 2014 FOMC meeting, we will use the rate of interest on excess reserves (IOER) as our primary tool to control the federal funds rate.

We also plan to use an overnight reverse repurchase agreement (ON RRP) facility, as needed.

In an ON RRP operation, counterparties may invest funds with the Fed at a given rate, possibly subject to a cap on the aggregate amount invested.

Because ON RRP counterparties include many money market participants that are not eligible to receive IOER, the facility can be a powerful tool for controlling money market interest rates.

Indeed, testing to date by the New York Fed suggests that ON RRP operations have generally established a soft floor for such rates.

However, an ON RRP program also has certain risks.

For example, a large and persistent program could have unanticipated and adverse effects on the structure of money markets.

In addition, in times of stress, demand for the safety and liquidity of ON RRPs with the central bank might increase sharply, potentially exacerbating disruptive flight-to-quality flows.

To mitigate these risks, the FOMC has agreed that it will use an ON RRP facility only to the extent necessary and will phase it out when it is no longer needed.

In addition, the Fed has been discussing and testing other supplementary tools, such as term reverse repurchase agreements and term deposits, and can use these tools as needed to help support money market rates.

With regard to balance sheet normalization, the FOMC has indicated that it does not anticipate selling agency mortgage-backed securities.

When the time comes, we plan to normalize the balance sheet primarily by ceasing reinvestment of principal payments on existing holdings.

When the FOMC chooses to cease reinvestments, the balance sheet will naturally contract, with a corresponding reduction in reserve balances.

This runoff of our securities holdings will also gradually remove accommodation, an effect that we will need to take into account in setting the stance of policy.

During normalization, we will, no doubt, learn more about our different tools and make adjustments to our operating framework.

In part because of this adaptability, I am confident that by using IOER and, as needed, these supplementary tools, we will be able to raise short-term interest rates when it becomes appropriate.

Monetary Policy after Liftoff

The focus of the great bulk of the discussion on monetary policy during the last few years, has been on liftoff--on the circumstances under which the FOMC will choose to raise the federal funds rate, on the date on which that will happen, and on the effect of the Fed's very large portfolio on how it will manage the liftoff process.

Those questions are natural after more than six years during which the federal funds rate has been held at its effective lower bound.

But as liftoff approaches, we need to think also about what will happen next. For liftoff is only the start of the process of normalization, and, going forward, the FOMC will once again be changing the federal funds rate as necessary, both up and down.

Accordingly, discussion of monetary policy needs to begin to shift to the future path of interest rates, and thus to the basis on which the FOMC will set interest rates following liftoff.

There has been a lively discussion of one element of the future path of the federal funds rate: whether liftoff should be sooner with a gradual rise in the rate, or whether liftoff should occur later and be followed by a steeper path of the rate.

These discussions are useful when considering the appropriate timing of the first increase in the federal funds rate.

But what comes after the first increase?

Standard interest rate projections might incline one to believe that the path of the federal funds rate after liftoff will consist of a steady rate of increase from zero to the longer-run normal nominal federal funds rate, which will be equal to the natural real rate of interest plus our 2 percent inflation goal.

One might even look back to the period from 2004 to 2007 and conclude that the FOMC will raise the federal funds rate by 25 basis points every meeting, or every second meeting, or every third meeting, depending on the date of liftoff.

I know of no plans for the FOMC to behave that way.

Why not?

Isn't that what the calculation of optimal control paths shows?

Yes.

But a smooth path upward in the federal funds rate will almost certainly not be realized, because, inevitably, the economy will encounter shocks--shocks like the unexpected decline in the price of oil, or geopolitical developments that may have major budgetary and confidence implications, or a burst of greater productivity growth, as the Fed dealt with in the mid-1990s.

When shocks happen, as they do, policymakers will have to respond to at least some of them.

Accordingly there is considerable uncertainty about the level of future interest rates--a degree of uncertainty that can be estimated statistically, and that should be taken into account by market participants and recognized by the FOMC when it discusses future levels of interest rates.

The uncertainty about future levels of the federal funds rate can be represented in a "fan chart"--that is, a figure showing the expected path of the federal funds rate as well as a range representing the degree of uncertainty around that path.

The two sure elements of forward guidance that the FOMC will be able to offer after liftoff are that monetary policy will continue to be aimed at fostering the Committee's dual objectives, and that it will be data driven.

As we move away from the zero lower bound, the data to which we will be responding will be driven less and less by the financial crisis and Great Recession, and increasingly by post-liftoff economic developments.

Whatever the state of the economy, the federal funds rate will be set at each FOMC meeting on the basis of what the members of the FOMC believe will best enable us to meet our dual goals of maximum employment and price stability over the course of time.

As the FOMC responds to incoming information, it will continue to be absolutely transparent in explaining its decisions and how and why they contribute to meeting the legally mandated dual goals of monetary policy.

That transparency serves three purposes:

First, it is required if we are to be accountable to the public; second, it is the best way of ensuring that monetary policy decisionmakers continue to follow sensible and rational policies; and third, it is the best way of informing the private sector of the basis on which monetary policy decisions are made and will continue to be made.

With respect to forward guidance: its role has been and continues to be important in the long period in which eventual liftoff has been the key interest rate decision confronting the FOMC and the focus of market expectations.

However, as monetary policy is normalized, interest rates will sometimes have to be increased, and sometimes decreased.

Market participants will be able to form their expectations of future interest rates on the basis of three elements: first, the policy record of the FOMC, which might be approximated as a reaction function; second, their analysis of the current economic and financial situation and outlook; and, third, whatever guidance the FOMC will provide as to how it sees monetary policy decisions likely to unfold given the economic situation and outlook.

It is likely that explicit long-term forward guidance will play less of a role in monetary policy after liftoff than it has during the past few years.

Policymakers' behavior is sometimes summarized as a reaction function, which can be an algebraic description of how the interest rate is set--for instance, a Taylor-type rule in which the federal funds rate reacts simultaneously to the rate of inflation and expectations of inflation as well as to the rate of unemployment and expected changes in the level of unemployment.

However, a simple rule of that sort will, by necessity, leave out many factors that appropriately influence monetary policy, such as financial developments, temporary divergences in relationships between different measures of economic activity or inflation, and the like.

A simple rule can provide the starting point for the decisions made by the FOMC, but in reaching their interest rate decision, members of the Committee will always have to use their judgment to identify the special circumstances confronting the economy, and how to react to them.

To ensure that monetary policy operates in as stabilizing a way as possible, the FOMC will continue to set out, as clearly as it can, the basis of every decision that it makes, and to provide guidance on its expectations of future decisions.

And on the basis of the information provided by the FOMC, of their understanding of the historical record of Fed policy decisions, and of their analysis and expectations of the state of the economy and, particularly, the financial markets, market participants will make the best decisions they can.

Number 8

Welcoming remarks

Jaime Caruana, General Manager of the BIS, at the Second BIS Research Network meeting on "Macroeconomics and global financial markets", Basel,

Introduction

Good afternoon, everyone. It is a pleasure to extend my warmest welcome to all of you to the Second BIS Research Network meeting.

The BIS Research Network was set up last year as part of our effort to serve as a bridge between central banks and academics to tackle some of the most pressing conceptual and empirical questions facing central banks today.

The network brings together active researchers from academia and central banks to meet regularly and share findings on issues related to banking, monetary policy, regulation and financial stability.

We hold two network meetings a year, alternating between micro- and macro-related themes.

The inaugural meeting of the BIS Research Network in September last year was "Banking and asset management", and it explored the interaction between capital and liquidity regulation; the adjustment of bank capital to Basel III; the cyclical behaviour of leverage; asset management flows; and equilibrium asset prices.

Today, the second research network meeting is organised around the theme "Macroeconomics and global financial markets".

Judging by the quality of the papers and the authors on the programme, we will have another very fruitful meeting that can enrich the research agenda on the functioning of the economy and its interaction with the financial system.

The significance of this interaction has arguably been underestimated. And it would be especially useful to understand how the underlying links have evolved since the global financial crisis.

Four challenges - many questions

To help set the scene, let me highlight four key challenges that policymakers face today, and pose some of the questions that we at the BIS have been grappling with.

The first challenge is to better understand the current environment of ultra-low interest rates, ample liquidity and unconventional central bank policies.

Interest rates in many countries are now incredibly low, or even negative.

Quantitative measures have resulted in large central bank balance sheets.

How far can this go?

As even long-term yields have turned negative in some cases, we may need to revisit all the familiar analytical rules of thumb that were developed in a world of positive rates and ask how things will work in this new environment.

Are such low rates effective in stimulating demand?

Can they also have side effects that influence the profitability of the financial industry, the build-up of financial risks and the efficiency of resource allocation?

Do they have an unusual impact on income and wealth distribution?

The research to be presented today in the first session sheds light on some of these questions - in particular, the measurement of unconventional monetary policies and their macroeconomic effects.

But clearly more research is needed, especially to clarify the effects of unconventional monetary policies.

A second challenge is to understand better how financial risks have been migrating and morphing, and how much of this is due to central bank policies.

Financial markets have been buoyant in recent years, and accommodative monetary conditions have arguably been an underlying factor.

The dependence of markets on central banks, however, carries the risk of sharp market corrections and evaporating market liquidity, if and when expectations of central bank support are disappointed or are being questioned.

At the same time, as the banking system has been made safer, bond market actors have come to play a bigger role in intermediating funds, as evidenced by the growth of the asset management industry.

These developments pose several questions.

How can we understand the broader impact of central banks on asset prices and risk premia?

How is the behaviour of market participants - their risk-taking and investment decisions - influenced by monetary policy?

Have new risks been emerging in the less regulated parts of the financial system, such as the asset management industry?

Such issues are addressed by the research papers in the second session.

The third challenge is the fall in inflation below objectives in several countries, which has prompted more discussions on the risk of deflation.

How serious is this risk, and what are the potential costs?

How effective can monetary policy be in reducing it, especially when interest rates are already very low?

Can downward wage rigidity be of help, by limiting second-round effects, or be harmful, by increasing the output costs?

Our view here at the BIS is that while we should be alert to deflation risks, we should also be mindful of the risk of overreacting.

Understanding the drivers of disinflation is critical to understanding its potential costs.

And we do not have a good handle on how long-term inflation expectations are formed.

The papers in the third session will examine these issues.

The fourth challenge is the high level of debt. At the global level, total non-financial sector debt is at a record high and seems to be still on the rise.

In other words, outside the financial sector, deleveraging has been limited in the past six to seven years.

A key question for policymakers is how far debt can rise before it becomes a drag on growth or poses a threat to financial stability.

In other words, what is a safe level of debt in an economy?

How much is growth dependent on debt, and is there a way to reduce this dependence?

Is fiscal consolidation self-defeating when the economy is weak, or can it help an economy rebalance?

In the aftermath of a financial crisis, is a strong macroeconomic stimulus to mitigate recessions always a help, or would it at some point become a hindrance to the reallocations of resources necessary for sustaining long-run economic growth?

Research on these critical issues is unfortunately scant.

The papers in the fourth session will try to shed some light.

Closing

The questions are many and the challenges novel. Top-quality research is more important than ever for policymakers.

And this is precisely the reason why we invited you here today.

I am sure that you will come up with a few answers.

But more importantly, I hope you will come up with good and relevant questions.

So let me thank the presenters and all those who will be actively contributing to the discussion.

I wish you a successful and fruitful meeting.

Number 9

SEC Headquarters, Washington, DC

SEC Suspends Trading in 128 Dormant Shell Companies to Put Them Out of Reach of Microcap Fraudsters

The Securities and Exchange Commission announced it has suspended trading in 128 inactive penny stock companies to ensure they don't become a source for pump-and-dump schemes.

The trading suspensions are the latest in a microcap fraud-fighting initiative known as Operation Shell-Expel in which the SEC Enforcement Division's Office of Market Intelligence utilizes technology to scour the over-the-counter (OTC) marketplace and identify dormant companies ripe for abuse.

The proactive efforts have prevented fraudsters from having the opportunity to manipulate these thinly-traded stocks by pumping the companies' stock value through false and misleading promotional campaigns and then dumping the stocks after investors buy in.

Since it began in 2012, Operation Shell-Expel has resulted in trading suspensions of more than 800 microcap stocks, which comprises more than 8 percent of the OTC market.

Once a stock has been suspended from trading, it cannot be relisted unless the company provides updated financial information to prove it's actually operational.

It's extremely rare for a company to fulfill this requirement, and the trading suspensions essentially render the shells worthless and useless to scam artists.

"Operation Shell-Expel continues to be an efficient way to combat microcap fraud by denying fraudsters the empty nests they need to hatch their schemes," Andrew J. Ceresney, Director of the SEC Enforcement Division.

"We are getting increasingly aggressive and adept at ridding the microcap marketplace of dormant shells within a year of the companies becoming inactive."

Today's massive trading suspension identifies dormant shell companies in 24 states and Canada.

The Operation Shell-Expel initiative has been led by William Hankins, Margaret Cain, Robert Bernstein, Victoria Adraktas, LaVerne Patterson, Jessica P. Regan, Leigh Barrett, and John Gibbons in the Office of Market Intelligence with assistance from the Enforcement Division's Delinquent Filings Group.

The SEC appreciates the assistance of the FBI's Economic Crimes Unit.

Number 10

EIOPA Advice to the European Commission Equivalence assessment of the Swiss supervisory system in relation to articles 172, 227 and 260 of the Solvency II Directive

1. Executive summary
Introduction

By letter of 25 February 2014, the European Commission requested EIOPA to update the equivalence advices for Switzerland and Bermuda (under articles 172, 227 and 260 of the Solvency II Directive) and Japan (under Article 172 of the Solvency II Directive) that EIOPA provided in October 2011.

As in 2011, EIOPA publicly consulted on the three reports. On 19 December 2014, EIOPA launched a Public Consultation on the draft 'EIOPA Advice to the European Commission - Equivalence assessment of the Swiss supervisory system in relation to articles 172, 227 and 260 of the Solvency II Directive'.

Content

This Final Report includes the EIOPA Advice and a feedback statement to the consultation paper (EIOPA-CP-14/041). It has been adopted by the Board of Supervisors of EIOPA and was subsequently submitted to the European Commission.

2. Feedback statement

EIOPA would like to thank all the participants to the Public Consultation for their comments.

All the comments received were of general nature; welcoming and supporting EIOPA's work and stressing the importance of an Equivalence determination in respect of Switzerland.

The comments received have not led to a redrafting of the 'EIOPA Advice to the European Commission - Equivalence assessment of the Swiss supervisory system in relation to articles 172, 227 and 260 of the Solvency

II Directive'.

3. EIOPA Advice to the European Commission - Equivalence assessment of the Swiss supervisory system in relation to articles 172, 227 and 260 of the Solvency II Directive

Chapter I: Introduction

Section 1 - Equivalence assessments under Solvency II:

1. Under the Solvency II directive the European Commission may determine whether the solvency regime of a third country is equivalent to that laid down in Solvency II in relation to three areas of focus.

Article 172 relates to equivalence of the solvency regime applied to the reinsurance activities of insurers with their head office in the third country concerned, where a positive determination would allow reinsurance contracts with insurers in that third country to be treated in the same way as reinsurance contracts with EEA insurers.

Article 227 relates to third-country insurers which are part of EEA groups, where equivalence would allow groups to take into account the local calculation of capital requirements and available capital rather than calculating on a Solvency II basis for the purposes of the deduction and aggregation method.

Article 260 relates to group supervision of EEA insurers with parents outside the EEA, where equivalence would mean EEA supervisors would rely on the group supervision of that third country.

2. The European Commission's Call for Advice of 11th June 2010 asked CEIOPS (EIOPA's predecessor organisation) to provide advice on whether the supervisory regimes of certain third countries satisfy the general criteria for assessing third country equivalence.

In its letter of 29th October 2010 the European Commission indicated that Switzerland should be assessed for equivalence under articles 172, 227 and 260.

Following full consultation, EIOPA provided its advice to the European Commission in October 2011.

3. By letter of 25th of February 2014 the European Commission requested

EIOPA to update the equivalence advice for Switzerland.

The updated report is intended to allow the European Commission to take fully-informed decisions in relation to the equivalence of Switzerland under each of the three articles.

4. In revising its report EIOPA has again consulted FINMA (the Swiss Financial Market Supervisory Authority) who provided an update on relevant legislative changes that have taken place since 2011, and on developments in their supervisory approach.

Following receipt of FINMA's input, EIOPA commenced a desk-based review of its previous advice, and following some further written queries which FINMA cooperated fully in answering, completed its deliberations.

5. Equivalence assessments are expected to take into account the principles contained in the Solvency II Directive, as well as the general criteria for assessing third country equivalence to be found in articles 378, 379 and 380 of Implementing Measures (in the form of a Delegated Act).

The assessment against the principles and objectives set out in this report reflect these provisions

6. EIOPA's advice on equivalence refers only to the regulatory regime applying to those insurers which would, by virtue of their size and the nature of their activities, fall within the scope of the Solvency II Directive.

Section 2 - EIOPA Methodology:

7. There are a number of over-arching principles under-pinning the assessment:

- Equivalence assessments aim to determine whether the third country supervisory system provides a similar level of policyholder and beneficiary protection.

- Supervisory cooperation under conditions of professional secrecy is a key, determinative element of a positive equivalence finding.

When assessing the criteria relating to professional secrecy, the principle of proportionality will not apply.

- The equivalence assessment is a flexible process based on principles and objectives (embedded in the general criteria for assessing third country equivalence).

All the applicable criteria (the principles and objectives) need to be met for a positive equivalence assessment; there are a number of indicators associated with these principles to help to guide the assessment, but a positive equivalence assessment does not require that every indicator be fulfilled.

- When pursuing an equivalence assessment, proper consideration should be given to the adequacy of third country practice in applying the proportionality principle.

This is further developed below.

- An equivalence judgement can only be made in respect of the regime in existence and applied by a third country supervisory authority at the time of the assessment.

Plans and on-going initiatives for changing the national supervisory regime should not be considered an adequate support for a positive equivalence finding until the day of their actual implementation.

Nevertheless, these initiatives should be taken into account, with due consideration given to their expected timing and the degree of commitment to them, when performing an equivalence assessment and providing advice to the Commission.

- Assessments will be kept under review and take into account any developments that might lead to relevant changes in the third country supervisory regime.

EIOPA will review its advice at least every 3 years or upon learning of significant developments within jurisdictions already found equivalent.

8. For a criterion to be considered equivalent, the third country supervisory authority must provide evidence that the relevant national provisions exist and are applied in practice.

The process of assessing each principle and objective requires a judgmental weighting of numerous factors.

Proportionality

9. The proportionality principle is embedded in the Solvency II Directive, Article 29 (4) of which states that: "[...] Implementing measures [should ensure] the proportionate application of this Directive, in particular to small insurance undertakings".

Consistently with this, the Directive:

- Recognises that the principle of proportionality should apply to captives, given that they only cover risks associated with the group to which they belong (Article 13 (2) and Recital 21 Solvency II Directive);

- Introduces a requirement for the system of governance to be proportionate to the nature, scale and complexity of the (re)insurance undertaking's operations (Article 41 (2) Solvency II Directive);

- Allows, where necessary, for simplified methods and techniques to be developed to calculate technical provisions in order to ensure that methods are proportionate to the nature, scale and complexity of the risk supported by the (re)insurance undertaking, including captive (re)insurance undertakings. (Article 86 (2) (b) Solvency II Directive);

- Allows for simplified calculations for specific risk modules and sub-modules where this is justified taking into account the nature, scale and complexity of the risks faced by insurers, including captives (Articles 109 and 111 (1) (l) Solvency II Directive);

- Establishes an absolute floor for the MCR (Minimum Capital Requirement) of €1.2m for captive reinsurers, as opposed to €3.6m for other reinsurers (Article 129 (1d) (iii) Solvency II Directive); and

- Introduces a requirement for supervisory powers in deteriorating financial conditions to be proportionate and reflect the level and duration of the deterioration of the solvency position of the (re)insurance undertaking concerned.

10. In line with this, in its 1st April 2010 cover letter to the EC, EIOPA stated that equivalence was "a proportionate process. [...]

As such, under each of the Chapters, [EIOPA] has advised that the existence of a proportionality principle in the application of regulatory provisions in 3rd country jurisdictions (contingent upon the nature, scale and complexity

of the risks inherent in the business) should not be in itself an obstacle [...] to the recognition of equivalence."

11. EIOPA has taken the principle of proportionality into account in its equivalence assessments in a manner consistent with the above.

Under this approach application of the proportionality principle could include discretion for the supervisory authority to apply the requirements in different ways as proportionate, but would not include discretion for the supervisory authority to exempt insurers from certain requirements.

For instance, a proportionate application of a requirement for all insurers to have certain function holders could include the supervisory authority being comfortable with a small insurer having one person who holds for example the risk management function and actuarial function at the same time; it would not include a small insurer not having one or other of these functions at all.

EIOPA's advice

12. In undertaking the assessment, the finding for each Principle will be given using five categories: equivalent, largely equivalent, partly equivalent, not equivalent and not applicable.

13. EIOPA's overall advice to the European Commission on the country's equivalence for each article will be given as one of the following:

- Country A meets the criteria set out by the Commission.
- Country A meets the criteria but with certain caveats.
- Country A needs to undertake changes in the following areas (...) in order to meet the Commission criteria for equivalence.

Section 3 - The Swiss insurance sector – an overview:

Overview of the Swiss (re)insurance market

14. Figures for 2013 show that Switzerland had the 16th largest domestic insurance market in the world, with written premiums estimated to be the equivalent of US$ 62,597 million, equating to a 1.35 % share of the world market.

Life insurance business represented 54.7% of the total premium income.

	Premium volume in millions of US dollars (estimated)	Change over 2013 (inflation adjusted)	Share of world market
Total premium volume	62,597	1.99%	1.35%
Life	34,227	2.2%	1.31%
Non-Life	28,370	1.8%	1.4%

15. Premiums per capita in 2013 were estimated to be the equivalent of US$ 7,701, ranking Switzerland first globally by this measure (EU average US$ 2,680).

The figure for insurance penetration (premiums as a % of GDP), estimated at 9.6%, ranked Switzerland 10th (EU average 7.82%).

16. These figures do not properly reflect the importance of the Swiss insurance industry globally.

The financial sector forms an important part of the Swiss economy, making a major contribution to value creation and employment.

Second only to the banking sector, the Swiss insurance sector accounts for a contribution to value creation of around 3% of GDP, with over 48,000 employees in Switzerland and 74,000 abroad working at subsidiaries and branches of Swiss groups (January 2013 figures).

It is home to some of the biggest insurance groups in the world, and around two thirds of the premium volume of the Swiss private insurance industry in 2012 was from business abroad.

17. The insurance sector offers a wide range of products, in direct insurance and reinsurance.

In 2013 the gross premiums of insurers domiciled in Switzerland (including their foreign operations) amounted to CHF 123.3 billion (CHF 35.1 billion for life insurers, CHF 51.3 billion for non-life insurers, and CHF 36.8 billion for reinsurers).

18. Number of supervised entities by type of business as of December 2013

	Insurers domiciled in Switzerland	Branches of foreign insurers	Total
	At the end of 2013 (at the end of 2012)		
Life insurers	19 (19)	4 (4)	23 (23)
Supplementary health insurers	20 (21)	1 (1)	21 (22)
Non-life insurers	60 (60)	43 (41)	103 (101)
Reinsurers	28 (27)	0 (0)	28 (27)
Reinsurance captives	34 (34)	0 (-)	34 (34)
Total number of insurers supervised	161 (161)	48 (46)	209 (207)

Not included in the above table are general health insurers of which there were 14 on 31 December 2013, supervised primarily by the Swiss Federal Office of Public Health (FOPH), but also subject to FINMA supervision in relation to their supplementary health insurance cover based on private contractual agreements.

19. As of end 2013 there were eight insurance groups subject to group supervision by FINMA.

20. Over the period 2009-13 the number of insurers under supervision has remained relatively stable, a fall in the total from 168 to 161 over the five year period being primarily due to a fall in the number of reinsurance captives in 2010.

Overview of the institutional and legal framework for the financial sector of Switzerland

21. The Federal Constitution of the Swiss Confederation of 18 April 1999 (FC) establishes a free market economic system in which own property and economic freedom are guaranteed (Articles 26, 27 and 94 FC).

Economic freedom includes in particular the freedom to pursue private economic activities, including financial services.

22. Articles 95 and 98 of the FC lay down the constitutional basis for the regulation of professional activities in the private sector, and the financial

sector in particular.

The Confederation is empowered to legislate on the banking and stock exchange system, and on private insurance. It may also legislate on other financial services (Article 98 FC).

However, regulatory activities undertaken by the state must always pursue a legitimate aim (i.e. they must be conducted in the public interest), and are bound by the constitutional principle of the rule of law including proportionality (Article 5 FC).

23. The Financial Market Supervisory Act of 22 June 2007 (FINMASA) serves as an umbrella law for sector-specific laws governing financial market regulation and supervision.

It entered into full force on 1 January 2009.

24. In addition to setting the organisational parameters for FINMA as an institution, including its liability, the FINMASA defines principles for the regulation of financial markets, as well as a set of harmonised supervisory instruments and sanctions. Seven sector-specific Federal Acts issued by the Federal Parliament (referred to as the "Financial Market Acts") complement the FINMASA: the Banking Act (BA), the Stock Exchange and Securities Trading Act (SESTA), the Collective Investment Schemes Act (CISA), the Insurance Supervision Act (ISA), parts of the Insurance Contract Act (ICA), the Anti-Money Laundering Act (AMLA), and the Mortgage Bond Act (MBA).

25. Statutory ordinances issued by the Federal Council (Insurance Supervisory Ordinance, Ordinance on the Levying of Fees and Duties; Financial Market Audit Ordinance) and by FINMA implement the Financial Market Acts on a second and third level.

26. Circulars (Rundschreiben) and other pronouncements (newsletters, discussion papers, FAQs) issued and published by FINMA provide further guidance on FINMA's interpretation and practical implementation of relevant financial market legislation.

They provide substance to the intention of the legislator as conveyed in acts and ordinances.

Switzerland has a partial system of self-regulation in place.

Self-regulation is practically non-existent in insurance regulation, except for anti-money laundering.

Chapter II: Overall assessment

EIOPA advice on Switzerland's equivalence under Article 172

27. EIOPA's advice is that Switzerland meets the criteria set out in EIOPA's methodology for equivalence assessments under Solvency II, but with certain caveats set out below.

These caveats would be mainly addressed by a pending revision of the Insurance Supervisory Ordinance (ISO) assuming the current draft is implemented and enters into force in 2015.

The Federal Council is expected to adopt the amended ISO in February 2015 which would then enter into force before July 2015.

28. We find FINMA equivalent with regard to its powers and responsibilities as a supervisory authority.

29. We find FINMA equivalent with regard to its professional secrecy and information exchange obligations under Principle 2.

30. We find FINMA equivalent with regard to its authorisation of reinsurance business.

31. We find FINMA largely equivalent with regard to Principle 4, taking into account the current differences around public disclosure, internal audit and compliance requirements for solo undertakings.

These caveats would be mainly addressed by a pending revision of the Insurance Supervisory Ordinance (ISO) assuming the current draft is implemented and enters into force in 2015.

EIOPA notes that the details of the public disclosure regime are not yet known.

32. We find FINMA equivalent with regard to its requirements around changes in business, management and qualifying holdings.

33. We find FINMA equivalent with regard to its solvency regime for insurers and reinsurers subject to the SST.

EIOPA advice on Switzerland's equivalence under Article 227

34. EIOPA's advice is that Switzerland meets the criteria set out in EIOPA's methodology for equivalence assessments under Solvency II.

35. We find FINMA equivalent with regard to its professional secrecy and information exchange obligations under Principle 2.

36. We find FINMA equivalent with regard to its solvency regime for insurers.

EIOPA advice on Switzerland's equivalence under Article 260

37. EIOPA's advice is that Switzerland meets the criteria set out in EIOPA's methodology for equivalence assessments under Solvency II, but with certain caveats set out below.

These caveats would be mainly addressed by a pending revision of the Insurance Supervisory Ordinance (ISO) assuming the current draft is implemented and enters into force in 2015.

The Federal Council is expected to adopt the amended ISO in February 2015 which would then enter into force before July 2015.

38. We find FINMA equivalent with regard to its powers and responsibilities as a supervisory authority.

39. We find FINMA equivalent with regard to its professional secrecy and information exchange obligations under Principle 2.

40. We find FINMA equivalent with regard to the scope of its group supervision.

41. We find FINMA equivalent with regard to its co-operation and exchange of information with other supervisory authorities under Principle 9.

42. We find FINMA largely equivalent with regard to its governance and public disclosure requirements, because we note that its public disclosure requirements are not as extensive as those under Solvency II (although for some undertakings this may be supplemented by the requirements of the Swiss Stock Exchange or the Swiss Code of Best Practice for Corporate Governance).

These caveats would be mainly addressed by a pending revision of the Insurance Supervisory Ordinance (ISO) assuming the current draft is implemented and enters into force in 2015.

EIOPA notes that the details of the public disclosure regime are not yet known.

43. We find FINMA equivalent with regard to its requirements around changes in business, management and qualifying holdings.

44. We find FINMA equivalent with regard to its solvency regime for insurance groups.

Chapter III: Assessment of each principle

Principle 1 - Powers and responsibilities of third country supervisory authorities

Objective - The supervisory authorities of the third country have the necessary means, and the relevant expertise, capacity, and mandate to achieve the main objective of supervision, namely the protection of policyholders and beneficiaries regardless of their nationality or place of residence.

In particular, the supervisory authorities in that third country shall have the necessary capacities, including financial and human resources.

For reinsurance assessments:

The supervisory authorities of the third country are empowered by law or regulation to effectively supervise domestic insurance or reinsurance undertakings carrying out reinsurance activities and to undertake a range of actions, including the ability to impose sanctions or take enforcement action in relation to the domestic insurance or reinsurance undertakings carrying out reinsurance activities that it supervises.

For group supervision assessments:

The supervisory authorities of the third country shall be empowered by law or regulation to supervise insurance and reinsurance undertakings which are part of a group.

The supervision of insurance and reinsurance undertakings which are part

of a group shall be carried out effectively and the supervisory authorities of the third country shall be empowered by law or regulation to undertake a range of actions, including the ability to impose sanctions or to take enforcement action in relation to the group that it supervises.

The supervisory authorities of insurance and reinsurance undertakings which are part of a group shall be able to assess the risk profile and solvency and financial position of that group as well as its business strategy.

The supervisory authority

FINMA's responsibilities and enforcement powers

45. According to Articles 1 (1), 3 (a) and 6 (1) FINMASA, together with Articles 2 (1) and 46 (1) ISA, FINMA is, inter alia, responsible for the supervision of Swiss insurers and branches of foreign insurers that operate direct insurance business, of Swiss insurers that operate reinsurance business, and of insurance groups as well as insurance intermediaries.

46. However, branches of reinsurers with their head office outside Switzerland are not supervised by FINMA.

47. Where a supervised person or entity violates the provisions of the FINMASA or of a Financial Market Act or if there are any other irregularities, FINMA is empowered to ensure the restoration of compliance with the law (Article 31 FINMASA).

Freedom from undue political, governmental and industry interference in the performance of supervisory responsibilities

48. FINMA is an independent institution under public law (Article 4 FINMASA).

FINMA can carry out its tasks objectively and efficiently without influences from other bodies (Article 21 FINMASA: “FINMA carries out its supervisory activity autonomously and independently”).

Institutional independence allows FINMA to organise itself as it determines to be most practical, and consistent with the legal provisions.

Furthermore FINMA is responsible for its own budget.

Transparency of supervisory processes/procedures

49. FINMA acts as a transparent and informative supervisory authority.

For example, the website of FINMA is used as an information hub enabling supervised entities to access the rules that apply to them and keeping all stakeholders informed.

Adequate financial and non-financial (e.g. sufficient numbers of appropriately skilled staff) resources

50. FINMA is equipped with adequate financial and non-financial resources.

FINMA is responsible for its own budget financed by supervised entities.

FINMA also has a sufficient number of appropriately skilled staff (468full-time equivalents as at end December 2013).

Appropriate protection from being liable for actions taken in good faith

51. FINMA is only liable if its management bodies or its staff have committed a breach of fundamental duties, and the loss or damage is not due to a breach of duty by a supervised person or entity (Article 19 FINMASA).

In this way FINMA benefits from appropriate protection from being held liable for actions taken in good faith.

Powers to take preventative and corrective measures

52. FINMA has evidenced its powers to take preventative and corrective measures to ensure that insurers comply with the applicable laws, regulations and administrative provisions.

This includes in particular the ability:

- to obtain all information necessary to conduct the supervision of the insurer or insurance group (for example under Article 29(1) FINMASA and Article 47(1) ISA);

- to ensure compliance on a continuous basis with laws, regulations and administrative provisions (including through on-site inspections) including measures to prevent or penalise further infringements (including preventing the conclusion of new contracts) (for example under Article 31 FINMASA and Articles 47 (1) and 51ISA);

- to communicate concerns, including those relating to the insurer or insurance group's financial position (for example under Article 46(1d) ISA); and

- to oblige the insurer to respond to concerns raised by the supervisor (for example under Article 31FINMASA).

Financial supervision

53. FINMA has also demonstrated the existence and extent of its powers in respect of financial supervision.

In the area of governance its regulations, supported by circulars and other pronouncements, require insurers to meet requirements in various areas of governance including the assessment of the financial condition of the insurer or insurance group.

FINMA regulations and circulars also include requirements for risk management, internal controls, internal and external audit and the actuarial function.

These areas are also included in the supervisory review that is done under the Swiss Qualitative Assessment (SQA).

54. The solvency of an insurer is measured by the Swiss Solvency Test (SST), (Article 9 ISA and Article 22 (1b) ISO).

A total balance sheet approach is used to determine own funds. Assets and liabilities are valued market consistently.

The reference date for the SST is typically 1January for individual insurers and both 1January and 1July for insurance groups.

Accounting standards

55. Insurance groups which are listed on the SIX Swiss Exchange according to the main standard must apply IFRS or US GAAP as their accounting

standard, whereas groups which are listed according to the domestic standard are additionally permitted to use Swiss GAAP FER.

56. The statutory accounting of the legal entities is based on the requirements of the Swiss Code of Obligation -which now includes a new standard approach for financial reporting for all legal entities governed by private law -supplemented by specific accounting requirements from FINMA.

The governance requirements for internal controls also apply to accounting.

It should be also mentioned that the Federal Council may issue deviating regulations from the Accounting Law, if this is justified by the specific characteristics of the insurance business or the protection of the policy holders.

Qualifying holdings

57. Qualified interests in an insurer are defined as 10% of the capital or the votes or other means of exercising significant influence (Article 4 (2f) ISA).

FINMA monitors such interests as part of the business plan. If the business plan requirements are not met, FINMA could ultimately withdraw the licence.

In the context of acquisitions and disposals, FINMA may prohibit a transaction or impose conditions if the nature or extent of the holding might endanger the insurer or the interests of the insured (Article 21(4) ISA).

Supervisory powers available to the authority in respect of undertakings in difficulties

58. FINMA is empowered to take actions to protect the interests of the insured (Article 51 (1) ISA).

Such actions include FINMA's competence to assign assets of the insurance companies to tied assets up to the amount6 required in accordance with Article 18ISA (Article 51(2)(h) ISA).

Similarly, if there is a risk of insolvency, FINMA can order deferral and extend the due date for payments (Article 51(2)(i) ISA).

59. Where solvency requirements are not met, measures such as a reduction of valuations of assets or a prohibition against reducing own funds through dividend payments or share repurchases are possible.

The insurer or insurance group may also be requested to build up capital or de-risk its activities, for example by selling particularly risky assets.

The writing of new business could be restricted.

Finally, FINMA may suspend or withdraw the approval to operate as an insurer for one or all insurance classes (Article 37 FINMASA).

In the event that an insurer's licence is withdrawn, FINMA orders liquidation (Article 52ISA).

60. FINMA has the competence to institute and conduct insurance bankruptcies (articles 53-56 ISA, and FINMA Insurance Bankruptcy Ordinance that sets out the procedure), but not for key non-regulated companies (e.g. the holding company) within insurance groups and conglomerates domiciled in Switzerland.

It is foreseen that this gap will be closed in the context of the new Financial Market Infrastructure Act through the enactment of two new provisions in the ISA.

The scope for appeals in bankruptcy proceedings will also be limited.

The relevant amendment is expected to enter into force in the first half of 2015.

61. The ISA describes a recovery process which takes place before bankruptcy proceedings are instituted (Article 53 (1) ISA).

FINMA's material recovery powers are essentially defined in Article 51 ISA, however, the law does not provide detailed procedural provisions.

FINMA has mentioned that it plans to incorporate a formal recovery process into the ISA, by taking due account of the requirements of the Financial Stability Board ("Key Attributes of Effective Resolution Regimes for Financial Institutions" of October 2011).

In particular, FINMA has expressed its intention to submit to the Federal Department of Finance (FDF) the following proposals amending the ISA:

- Extension of the scope of restructuring legislation with regard to holding and group companies;
- Encroachment upon shareholder's rights;
- Compulsory participation of creditors in the insurer's debts ("bail in");
- Intervention in insurance contracts;
- Continuance of insurance benefits / transitional insurance;
- Revocation of rights of the annual general meeting;
- Exercise of rescission and responsibility claims.

Enforcement actions available to the authority

62. FINMA has a toolkit of various measures.

In particular:

- Where the supervised entity has seriously violated supervisory provisions, FINMA may issue a declaratory ruling (Article 32 FINMASA) (i.e. a form of public censure).
- Where there has been a serious violation of supervisory provisions, it may prohibit the person responsible from acting in a management capacity at any entity subject to its supervision (Article 33FINMASA).
- Where there has been a serious violation of supervisory provisions, FINMA may publish in electronic or printed form its final ruling once it takes full legal effect, and disclose the relevant personal data (Article 34 FINMASA).
- FINMA may confiscate any profit that a supervised entity or a responsible person in a management position has made through a serious violation of the supervisory provisions (Article 35(1) FINMASA).
- FINMA may appoint an independent and suitably-qualified person to investigate circumstances relevant for supervisory purposes (Article 36(1) FINMASA).

- FINMA will revoke the licence of a supervised entity, or withdraw its recognition or cancel its registration, if it no longer fulfils the requirements for its activity (Article 37FINMASA).

Cooperation with other authorities/bodies

63. FINMA has the ability to cooperate with domestic authorities (Article 39 FINMASA), in particular with prosecution authorities (Article 38 FINMASA).

FINMA has the power to cooperate with foreign supervisory authorities to ensure compliance with financial market regulation (Articles 42 and 43 FINMASA).

Specificities for 172

Type and frequency of accounting, prudential, statistical information obtainable by the supervisory authority from an undertaking

64. Individual insurers:

- An annual management report as of 31 December of each year, consisting of the annual accounts, annual report and, if required by corporate law or if the insurer is part of an insurance group or conglomerate, the consolidated accounts for the group.

- An annual supervisory report (Aufsichtsbericht) including details on solvency margins, technical provisions (gross and net), lines of business, type of reinsurance treaties, geographical information, details on investments categories and other information.

- A report on the regulatory audit by the external auditors including specific audit programmes initiated by FINMA if applicable and the detailed report of the statutory report to the Board of Directors as well as a risk analysis (Circular 2013/3).

- An annual Swiss Solvency Test report on “the calculation of target capital and risk-bearing capital”.

Entities which are part of a group subject to FINMA group supervision have to report on a biannual basis.

- An annual report “to control the available solvency margin” under

Solvency I (Article 40(1) ISO).

- An annual update on "transactions in derivative financial instruments".

- A report on liquidity risks and liquidity situation for insurance companies in supervisory category 28.

Insurance companies in supervisory category 3 submit a report to their executive boards.

FINMA has the right to request this report at any time(Circular 2013/5).

- Statistical reporting through FINMA's web-based Insurance Reporting and Supervising Tool (FIRST)

65. In addition, FINMA is empowered to request further information at any time.

Specificities for 260

Type and frequency of accounting, prudential, statistical information obtainable by the supervisory authority from the parent undertaking

66. Groups:

- Consolidated financial statements (biannually).

- Interim supervisory report that is less detailed than the annual supervisory report, and includes reporting on solvency, on investments in general, bond exposures, ABS portfolio positions, financing structure and liquidity.

Currently the frequency of the interim report is quarterly.

- Swiss Solvency Test report (biannually).

- Solvency I report (biannually).

- Risk management documentation (annually).

- Risk report (annually).

- Information on risk management, governance and internal controls

under the Swiss Qualitative Assessment (periodic).

- Further information on the group (Article 194(1) ISO):

o Organisational details (including structure charts, committee structures, organisational processes and details of management personnel) (annually, material changes to be reported within 14days of their taking effect).

o Group structure (in terms of legal entities) (annually, important changes to be reported ad hoc).

o Intra-group transactions (annually, material changes to be reported ad-hoc) (Circular 2008/29).

o Key figures, statistics (bi-annually) through FINMA's web-based Insurance Reporting and Supervising Tool (FIRST-GRE).

67. In addition, FINMA is empowered to request any further information at group level at any time.

EIOPA advice

Articles 172/260

68. FINMA has the necessary means, and the relevant expertise, capacities, and mandate to effectively protect policyholders and beneficiaries regardless of their nationality or place of residence.

FINMA has the power to effectively supervise insurers carrying out reinsurance activities and groups, and impose sanctions or take enforcement action where necessary.

FINMA is able to effectively assess the risk profile, solvency and financial position and business strategy of groups subject to its supervision.

As a result Principle 1 is, in respect of the Solvency II Directive, considered to be equivalent.

Principle 2 - Professional secrecy, exchange of information and promotion of supervisory convergence

Objective – The supervisory authorities of the third country and

supervisory authorities of Member States involved in the supervision of domestic insurance and reinsurance undertakings shall cooperate and, where relevant, ensure the effective exchange of information.

The supervisory authorities of the third country shall provide that all persons who are working or who have worked for the supervisory authorities, as well as auditors and experts acting on behalf of those authorities, are bound by obligations of professional secrecy.

The above mentioned obligations of professional secrecy shall extend to information received from the supervisory authorities of Member States.

General Remarks

69. Articles 42 (2) and (3) FINAMASA serve as a general basis for the exchange of information in an international context, according to which FINMA can provide foreign financial markets supervisory authorities with non-public information and documentation if strict requirements regarding confidentiality and professional secrecy are met.

These requirements also apply to all forms of informal cooperation. Confidential information is understood as any information that is not disclosed to the public.

Internal rules limit the access to classified information through special access requirements.

70. Based on Article 43 (2) FINMASA, FINMA may authorise foreign authorities responsible for financial market supervision to carry out on-site inspections at Swiss establishments of foreign institutions, to the extent warranted for the purposes of group supervision and under the conditions set out for information requests (Article 42 (2) FINMASA).

In turn, FINMA may also request to conduct on-site inspections of Swiss institutions in foreign locations for the purposes of group supervision (Article 43(1) FINMASA).

Ability and willingness to cooperate

71. FINMA has shown on the basis of the above mentioned provisions its willingness to cooperate in information sharing for suitability assessments and in crisis situations under the legal provisions of Article 42 FINMASA.

As well as the practical proof given during the on-site-visit, FINMA has concluded an Agreement with the European Economic Community on direct insurance other than life assurance (1January 1993), and with the Principality of Liechtenstein on direct insurance and insurance intermediaries (9 July 1998), which are an explicit legal basis for information exchange regarding suitability assessments.

Cooperation agreements

72. According to Articles 6 (2), 42 and 43 FINMASA, FINMA is legally authorised to cooperate with foreign supervisory authorities responsible for financial market supervision even in the absence of a formal arrangement such as a Memorandum of Understanding (MoU).

FINMA may enter into administrative arrangements for international cooperation if deemed necessary.

FINMA has entered into bilateral and Multilateral Memoranda of Understanding with all the individual members of the EEA and other authorities, has exchanged letters with the Bermuda Monetary Authority (2010) and has exchanged confidentiality agreements regarding supervisory colleges.

The decision on whether to conclude cooperation agreements which do not qualify as international public law treaties is within FINMA's discretion.

Where no MoU is signed, FINMA may exchange confidentiality agreements in order to coordinate information exchange.

Exchange of information

73. Articles 38 et seq. FINMASA form the general basis for the exchange of confidential information.

Domestically FINMA may cooperate with other Swiss authorities subject to Articles 38 and 39 in conjunction with Articles 40 and 41 FINMASA, and other relevant provisions in the Financial Market Acts.

74. In the international context, based on Articles 42 (2) and(3) FINMASA, FINMA may provide foreign authorities responsible for financial market supervision with non-public information and documentation provided the recipient is subject to official or professional secrecy obligations and the information and documentation provided are only used for the direct

supervision of foreign institutions.

Such information and documentation provided may only be passed on to other authorities and bodies tasked with acting in the public interest if there is a general authority to do so in a bilateral agreement or if FINMA specifically consents.

The information may also be passed on to criminal prosecution authorities if the requirements under the applicable criminal legal assistance regime are met (treaties or Federal Act on International Legal Assistance in Criminal Matters).

FINMA makes decisions in this regard jointly with the Federal Office of Justice (FOJ).

Regime with regard to the professional secrecy obligations the authority must observe

75. FINMA management bodies, staff and mandated third parties as well as mandated persons of FINMA are bound by official secrecy, meaning that they must observe secrecy on official matters (Article 14 FINMASA).

The duty of secrecy continues to apply after termination of employment or membership of a governance body of FINMA.

When these persons are participating in evidentiary hearings and in court proceedings as parties, witnesses or expert witnesses, they are allowed to disclose matters that have come to their knowledge in the course of their duties and that relate to their official tasks only with FINMA's authorisation.

76. The official secrecy obligation (Article 14 FINMASA) mandates that the sharing of confidential information is only possible under the strict and precise conditions set out in Articles 38 to 43 FINMASA, regarding cooperation with domestic and foreign authorities.

FINMA will only consent to handing over information if the principles of Article 42 FINMASA are met (specific purpose, confidentiality, handing over to third party onlywith the prior consent of FINMA).

77. Furthermore, it is FINMA's established policy to hand over information to other domestic or foreign authorities only if the authority from which the information was received confidentially has given prior explicit consent.

This policy is based on Article 42 (2b) FINMASA. According to this provision FINMA may hand over information to foreign authorities if it is guaranteed that the shared information would be passed on to another authority only on the basis of a general authorisation in an applicable international treaty or with FINMA's consent.

By way of reciprocity and equal treatment, FINMA applies this principle of prior consent in the same way where it is the recipient rather than the provider of information.

78. To implement the relevant statutory requirements regarding confidentiality, FINMA has issued a policy note for internal use (Policy Note on Information Protection and Procedure).

This policy note summarizes, inter alia, the rules covering official secrecy and the practical process on how to handle the information received from foreign authorities.

Exceptions to the professional secrecy obligations

79. FINMA may cooperate with other Swiss supervisors and authorities and such cooperation may also include the transfer of confidential information (Articles 38 et seq. FINMASA).

However, FINMA may refuse to transfer information or materials even to public prosecutors and other national authorities if "their disclosure or handover would prejudice on-going proceedings or the fulfilment of [FINMA's] supervisory activity" or if "it is not compatible with the aims of financial market supervision or with [FINMA's] purpose" (Article 40 FINMASA).

FINMA has demonstrated that this legal provision is understood to the effect that requested information should only be disclosed when necessary for supervisory purposes.

In all other cases, where such information would be intended to be used for other purposes (e.g. as proof in a private civil procedure) FINMA refuses disclosure.

80. FINMA commits itself not to disclose information received from foreign supervisors to third parties without the consent of the foreign supervisor and (in the absence of their consent) to make best efforts to oppose possible disclosure orders with all legal means.

Breach of professional secrecy obligations

81. A breach of professional secrecy by FINMA management bodies, staff and all mandated persons of FINMA (investigating agents, restructuring agents, liquidators, administrators in bankruptcy and other mandated persons) constitutes a criminal offence under Article 320of the Swiss Penal Code.

It is subject to monetary sanctions or imprisonment.

EIOPA advice

Articles 172/227/260

82. FINMA's professional secrecy framework provides for a high level of protection for confidential information.

The relevant legal provisions provide for the confidentiality of all information that becomes available to FINMA, be it collected as part of its own supervisory activities or received from third country supervisory authorities.

The Swiss legal framework –and the policy applied by FINMA - allows FINMA to obtain information classified as confidential and to share it with other supervisors and with other administrative bodies only under strict criteria.

FINMA therefore applies the principle of prior consent, whereby information may only be passed on with the prior consent of the authority which provided it (in the case of information provided to FINMA by foreign supervisors and vice versa).

A breach of secrecy requirements is punishable under Swiss law.

On the basis of this legal framework FINMA has the necessary ability -and it has provided proof that it has the necessary willingness -to cooperate with other authorities in the field of information sharing by means of bilateral and multilateral agreements, Memoranda of Understanding and confidentiality agreements as well as in the framework of international agreements and national legal provisions as to cooperation in criminal cases (cooperation with the FOJ).

As a result Principle 2 is in respect of the Solvency II Directive considered to be equivalent.

Principle 3 - Taking-up of business

Objective – The taking-up of the business of reinsurance in the third country shall be subject to prior authorisation.

Authorisation for the taking-up of business shall be conditional on the undertaking meeting a clear, objective and publicly available set of written standards on a continuous basis.

83. Prior authorisation is a formal process, with requirements set out under Article 4 ISA.

As well as the legal requirements for licensing, FINMA has published on its website a guide with details on the licensing process and templates for each legal requirement.

Furthermore FINMA has internal guidelines on the licensing process.

Legal entity

84. According to Article 7 ISA insurers can adopt the legal form of a stock company or a cooperative society.

The scope of FINMA's supervision is set out in Article 2 ISA and covers all kinds of reinsurance activities carried out by domestic insurers and reinsurers. Branches of foreign direct insurance companies are also subject to Swiss supervision.

However reinsurance companies that have their registered office outside Switzerland and that only conduct reinsurance business in Switzerland with or without a branch office in Switzerland are not in the scope of Swiss regulation.

Undertaking's operations

85. Since all insurance activities are within the scope of FINMA supervision, they are subject to prior authorisation.

After the initial contact, where the applicant explains the objectives of the proposed insurer, the applicant submits the application and the business

plan.

The business plan must contain inter alia the financial resources, technical provisions, investment policy, opening balance, planned lines of business and type of risks to be insured, retrocession plan and estimated set-up costs of the insurer, as well as the names of the directors and management board, responsible actuary, and important shareholders.

These set-up costs (called the organisational fund) have to be at least 20% of the minimum capital requirements.

For insurance activities abroad, a permit from the responsible foreign supervisory authority or a comparable certification is essential.

At the end of the licensing process an official notification is issued to the applicant by FINMA.

Any changes to the business plan must be approved by FINMA.

The business plan has to be updated constantly and FINMA has a remit to monitor compliance with it (Article 46 (1c) ISA).

These legal requirements and the parameters for approval are set out in Article 4 (2), Article 5, and Article 6 ISA.

According to Article 8 ISA and Articles 8 and 9 ISO, the minimum capital requirements vary according to the different types of insurance authorisation.

In addition to its insurance activities, an insurer may only operate business directly associated with insurance activities, and, in any case, provided that the interest of the policyholders are not endangered.

Information on shareholders/members

86. In the business plan, details of shareholders have to be disclosed and submitted for approval, whether natural persons (name, place of residence and profession) or legal entities (undertaking, headquarters and business scope).

87. Swiss supervisory law defines a threshold for “qualified investors”.

According to Article 4 (2) ISA a “qualified investor” is one who holds

directly or indirectly at least 10% of the capital or the voting rights in an insurer, or who otherwise exerts significant influence on its commercial activities. For this purpose a register of shareholders containing details on the shareholdings must be submitted.

88. If such qualified positions are acquired after the licence has been obtained, FINMA has to be notified of the change in the business plan.

89. FINMA will review, among other things, the suitability (fitness and propriety) of the qualified investors as well as of the board of directors and the general management.

Close links

90. FINMA's Circular 2008/32 (corporate governance, risk management and internal controls) obliges members of the board of directors and executive management to avoid conflicts of interest. Furthermore with regard to insurance groups there is required reporting to FINMA on intra-group transactions.

Withdrawal of authorisation

91. According to Article 6 ISA, prior authorisation for taking-up of business has to be granted by FINMA, if the legal requirements are met and the interests of the insured are safeguarded.

In contrast to this, FINMA withdraws its approval of authorisation if the insurer no longer satisfies those requirements, in accordance with Article 37FINMASA and Article 61(1a) ISA.

Moreover FINMA has the power to withdraw authorisation if the insurer suspends its commercial activity for more than six months (Article 61(1b) ISA).

EIOPA advice

Article 172

92. FINMA has a sound and prudent process for prior authorisation.

Swiss supervisory law enables FINMA to obtain a comprehensive overview of the insurer's business processes and financial resources.

Moreover FINMA's approach to monitoring the fitness and propriety of shareholders and members is adequate.

As a result Principle 3 is in respect of the Solvency II Directive considered to be equivalent.

Principles 4 and 10 - System of Governance and Public Disclosure

Objective - The solvency/prudential regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to have in place an effective system of governance which provides for sound and prudent management of the business, and require groups to have in place such a system at the level of the group.

That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities, requirements for ensuring that persons managing the undertaking are fit and proper and effective processes to ensure the timely transmission of information both within the undertaking or group and to the relevant supervisory authorities.

The solvency/prudential regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to have in place an effective risk-management system comprising the strategies, processes and internal and supervisory reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis and at an individual and an aggregated level, the risks to which the undertaking is or could be exposed, and their interdependencies, as well as an effective internal control system.

It shall require groups to have in place such a system at the level of the group.

The solvency/prudential regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to establish and maintain risk-management, compliance, internal audit and actuarial functions. Groups shall be required to establish and maintain these functions at group level.

The solvency/prudential regime of the third country shall require groups and domestic insurance and reinsurance undertakings carrying out reinsurance activities to disclose publicly, on at least an annual basis, a

report on their solvency and financial condition.

For group supervision assessments:

The prudential regime of the third country shall require the group to have sound reporting and accounting procedures to monitor and manage its intra-group transactions and risk concentrations and to report at least annually significant risk concentration at the level of the group and significant intra-group transactions.

General Governance Requirements

93. There are rules within the ISA, ISO and Circulars, in particular Circular 2008/32, which apply to insurers and groups and set out the general requirements as to a system of governance.

Fit & Proper

94. Article 14 ISA and Articles 12 to 14 ISO in conjunction with Circular 2008/32specify the fit and proper requirements for the board of directors (Verwaltungsrat) and the management board (Geschäftsleitung).

Risk Management/Effective Internal Control Mechanisms

95. Articles 22, 68 and 76 ISA, Articles 96 et seq., 195 et seq. and 204 ISO and Circular 2008/32 set out FINMA's risk management requirements.

Article 27 ISA in conjunction with Circular 2008/32 does the same for the internal control system.

Accounting procedures have to be submitted to FINMA together with the external audit report.

96. In addition, Circular 2008/44 sets out FINMA's risk management requirements under the SST.

FINMA requires insurers to include in their SST report all relevant information required to assess their risk situation.

In line with this, the SST report template provides for a chapter covering "other risks" not forming part of the target capital calculation, requiring insurers to consider their wider risk situation; this section of the report would also be expected to include information on risk management.

Insurers are also required to consider the applicability of the standard model to their own risk profile.

In addition, the Swiss Quality Assessment (SQA) would also serve to review and assess the insurers' qualitative risk management practices, including in respect of the risk management function.

97. Through the revision of the ISO, an ORSA shall become a formal separate requirement in the ISO for solo companies and for insurance groups and conglomerates.

Details with regard to definition and goals, scope, forward-looking perspective, overall risk profile, overall capital needs, internal reporting and reporting to FINMA that are mainly comparable to the requirements for the ORSA under Solvency II will be set out in a FINMA circular.

Internal Audit Function

98. Article 47 Solvency II Directive requires that insurers falling under the scope of the Directive shall provide for an effective internal audit function.

This internal audit function must be objective and independent from the operational functions (except in certain circumstances described in Article 271 (2) of the Solvency II Delegated Acts).

The independence of the internal audit function is ensured by Article 27 (1) ISA.

However, pursuant to Article 27 (2) ISA, FINMA is able to exempt an insurer from the requirement to establish an internal audit function.

According to Circular 2008/35 an exemption can be made if the insurance company does not have a complex risk structure (e.g. if no material operational, market, credit or insurance risks are present).

This is the Swiss interpretation of the proportionality principle in this respect.

However, FINMA states that this exemption has always been granted sparingly and the exemption practice has been further tightened in the aftermath of a 2011 EIOPA assessment.

Where such exemption is granted, FINMA states it expects external

auditors to look even closer at the operational capability of internal audit.

FINMA plans to amend the exemption options to mirror the scope of the provisions that will be embedded in Solvency II by way of amendment of its Circular 2008/35in middle of 2015.

99. The companies which are not exempted have to fulfil very specific requirements as to the contents of the report they have to produce.

The internal auditor has to submit a summary of this comprehensive and detailed report to FINMA as an annex to the external audit report.

In addition, under SQA II the adequacy of the internal audit function as a function was assessed.

We also note that in the context of the group internal audit function, reported practice indicates that all groups need to have an internal audit function, although the Swiss law is not explicit on this point.

Contingency plans

100. According to FINMA every insurer and insurance group must have a contingency plan as part of effective risk management pursuant to Article 22 ISA, Articles 96 and 98 ISO (and for groups Articles 195 and 204 ISO in conjunction with Articles 96 and 98 ISO).

Although a contingency plan is not explicitly required under any laws, regulations or circulars, the actual practice seems to provide for this as FINMA states that it considers contingency planning to be part of good risk management.

Actuarial function

101. At solo level an accountable actuary is required under Articles 23 and 24 ISA, Article99 ISO, Articles 2-4 FINMA-ISO, and Circular 2008/16.

Although at group level an accountable actuary is not a legal requirement, appropriate and state of the art actuarial processes must be implemented throughout the group (Articles 67 and 75 ISA in conjunction with Article 22ISA, Article 198ISO in conjunction with Article 22ISO).

Outsourced functions

102. FINMA is of the view that while insurers may outsource certain functions they cannot outsource responsibility.

According to Article 47 (4) ISA in conjunction with Article 47 (2) ISA natural or legal persons to which important functions of an insurer are outsourced are obliged to provide FINMA with the information and documents that it requires to carry out its tasks, and, in conjunction with Article 47 (1) ISA, FINMA can perform inspections of them at any time.

In addition, they have to report to FINMA any incidents that are of substantial importance to their supervision (Article 29 (2) FINMASA). Changes to outsourcing agreements, like any changes to the business plan, are required to be notified to FINMA under Article 4(2j) ISA in conjunction with Article 5(2) ISA.

Compliance function

103. The compliance function is not directly referred to in the ISA or in the ISO, however it is mentioned in Circular 2008/32.

In its Circular FINMA has taken the approach that a compliance function only needs to be established if it is appropriate and proportionate taking into account the size and complexity of the company.

In practice we also understand that all Swiss groups need to provide for a compliance function, although the Swiss law is not explicit on this point.

The Swiss Federal Council intends to introduce a broader compliance function requirement for solo companies in the revised ISO.

104. We note that aside from the supervisory rules and regulations there is a compliance function requirement for the Board of Directors for stock companies ("Aktiengesellschaften") under Article 716a (1) Nr. 5 Code of Obligations and with the administrative body ("Verwaltung") for mutual companies ("Genossenschaften") under Article 902 (2) Nr. 2 Code of Obligations.

In accordance with these provisions the board of directors or the directors have the non-transferable and inalienable duty of the overall supervision of the persons entrusted with managing the company or the cooperative's business, in particular with regard to compliance with the law, articles of association, operational regulations and directives.

Thus every insurer in Switzerland has to have at least some sort of compliance function.

However, the characteristics of the Swiss Compliance function are only to a certain extent comparable to those of Article 46 in conjunction with Recitals 30 to 33 of the Solvency II Directive.

Through the revision of the ISO, a compliance function shall become mandatory for all insurers.

Ensuring identification of deteriorating financial conditions

105. In accordance with Article 22 ISA, Articles 96 to 98 ISO and Circular 2008/32, insurers as well as groups are expected to have the means to regularly monitor, report on, and address changing financial conditions.

One of FINMA's tools to check this is the SQA, which looks in detail into various elements of governance, risk management and internal controls relevant, among other things, to the effective monitoring of financial conditions and the remediation thereof.

Deteriorating financial conditions will be notified to FINMA in particular through the SST regime, whereby insurers must report significant losses or material changes to their risk profile to FINMA on an ad hoc basis.

Auditor's duty

106. External auditors are required to notify FINMA without undue delay if they have identified any criminal offences, serious irregularities, breaches of good business principles or circumstances likely to endanger the solvency of the insurer or the interests of the insured (Article 30 ISA).

Although a direct reference to Article 30 ISA is missing in Article 70 ISA (External audit for groups), FINMA were able to show that they nevertheless require the external auditors of groups to notify FINMA of any of the circumstances mentioned in Article 30ISA.

Public disclosure

107. Currently all Swiss insurers are required to publicly disclose their financial statements through FINMA's website.

In addition, insurance groups listed on the Swiss Stock Exchange are

subject to the exchange's additional disclosure requirements, particularly in terms of information relating to corporate governance.

Furthermore, insurers may adhere to the Swiss Code of Best Practice for Corporate Governance in their reporting.

However, FINMA currently have no public disclosure requirements for Swiss insurers or insurance groups under the SST regime.

108. Articles 51 and 256 of the Solvency II Directive detail the public disclosure requirements for insurers and insurance groups respectively.

Specifically, insurers and insurance groups are required to disclose publicly, on an annual basis, a report on their solvency and financial condition.

This report should include, but is not limited to, information on the insurer's business, external environment and performance, system of governance, risk profile, valuation for solvency purposes and capital management.

109. This is an important difference between the two regimes and affects not only principles 4 and 10 but also principles 6, 7and 12.

The competent Swiss authorities intend, via the ISO revision, to introduce annual disclosure requirements for insurance companies and insurance groups and conglomerates including the following quantitative and qualitative information:

• Business activities

• Performance

• Risk management and its appropriateness

• Risk profile

• Basis of assessment and methods used, particularly as regards provisions

• Capital management

• Solvency

The full details of the public disclosure regime have still to be elaborated.

EIOPA advice

Articles 172/260

110. FINMA requires insurers and insurance groups to have in place an effective system of governance which provides for sound and prudent management of the business and an effective risk management system.

In general its requirements in relation to governance, the actuarial function, outsourced functions and the auditor's duty are equivalent to the Solvency II requirements.

However the characteristics of the compliance function under the current Swiss supervisory regime is only in some aspects comparable to the requirements of those of the Solvency II Directive.

Insurers are required to establish an internal audit function, however a dispensation for solo entities from this requirement in exceptional cases is possible with FINMA's approval (although it does not seem to be intensely used in practice), particularly for non complex carriers, whereas we note that the Solvency II Directive requires without any exception an internal audit function that, however, does not necessarily have to be performed on a standalone basis, but could be performed by one person or unit along with other tasks (Article 271(2) of the Solvency II Delegated Acts).

111. On disclosure, some Swiss insurers are subject to the requirements of the Swiss Stock Exchange or adhere to the Swiss Code of Best Practice in Corporate Governance, and financial statements for all firms are published by FINMA.

However there is no public disclosure required for any insurers in the areas covered by the Solvency II solvency and financial condition report. FINMA is currently reviewing the issue of public disclosure.

112. Taking the overall picture into account, but acknowledging these current differences around public disclosure, internal audit and compliance requirements for solo undertakings, Principle 4 in respect of the Solvency II Directive is considered to be largely equivalent.

In respect of Principle 10, the Swiss regime is considered to be largely equivalent in respect of the Solvency II Directive in light of these differences

around public disclosure.

These caveats would be mainly addressed by a pending revision of the Insurance Supervisory Ordinance (ISO) assuming the current draft is implemented and enters into force in 2015.

EIOPA notes that the details of the public disclosure regime are not yet known.

Principles 5 and 11 - Changes in business, management or qualifying holdings

Objective – The solvency/prudential regime of the third country shall require that proposed changes to the business or management of domestic insurance or reinsurance undertakings carrying out reinsurance activities or of groups, or to qualifying holdings in such undertakings and groups are consistent with maintaining the sound and prudent management of the domestic insurance or reinsurance undertaking or group.

Acquisitions of insurance and reinsurers

Notification of intention to hold or increase directly or indirectly a qualifying holding

113. According to Article 21 (2) ISA anyone intending to take a direct or indirect equity holding in an insurer with its registered office in Switzerland must notify FINMA in advance.

The thresholds are 10%, 20%, 33%or 50%of the capital or voting rights.

114. Articles 192 (2) and (3) ISO and Circular 2008/28 provide for detailed notification to FINMA by insurance groups and insurance conglomerates about the creation, acquisition or sale of a significant holding.

FINMA defines what constitutes a significant holding. FINMA is authorised to assess the acquisition from the perspective of the financial condition of the group and of risk management.

If it has any concerns they are communicated to the group and the necessary follow-up actions or sanctions are pursued according to Article 31et seq. FINMASA.

115. Articles 192 (2) and (3) ISO and Circular 2008/28 also cover notification of a change in the group or conglomerate's shareholder base.

FINMA is to be notified if a direct or indirect interest of natural or legal persons in the parent undertaking of the group or conglomerate would result in a change of 3%, 5%, 10%, 20%, 331/3%, 50% or 662/3% of the voting rights of the parent undertaking, or if a contractual agreement would empower a natural or legal person to exert significant influence over the parent undertaking of the group or conglomerate.

Assessment of acquisition

116. In this process FINMA will assess the financial soundness and reputation of the new qualified shareholder.

This may include, inter alia, the motivation and background of the acquirer, pricing and financing of the transaction, proposed restructuring, organisational changes, due diligence reports, reports on insurance, market, credit and operational risks, solvency and, if applicable, rating agencies' reports.

117. FINMA may prohibit an acquisition or disposal or impose conditions on it if the nature or extent of the holding may endanger the insurer or the interests of the insured (Article 21(4) ISA).

Prior consultation, including advance rulings under Article 31 FINMASA, is possible.

118. In the sphere of group supervision changes are only notified (there is no approval process).

In the absence of an explicit ability to assess transactions prior to their announcement, FINMA may nevertheless prohibit transactions or impose conditions on them in respect of individual insurers, or in respect of groups from the perspective of their financial condition and risk management.

In effect FINMA is often consulted by the supervised (parent) undertakings prior to the announcement of any material transaction.

Although there is no formal approval process, FINMA is empowered by law to impose sanctions in order to restore compliance with the law (Article 31 FINMASA).

Existence of provisions in relation to disposals

119. Article 21 (3) ISA requires that anyone who intends to reduce its equity holding in an insurer with its registered office in Switzerland to below 10%, 20%, 33%or 50%of the capital or voting rights, or to change its holding such that the insurer is no longer a subsidiary company, has to notify FINMA to that effect.

Information obtainable from an undertaking regarding acquisitions and disposals

120. Article 21 ISA relates to acquisitions or disposals both in terms of an insurer with its registered office in Switzerland intending to acquire an equity holding in another company, and in terms of an investor intending to purchase or sell directly or indirectly equity positions in a Swiss insurer.

Under Article 21 (1) ISA an insurer with its registered office in Switzerland that intends to acquire an equity holding in another company must notify FINMA if the holding in the other company equals or exceeds 10%, 20%, 33% or 50% of the capital or voting rights.

Under Article 21 (2) ISA anyone who intends to take a direct or indirect equity holding in an insurer with its registered office in Switzerland must notify FINMA in advance if the proposed holding in that insurance company will equal or exceed 10%, 20%, 33% or 50% of the capital or voting rights.

In this context it is also of relevance to note that anyone who acquires or disposes of securities that are at least partially listed in Switzerland, must notify in writing the stock exchange and the company concerned when their holding exceeds (or falls below) the thresholds of 3%, 5%, 10%, 15%, 20%, 25%, 331/3%, 50% or 662/3% of the voting rights in that company (Article 20 SESTA).

This applies indirectly to insurers insofar as they may be either the listed company or the shareholder, or if they belong to groups with a listed company (e.g. for providing information to the stock exchange).

121. As for other changes in the business plan, changes regarding qualifying holdings must be reported to FINMA and are subject to supervisory approval (Article 5ISA).

122. In addition to the requirements outlined above, insurers have to report

in their annual returns all material positions in their equity and their holdings.

Each year within three months of the annual financial statements being produced, or more frequently if FINMA require it, the insurance group is to provide FINMA with a full structure chart showing all companies in the group (Article 192 ISO).

According to Circular 2008/28 the minimum reporting requirements include a group organisational chart (in the form of a graph as well as a list) as well as detailed information on the creation, purchase and disposal of all holdings.

Conglomerates also have to indicate if entities belong to the insurance block or the finance block of the conglomerate (Article 205 ISO).

The detailed information to be provided on the creation, purchase and disposal of all relevant holdings includes the name of the entity, its address including country, the holding company within the group or conglomerate, the entity's function, its supervisory authority if supervised, and the holding in percentage terms as well as the net asset value.

123. According to Article 29 FINMASA and 47 (2) ISA FINMA may require any additional information it needs on acquisitions and disposals in a group context to be provided.

Existence of provisions in relation to outsourcing

124. Contracts or other agreements that indicate under what terms functions or activities of the insurer are outsourced, are part of the business plan (Article 4 (2j) ISA).

Changes to such contracts or agreements must be reported to FINMA and are subject to FINMA's approval under Article 4 (2j) ISA in conjunction with Article 5 (2) ISA.

The changes are deemed approved unless FINMA starts an examination of the changes within four weeks of receiving notification.

The supervisory authority is tasked with monitoring compliance with the business plan (Article 46ISA).

125. In general, insurers may not outsource functions to the extent that the

insurer ceases to carry out any of its own functions.

Under FINMA's established practice, insurers may outsource a maximum of two of the following significant functions:

- Production (product development, distribution and risk description)
- Administration of insurance contracts
- Settlement of claims

126. The outsourcing agreement has to be in writing and has to specify, inter alia, the following:

- duration and terms of termination of the contract;
- precise description of the outsourced function;
- reasons for and intended benefit from the outsourcing;
- financial obligation for the insurance company;
- data protection and security considerations; and
- liability of the third party to whom functions are outsourced.

127. Operational risk resulting from outsourcing in a group context has to be addressed in line with Article 68 ISA in conjunction with Article 22 ISA.

Furthermore, on a group-wide level, cost-sharing agreements are one element of the intra-group transactions (IGTs) which have to be reported to FINMA (Article 194ISO, and Circular 2008/29).

Ongoing assessment, approval and disclosure of relevant information (including portfolio transfers, changes to board and senior management and scheme of operation)

128. Under Article 62 ISA all portfolio transfers from a Swiss direct insurer to another insurer must be approved by FINMA.

This is not applicable to reinsurers, however the transfer of reinsurance contracts does require the consent of the ceding company.

129. From a group perspective, FINMA has to be notified if such a transfer represents a material transaction, or if it results in substantial changes to organisation, structure, risk management and solvency (Article 192(2) ISO, Circular 2008/28).

130. Changes to the board of directors and executive management represent changes to the business plan (Article 4 (2g) ISA in conjunction with Article 5 (2) ISA).

Such changes have to be reported to FINMA within 14 days of their being made.

The changes are deemed approved unless FINMA starts an examination of the changes within four weeks of receiving notification.

FINMA is responsible for monitoring compliance with the business plan (Article 46(1c) ISA.

131. At group level changes to the board and senior management have to be reported to FINMA according to Article191 (2) and (4) ISO, Art. 204 ISO respectively, and Circular 2008/27.

Contrary to solo supervision criminal record checks on managing board members are not required. Information on the structure of operation has to be reported to FINMA according to Article 191(2) ISO, and Circular 2008/27.

Specificities for 172

Details as to existence and content of standards in respect of the undertaking's obligation to provide information on the assessment of the reputation and financial soundness of the acquirer

132. According to Article 5 (2) ISA insurers have to notify FINMA of any changes in a qualifying holding (as defined under Article 4 (2f) ISA).

This may include information on, inter alia, the motivation and background of the acquirer, pricing and financing of the transaction, proposed restructuring, organisational changes, due diligence reports, reports on insurance, market, credit and operational risks, solvency and, if applicable, rating agencies' reports.

The changes are deemed approved unless FINMA starts an examination of

them within four weeks of receiving notification. FINMA monitors insurers' compliance with their business plan (Article 5(2) ISA).

EIOPA advice

Articles 172/260

133. FINMA's processes around changes in business, management and qualified holdings provides for adequate ongoing supervision of the sound and prudent management of insurers and insurance groups.

Swiss supervisory law enables FINMA to obtain a comprehensive overview of insurers and insurance groups' business plan changes.

Moreover FINMA's approach to monitoring the fitness and propriety of shareholders with a qualifying holding is adequate.

As a result Principles 5 and 11 is in respect of the Solvency II Directive considered to be equivalent.

Principles 6, 7 and 12 – Solvency Assessment

Objective - The solvency/prudential regime of the third country shall require domestic insurance and reinsurance undertakings and groups to hold adequate financial resources.

The assessment of the financial position of domestic insurance and reinsurance undertakings and groups in the third country shall rely on sound economic principles and solvency requirements shall be based on an economic valuation of all assets and liabilities.

The solvency/prudential regime of the third country shall require domestic insurance and reinsurance undertakings and groups to establish technical provisions with respect to all of their insurance and reinsurance obligations towards policyholders and beneficiaries of insurance and reinsurance contracts.

The solvency/prudential regime of the third country shall require that assets held to cover technical provisions are invested in the best interests of all policyholders and beneficiaries taking into account any disclosed policy objective and that domestic insurance and reinsurance undertakings and groups only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and

report.

The solvency/prudential regime of the third country shall require domestic insurance and reinsurance undertakings and groups to meet capital requirements that are set at a level which ensures that in the event of significant losses policyholders and beneficiaries are adequately protected and continue to receive payments as they fall due to a level of confidence at least equivalent to that achieved by Article 101 of Directive 2009/138/EC.

Those capital requirements shall be risk-based with the objective of capturing quantifiable risks.

Where a significant risk is not quantifiable and cannot be captured in the capital requirements, then that risk shall be addressed through another supervisory mechanism.

The solvency regime of the third country calculation of capital requirements shall ensure accurate and timely intervention by supervisory authorities of the third country in the event that those capital requirements are not complied with.

The solvency regime of the third country shall require domestic insurance and reinsurance undertakings and those which are part of a group to maintain a minimum level of capital, non-compliance with which shall trigger immediate and ultimate supervisory intervention.

The solvency regime of the third country shall require domestic insurance and reinsurance undertakings carrying out reinsurance activities to meet the capital requirements referred to in paragraphs 5 and 6 above with own funds that are of a sufficient quality and which are able to absorb significant losses.

Own-fund items considered by the supervisory authorities to be of the highest quality shall absorb losses both in a going concern and in case of a winding up.

For group supervision assessments:

The calculation of group solvency in the third country's prudential regime shall produce a result that is at least equivalent to the result achieved by either one of the calculation methods set out in Articles 230 and 233 of Directive 2009/138/EC.

The calculation shall ensure that there is no double use of own funds to meet the group capital requirement and that the intra-group creation of capital through reciprocal financing is eliminated.

Financial supervision

134. There is constant interaction between FINMA and the entities it supervises, including regular or ad hoc discussions with the board of directors and the management board on all necessary supervisory topics, as necessary.

135. FINMA is an independent institution under public law and has the power to ensure that breaches of its provisions are rectified (Article 31 FINMASA).

FINMA is authorised to issue binding rulings and to take specific measures in relation to supervised entities (such as the replacement of all or part of their management by an investigating agent or even the revocation of their business licence).

FINMA can also trigger criminal prosecution and is authorised to carry out investigations itself or through a third party at any time.

136. Supervised entities are legally bound to submit thematic, ad hoc and periodic reporting.

The most important reporting requirements for Swiss insurers are:

- An annual management report (31 December of each year), which includes the annual accounts, annual report and (if required) the consolidated accounts.

- An annual supervisory report which includes further detailed information on the results (e.g. technical provisions, solvency margins) (Article 25 (2) ISA).

- An annual detailed report by the external auditors to the board of directors and to FINMA (Circular 2008/41).

- An annual Swiss Solvency Test (SST) report on “the calculation of target capital and risk-bearing capital” (Article 53 (1) ISO).

Under the current regulation, insurance groups and insurance based

conglomerates have to report twice a year (Articles 202 and 204 ISO).

According to the proposed revision of the ISO, it is foreseen that insurance groups and conglomerates will have to report only once a year in the future, in line with requirements for solo entitites.

Material changes to the internal or standard model have to be reported.

The SST report is subject to the principle of proportionality.

The minimum level of information required includes detailed data about the target capital and the risk bearing capital.

Apart from the periodic SST report, insurance companies using an internal model for the SST have to submit the methodology of the model and a full (internal) model description.

Material changes to the model require a new report to be submitted.

- An annual tied assets report together with an inventory of the assets (Article 72 (1) ISO) (not applicable to reinsurers).

- Annual report on transactions in derivative financial instruments (Article 109 ISO).

137. Besides the periodic reporting requirements, FINMA also asks for ad hoc information in relation to particular events (such as amendments to the business plan, acquisition or disposal, merger or liquidation, intra-group transactions, departure of the actuary).

138. Furthermore FINMA also obtains information from specific examinations and on-site inspections that it conducts itself or through third parties (e.g. information about violations and irregularities, information if solvency is endangered, reports from investigating agents).

139. Significant incidents, as defined and explained in Circular 2008/25, have to be reported immediately (from the entity and/or the auditor) to FINMA.

140. In addition, FINMA is empowered to request any further information it requires from solo or group level at any time. FINMA is also empowered to ask for information from the insurer's auditor and qualified investors.

Parties carrying out significant outsourced functions for insurers also have to fulfil information and reporting obligations towards FINMA.

141. FINMA requests information which reflects the nature, scale and complexity of the business of the insurer concerned and the risks inherent in that business.

Valuation

142. The SST uses a total balance sheet approach to determine own funds. Assets and liabilities are valued market consistently.

The valuation has to be in line with information obtainable from liquid markets.

Market-consistent values are either equal to prices directly observable in markets, or they are determined by using generally acceptable models based on well-founded financial mathematics.

Assets and liabilities are valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction.

The overall and fundamental principle of the SST is the market-consistent valuation combined with risk measurement.

This is not based on international accounting standards where these deviate from the market-consistent valuation basis.

Nontheless it is consistent with the IAIS Core Principle 17 on Capital Adequacy.

143. Due to its risk sensitivity and effective implementation, the SST outperforms the static and purely volume-based Swiss Solvency I rules which are of limited use for risk-management and supervisory purposes from FINMA's perspective.

Therefore, Swiss Solvency I is to be retained only to the extent necessary under international agreements, namely under the Agreement between the European Economic Community and the Swiss Confederation concerning direct insurance other than the life insurance of10October 1989.

Discussions between the EU and Switzerland are under way to adapt the

Direct Insurance Agreement to Solvency II.

Technical provisions

144. Insurers are required to determine technical provisions (TP) for all of their insurance and reinsurance obligations since the market-consistent SST balance sheet has to include all economically relevant liabilities.

The calculation of TP has to be comprehensive, objective and based on the most recent information.

Best estimate TP have to equal the expected value of discounted cash flows.

Objectivity is required in terms of transparent input data for their determination.

TP have to be determined on the basis of generally acceptable, recognised actuarial principles.

Insurers have to document and disclose the methods applied for each TP class as well as the main results.

145. The market valuation of TP has to be based on the arm's length principle such that independent and knowledgeable partners would be willing to acquire the insurance obligations at that price.

TP have to be market-consistent and consist of a best estimate and a market value margin for capital costs.

This implicitly includes the requirement for an appropriate segmentation of risks as well as sound calculation processes.

FINMA reviews the appropriateness of TP calculations through a variety of different approaches including reports, on-site reviews and the model approval itself.

146. FINMA has the legal power to require insurers to increase their technical provisions and can also pursue further actions in cases of non-compliance in order to protect the interests of policyholders.

147. FINMA has implemented a circular (Circular 2011/3) which specifies technical provisions of worldwide reinsurance business by Swiss entities, from a statutory and market-consistent basis.

It determines principles and minimum requirements for the valuation, documentation and control of technical provisions in the reinsurance business.

148. During a period of extraordinary low interest rates and according to ISO Annex 3 para. 3, Section 3, FINMA has the power to allow other than risk-free interest rate curves for the discounting of existing commitments in the Swiss Solvency Test (SST).

This is only possible for current, not for new business.

149. Due to the current difficult economic situation with continuing extraordinarily low interest rates, FINMA is using this competence at the time of this report.

In the beginning of 2013, FINMA published Circular 2013/2 which allows discounting with counterparty-risk yield curves.

This provides a relief within the SST calculation mainly for life insurers.

Non-life insurers, insurance groups and insurance-based conglomerates are less affected.

Moreover, the FINMA temporarily loosens the intervention threshold concept (see p.11 of this report: Ladder of supervisory intervention). FINMA's use of this extraordinary power is due to expire at the end of 2015.

150. In the course of these temporary adjustments, insurance undertakings have the option to discount their technical provisions either with the risk-free curve based on Government Bond yields or with the potentially more risky curve based on swap rates.

There is no change in the calibration of the capital requirement or the valuation of assets.

151. FINMA is carefully monitoring the effect of the temporary adjustments and their impact on the different types of insurers.

To this end, FINMA is requesting insurers to perform and submit shadow calculations without the temporary adjustments.

This allows a better comparison of developments with and without the adjustments.

152. According to the FINMA Circular 2013/2the adjustments are aimed at mitigating the valuation only of current business, not new business.

The regular SST provisions in respect of new business are left unchanged.

153. Under Solvency II, the determination of the risk-free yield curve for the determination of the technical provisions is already based on the swap curve.

An additional relief for undertakings is to be provided by measures of the SII LTG package.

Therefore, the temporarily changes regarding the valuation of TP are acceptable from an Equivalence perspective.

Own funds

154. In the SST, "Risk Bearing Capital" (RBC) (corresponding to the "own funds" in Solvency II) comprises two layers called core capital and complementary capital.

155. Core capital is defined as market value of assets (A) minus market value of liabilities (L) minus corrections plus the market value margin (MVM), which is comparable to the Solvency II risk margin:

Core Capital = A - (L - MVM) – corrections

156. "Corrections" in the above formula refers to deductions of:

- foreseen dividend payments to shareholders;
- own shares;
- potential immaterial funds; and
- latent taxes for real estate in Switzerland.

157. The insurer's own credit risk cannot be taken into account in the valuation of its own liabilities.

158. In order to facilitate the calculation of the MVM, under FINMA's approach it is deducted from the market value of liabilities and is included in the target capital instead.

159. As subordinated debt is deducted as a liability in the formula above, it is not part of core capital (although it may form part of complementary capital if it meets the criteria set out below).

Therefore core capital is considered to be of the highest quality with the ability to absorb losses in a going concern as well as in a winding up situation.

160. Complementary capital consists of risk-absorbing instruments (e.g. hybrid instruments) that have to be approved by FINMA on a case-by-case basis and meet strict requirements:

a) instruments are paid-in;

b) instruments cannot be offset against other obligations;

c) subordination is contractually fixed and irrevocable;

d) the insurer has the right to suspend interest payments;

e) the notional debt and interest bear losses without triggering the cessation of the insurer;

f) the notional debt is not callable by the investor before the date of redemption, except in case of the liquidation of the insurer; and

g) redemption prior to maturity needs approval by FINMA.

161. Complementary capital is eligible to cover capital requirements subject to the following limits: the eligible amount cannot be larger than core capital for hybrid instruments with no fixed redemption date.

The eligible amount of subordinated debt/hybrid instruments with fixed redemption date cannot be larger than 50%of core capital.

162. Contingent capital (referred to as “ancillary own funds” under Solvency II) is included in the complementary capital.

The SST is based on a total balance sheet approach and does not distinguish between off-and on-balance positions.

Any asset or liability, whether on or off-balance-sheet in accounting terms,

has to be included in the SST calculations and valued market consistently either through observable market prices or a valuation model.

Under normal conditions the market consistent value of a contingent position (e.g. a guarantee) is much lower than the notional amount, as the contingent position would usually be "out of the money".

This is why including this amount on the SST balance sheet does not usually lead to a large impact on the RBC at the measurement date.

However, in distressed situations, the market consistent value of a contingent position would increase according to the trigger conditions.

This means that the market consistent value of the contingent position and thus the RBC can change substantially over the course of the following twelve months.

Therefore, the main effect of contingent positions in the SST is seen in the target capital (i.e. the "SCR") and not the RBC.

Capital requirements

Calibrations of SST

163. Under the SST, the capital requirement which is more commonly referred to as the Target Capital (TC) under the SST, is calculated to cover unexpected losses arising from existing business that correspond to the Tail Value-at Risk (Tail-VaR) of the Risk Bearing Capital (RBC) subject to a confidence level of 99%over a one-year period.

164. Specifically, the TC is defined as the sum of the discounted market value margin plus the expected shortfall resulting from the change in RBC over a one-year period at a confidence level of 99%Tail VaR.

165. Mathematically, the TC at time zero (TC0) can be expressed as:

$$\mathrm{TC}_0 = \frac{\mathrm{MVM}_1}{1 + r_0} - \mathrm{ES}_\alpha \left[\frac{\mathrm{RBC}_1}{1 + r_0} - \mathrm{RBC}_0 \right]$$

Where

☐ MVMt is the cost of capital at time tto cover the RBC over the lifetime of insurance liabilities.

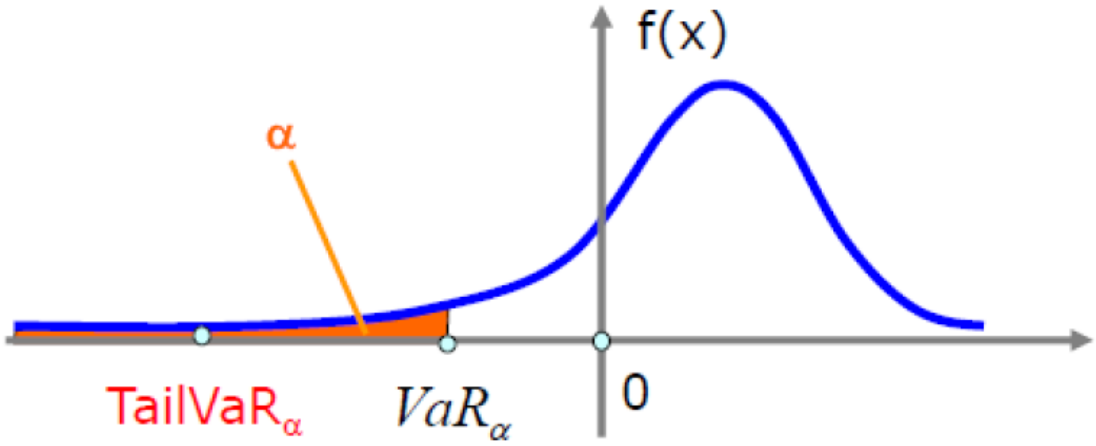
☐ r_0 denotes the one-year risk-free interest rate at time 0.

☐ ESα (Expected Shortfall) is a synonym for Tail-VaR at α (i.e. α = 1% for SST) and the confidence level of (1-α) (i.e. 99%for SST) for the change in RBC.

☐ RBC refers to Risk Bearing Capital which is the sum of the core capital and complementary capital to the extent that the complementary capital is eligible.

166. The SST requires the (re)insurer to have RBC at least equal to the TC.

This ensures that there is enough capital at the beginning of the year such that the market value of assets is equal to or larger than the market value of liabilities over a one-year period in all situations corresponding to a 99%Tail-VaR confidence level.



99%Tail-VaR as opposed to 99.5%VaR

167. A 99% Tail-VaR confidence level represents the probability-weighted average amount of all losses in the 1% tail of the probability distribution function of changes in RBC (illustrated by the orange area in the diagram below) which could be greater than (or, if there is no probability mass beyond the 1% quantile, equal to) a 1% VaR of the profit and loss distribution.

Assuming the changes in RBC have a normal distribution, then a Tail-VaR subject to a confidence level of 99% over a one-year period is at least as strong as a VaR subject to a confidence level of 99.5% over a one-year period and as such, provides equivalent policyholder and beneficiary protection to the Solvency II Directive requirement.

Where α: equal to 1%(i.e. at a confidence level of 99%)

f(x): probability distribution function of changes in RBC

SST risk sub-modules

168. The SST requires the modelling of "all significant items of the market-consistent balance sheet and all relevant risks in terms of this Circular" (Circular 2008/44 Section IV), in particular market, credit and insurance risks, similar to Solvency II requirements.

169. Unlike under the Solvency II Directive, there is no "standard formula" under the SST.

Instead, the SST is carried out using either the FINMA standard model or a company-specific internal model ("internal model").

The same SST requirements, in particular capital requirements calibrated to a confidence level of 99%Tail-VaR, and the modelling of market, credit and insurance risks, apply to both the FINMA standard model and internal models.

Standard model: overview

170. The standard model is a stochastic model for each of market, credit and insurance risk sub-modules.

The calibrations mainly consist of:

- Distributions assumed in the modelling; and
- Parameter estimations for the distributions.

171. The dependency structures between the different risk sub-modules as well as between risk factors for a risk sub-module are generally based on past experience and expert judgement.

172. The output of the standard model is the RBC at the reference date, a probability distribution of the change in RBC, and the resulting target capital.

Standard model: modelling of risk sub-modules

173. For market risks, the RBC is expressed as a quadratic function of 82risk factors and the change in RBC is modelled as a function of these risk factor changes.

174. The 82market risk factors are:

- Interest rates for CHF, EUR, USD, GBP (13 maturities) [4x 13risk factors]
- Implied interest rate volatility [1risk factor];
- Credit spreads Europe (AAA, AA, A, BBB) [4risk factors]
- Credit spread US (AAA, AA, A, BBB) [4risk factors];
- Credit spread BB [1risk factor];
- Swap-Government spread [1 risk factor];
- Foreign exchange rates (EUR/CHF, USD/CHF, GBP/CHF, JPY/CHF) [4risk factors];
- Implied FX-volatility [1risk factor];
- Equity indices (CHF, EMU, USA, Great Britain, Japan, Pacific ex. Japan, EMU Small Cap) [7risk factors];
- Implied equity volatility [1risk factor];
- Hedge fund [1risk factor];
- Private equity [1risk factor];
- Real estate CHF (Residential, Commercial, Real estate funds) [3risk factors];

- Participations [1risk factor].

175. The parameters for market risk factors are estimated based on monthly returns over the most recent 10-year observation period.

For interest rates and credit spreads, the absolute returns are used.

For other market risk factors such as equity, real estate and exchange rates risks, logarithmic (i.e. relative) returns are used.

176. Implied volatilities are also considered. Some examples of annual volatilities used in the standard model for some of the market risk factors are set out in the tables below (Source: SST-Template as of 1July 2014).

Term [years]	Volatility [bps]
1	66.8
2	72.4
3	73.5
4	75.0
5	75.6
6	75.3
7	74.4
8	72.8
9	72.4
10 – 12	72.2
13 – 17	75.1
18 – 24	73.4
25 – 50	74.7

Table 1: EUR interest rates volatilities (as of 30 June 2014)

Economy	Volatility
MSCI CHF	12.9 %
MSCI EMU	17.1 %
MSCI US	15.0 %
MSCI UK	13.8 %
MSCI JP	19.4 %
Pacific ex. Japan	22.7 %
Small cap EMU	26.0 %

Table 2: Equity volatilities (as of 30 June 2014)

177. Credit risks are modelled using the Basel III standard approach which involves a factor model.

178. Life insurance risks are modelled using the same approach as for market risks.

Parameters for biometric risks are based on past experience and expert judgment.

179. Non-life insurance risks are modelled using a stochastic risk model. Parameters for stochastic and parameter risks per line of business are

determined based on experience from large portfolios of business.

In addition, the parameters for parameter risks also involve expert judgement.

180. Health insurance risks are modelled using a simplified version of the stochastic risk model for non-life insurance risks.

Parameter estimations are determined in the same way as for non-life insurance risks.

Undertaking specific parameters

181. FINMA may allow an insurer to use undertaking specific parameters in the standard model where their use is justified in relation to the statistics and experience of the insurer, as well as in comparison with other similar portfolios of business.

Additional scenario testing

182. The modelling of market, credit and insurance risks outlined above (the analytical model) is complemented by scenario testing in accordance with Article 42 ISO.

These scenarios consist of "what if" analysis of defined situations and their impacts on the market consistent balance sheet of the insurer concerned.

183. If the analytical model producing the probability distribution is considered to have inadequately or miss modelling some elements of risk, then the determined losses (subject to a minimum value of zero) arising from these scenario tests are taken into account when determining the TC by aggregating the scenario impacts to the probability distribution function resulting from the analytical model to arrive at the ultimate probability distribution function of the change in RBC.

The final TC is derived by applying the risk measure (i.e. Tail-VaR 1%) to the ultimate probability distribution function.

184. The scenarios that are tested include scenarios prescribed by FINMA as well as insurer-specific scenarios which the insurer is required to define taking into account its own risk profile.

185. The FINMA prescribed scenarios include 10 financial market scenarios

and twelve synthetic scenarios such as a pandemic.

186. For the insurer-specific scenarios, an insurer is required to analyse whether and to what extent the assumptions underlying its SST calculations might understate the probability of extreme events or the impact of risk concentrations on capital requirements, for example, where the credit risk is based solely on the probability of default suggested by the counterparty's rating.

Where there is a risk of understatement, the insurer is required to define and evaluate additional specific scenarios for these risks.

187. In contrast, the Solvency II Directive requires an insurer to take into account scenario and stress testing in its Own Risk and Solvency Assessment –the capital requirements from these scenario and stress tests do not automatically form part of its Solvency Capital Requirement (SCR).

Other risks

188. Other main differences between the SST and the Solvency II Directive are:

189. New business risk

There is no explicit requirement under the SST for insurers to take into account "new business expected to be written over the following 12 months" when calculating the TC.

However the SST explicitly requires insurers to take into account "all significant items of the market-consistent balance sheet and all relevant risks in terms of this Circular" (Circular 2008/44 Section IV).

An insurer will need to consider any material risks arising from new business that is expected to be written when conducting the SST.

Where there is a material risk, the insurance company is required to define and undertake additional scenario testing specific to its new business risk.

To this end, we conclude there is a similar requirement under the SST for insurers to take into account "new business expected to be written over the following 12 months" in their SST calculations.

190. Operational risk

There is no explicit requirement under the SST for insurers to take into account the quantification of capital requirements for operational risks.

Operational risks are generally addressed qualitatively in the risk management processes of the insurer, including its corporate governance and internal control systems.

For example in an outsourcing agreement, an insurance company is required not only to assess the service reliability of the potential service provider but also the corporate governance and risk management system of the service provider to ensure that the service provider will be able to fulfil its obligations, including contingency planning for unexpected events.

Where a material operational risk is identified, FINMA will require the insurer to define and undertake additional scenario testing specific to that operational risk and/or impose a capital add-on on the insurer.

The launch of the SQAII Risk Management modules which started in the second quarter of 2011, has probed into issues such as:

- How the insurer addresses operational risk organisationally and the performance goals that are set, with a focus on the work of the board of directors and each of the key control functions.

- The specific strategies and systems the insurer pursues to ensure effectiveness in its corporate governance, risk management and internal control systems.

- The kinds of risks that are monitored, assessed and reported as part of operational risk.

- The methodologies used for the identification and assessment of operational risk and whether the insurer quantifies operational risk.

This also includes looking into how past loss events are taken into account and in the modelling.

Insurers are also asked to indicate how operational risk is taken into account in stress testing and scenario planning.

- The kind of reporting made to management and to the board of

directors on operational risk, including the statistical data that is collected and reported.

- How an insurer operationalises business continuity and crisis management and how it addresses various compliance topics, such as internal fraud, money laundering, insider trading and employee reporting (whistle-blowing).

Operational risk was a main component of the SQAII, which was designed to provide a 3600 assessment of the risk management of an insurer from different risk functions including the risk manager, the compliance officer, the internal auditor and a board member, who are each required to provide and certify their respective assessment and views.

The SQA in general is expected to be a perpetual but evolving supervisory tool.

SQAII was a "risk-based" exercise and as such, did not cover all insurers.

The selection of insurers for SQAII was based on FINMA's internal risk rankings for insurers as well as other considerations including, particular corporate governance structures, risk management practices, internal control systems or other concerns that FINMA may have about an insurer.

In addition, a number of additional insurers was selected at random, which included reinsurance captives.

The fact that an insurer was not selected initially in 2011 for SQAII does not mean that it may not be selected later.

FINMA may also request from an insurer at any time, information regarding matters involving corporate governance, risk management and/or internal control system.

In addition, FINMA may ask the board of directors of an insurer to provide FINMA with a certification of the insurer's corporate governance, risk management and internal control systems and strategies, and in some cases, FINMA may require independent verification of that, whether in general or on specific issues.

A report containing FINMA's observations gathered from SQA II was published last year.

FINMA observed evidence of greater awareness among many insurers of the need to pursue a more pro-active and systematic approach to operational risk and a more disciplined approach to operational risk as a distinct risk category.

Risk mitigation techniques

191. An insurer is required to take into account all legally binding and enforceable risk transfer instruments in its SST balance sheet.

192. In particular, capital and risk transfer instruments such as loans, guarantees and reinsurance contracts are frequently used among legal entities of a group.

As such, the correct modelling of these instruments, and their impacts on the RBC and TC of the individual legal entities in line with the valuation and risk modelling principles of the SST, are of particular significance to FINMA.

All relevant risks such as counterparty default risk (e.g. in the case of a legally binding and enforceable guarantee from another legal entity of the group) and increased risk to policyholders (e.g. in the case of a legal entity of a group that acts as the reinsurer for an internal reinsurance arrangement) are to be taken into account in line with the SST principles.

193. Where a risk transfer instrument leads toa risk concentration, such as an 80% quota share reinsurance agreement with a single reinsurer, FINMA is likely to restrict the eligibility of the risk transfer instrument.
194.

Management actions may also be taken into account in the SST calculations where appropriate.

Management actions used in the SST calculations must be signed off by the senior management of the insurer as being realistic, and disclosed in its SST report.

FINMA may ask an insurer to justify the management actions assumed in its SST calculations using tools such as supplementary scenario/stress tests to assess their reasonableness and impact.

Frequency of SST calculations and reporting

195. An insurer must determine and report its TC and RBC at least once a year (Circular 2008/44 Section VIII §71).

For an insurer belonging to a group, the TC and RBC must currently be calculated and reported at least once every 6 months at the beginning of each half year (Circular 2008/44 Section VIII §72).

With the revision of the ISO, it is foreseen that insurance groups and conglomerates will have to report only once a year in future, in line with requiements for solo entitites.

FINMA may also require insurers to calculate and report the SST more frequently under certain circumstances, for example where there is a material change to the risk profile of the insurer.

Monitoring of SST compliance

196. FINMA requires insurers to monitor their compliance with the SST requirements on an on-going basis.

This is set out in Article 46 ISA which states that FINMA "may call upon third parties at any time to check compliance with the law" by the insurer.

197. An insurer is required to report significant losses to FINMA in accordance with Circular 2008/44Section XIV(A).

198. Where there is a material change to its risk profile, an insurer is required to submit an interim SST as required under Circular 2008/44 Section XIV(B) and Article 51(2) ISO.

Ladder of supervisory intervention

199. Under the SST, the SST ratio12 is used by FINMA as a monitoring tool to identify deteriorating financial conditions in an insurer (Circular 2008/44Appendix 4).

200. The SST ratio of an insurer determines its supervisory zone (green, yellow, amber or red) and the corresponding degree of supervisory intervention:

- If the SST ratio is 100% or more, there will be no supervisory intervention – i.e. the insurer will be subject to normal supervisory monitoring.

- If the SST ratio falls below 100%, the intensity of supervisory intervention and the intrusiveness of supervisory actions will increase as the SST ratio decreases.

- If the SST ratio falls below 33%, the insurer will be required to take immediate actions to restore the SST ratio, the failure of which will trigger FINMA to revoke its licence.

The ladder of supervisory intervention for the different zones, as determined by specific thresholds based on the SST ratio, is summarised in the table below.

Threshold (SST ratio)	**Zone**	**Supervisory Intervention**
≥ 100%	Green	None *Note all transactions directly resulting in the SST ratio falling below the thresholds are subject to approval.*
80%≤T<100%	Yellow	FINMA will intensify risk dialogue with the insurer with the objective of mitigating the increased risk. Possible actions include: a. Causal analysis and action plan to be submitted by the insurer. The action plan, to be based on realistic assumptions, is subject to approval by FINMA and shall establish in a binding manner the content and timing of the actions to improve solvency – the Green Zone is generally to be achieved within one year. The action plan to be submitted within 2 months of the underfunding being detected. b. Approval requirement pertaining to certain transactions that will reduce the RBC in general such as dividend payments, capital repayments, voluntary repayments of the company's own loans, intra-group transactions including the issuing of guarantees and distribution of with-profit bonuses to policyholders. According to Circular 2013/2 ("Temporary adjustments to the Swiss Solvency Test") FINMA decided not to prohibit paying dividends or surpluses for a yellow-zone-insurer when there is an action plan which is already approved by FINMA. This exception is valid until the end of 2015.

		c. Other further measures taking the insurer's situation into account such as audits conducted by external experts to verify the valuation in terms of the market-consistent balance sheet or the appropriateness of the procedure followed in determining the TC, additional reporting and supplementary stress/scenario tests.
33%≤T<80%	Amber	FINMA may tighten the Yellow Zone measures where applicable and/or initiate further actions including: a. Restructuring plan to be submitted by the insurer that will return the insurer to the Yellow Zone within 2 years and the Green Zone within 3 years. The restructuring plan must also show which of the insurer's risks will be immediately reduced by which methods, as well as the impact of various scenarios (including negative scenarios) on its effectiveness. b. Other further measures may include: • Ordering an extraordinary liquidity plan to be prepared.
		• Making particularly risky new business and renewals subject to approval. Prohibiting new and renewal business. According to FINMA-Circular 2013/2 ("Temporary adjustments to the Swiss Solvency Test") FINMA decided not to prohibit new and renewal business for an amber-zone-insurer when there is an action plan which is already approved by FINMA. This exception is valid until the end of 2015. • Prohibiting risky and complex transactions where it is not ensured that they serve to improve the SST ratio.
		• Having an insurer carry out organisational changes and having more in-depth controls, monitoring, reporting and audits performed by internal audit.

Below 33%	Red	An insurer must take immediate actions to protect the interests of the policyholders. It has to be apparent to FINMA within a short period of time whether the actions initiated by the insurer are likely to lead to success. Such immediate actions include: • Immediate increase of the RBC or reduction of the TC. • Voluntary transfer of the entire insurance portfolio. • Partial transfer of the insurance portfolio, resulting in the SST ratio being out of the red zone subsequent to the transaction. Where it is not possible for an insurer to initiate suitable measures and where the measures ordered by FINMA do not lead to success in the short term either, FINMA will revoke the insurer's licence.

The ladder of supervisory intervention based on the risk-based SST ratio thresholds ensures appropriate and timely action by FINMA to protect the interests of policyholders.

In particular, the risk-based SST ratio thresholds of 100% and 33% are equivalent to the SCR and Minimum Capital Requirement (MCR) thresholds under the Solvency II Directive.

201. As a second measure of the temporary adjustments to the SST, FINMA is relaxing the supervisory intervention ladders (cf. FINMA-Circular 2013/2).

FINMA alleviates measures in place to counteract the undershooting of defined threshold values under the SST Circular and will grant the companies longer deadlines to again reach the target threshold values.

For instance under certain conditions, FINMA will refrain from banning an insurance company from making dividend payments and distributing surplus participation to policy holders if its SST ratio is between 80% und 100%.

Moreover, companies with an SST ratio of over 60%may, as prescribed in the Circular 2013/2, continue to write new business if they adhere to certain conditions.

202. As indicated in the table above, FINMA as well as the SII regime

tolerates some situations when an undertaking temporarily falls below the presribed capital requirement (SII: SCR, SST: TC) as there is no automatic prohibition of dividends or surplus payments to policyholders.

The measures below the minimum capital requirement will remain unaffected.

Absolute minimum capital requirement

203. The absolute minimum capital requirements (minimum capital) for insurers are set out in Articles 7-9 ISO and vary according to the lines of business conducted: between CHF 5 million and CHF 12 million for life insurers, CHF 3 million and CHF 8 million for non-life insurers, CHF 3 million for insurance captives and CHF 10 million for professional reinsurers.

Where an insurer is licensed for more than one branch of insurance (i.e. line of business), the minimum capital is the highest of the different branches.

Under current exchange rates (approximately EUR1 = CHF1.21 as of October 2014), these are higher than the Solvency II requirements in all cases.

A slightly lower requirement might be possible under the Swiss regime for certain composites, however there are currently no Swiss insurers with the combination of licences that would permit this.

We also note that under Article 10 ISO FINMA is empowered to deviate from these amounts if justified by particular circumstances, so long as the minimum capital remains between CHF 3million and CHF 20million.

Enforcement measures

204. FINMA has the supervisory powers to take necessary and appropriate actions if insurers fail to comply with the SST or if the interests of policyholders are threatened.

These powers are in particular set out in Articles 31et seq. FINMASA and Articles 51et seq. ISA and Circular 2008/44.

205. Enforcement measures that FINMA could take include:

- block an insurer's free access to its own assets;
- order the deposit of assets or block them;
- assign powers entrusted to an executive body of an insurer to a third party in full or in part;
- transfer the insurance portfolio and the associated tied assets to another insurer subject to the latter's agreement;
- order the realisation of tied assets; and
- demand the dismissal of persons entrusted with the direction, supervision, control or management of the insurer, of the person(s) with general power of attorney or of the accountable actuary, and ban them from exercising further insurance activities for a maximum of five years.

For example,

- If there is non-compliance by the executive body of an insurer, FINMA will have the power to assign the powers entrusted to these governing bodies to a third party in full or in part.
- If the responsible governing bodies of an insurer do not carry out the actions ordered by FINMA when the insurer is in the Yellow, Amber or Red Zone such that there is a continued risk to the interests of policyholders and beneficiaries, FINMA will have the power to dismiss the respective person(s).

Internal models

Use of internal models

206. By default, an insurer would use the FINMA standard model except where the FINMA standard model is deemed inappropriate, in which case FINMA may require the insurer to use an internal model or the insurer may apply for approval to do so on its own initiative.

Insurance groups, reinsurers (excluding reinsurance captives) and most life insurers are required to use an internal model.

As at May 2011, 70 (out of 140) insurers have applied to use an internal

model for SST calculations.

FINMA takes the view that for many of the small and mid-sized non-life insurers the corresponding standard model is deemed appropriate.

Change policy

207. In accordance with Circular 2008/44 Section VIII(H)(d), an insurer must submit to FINMA any andall material changes to its internal model for approval.

The insurer must submit the associated documentation for the model changes.

Where there are material changes to the internal model, the impact of these changes on the SST calculations has to be assessed and documented.

The details of FINMA's model change policy are spelled out in a corresponding guideline.

208. In addition, FINMA will also verify on a regular basis whether general advances in modelling methods have been taken into account in an internal model.

If necessary, FINMA may require that the internal model be adapted in line with such advances.

Pre-approval

209. An internal model that is used by an insurer for SST purposes requires the prior approval of FINMA as set out in Circular 2009/44 Section VIII(H)(a).

Such approval may take the form of qualified approval subject to terms and conditions.

210. Where an application for an internal model approval has been made and there is sufficient and detailed documentation of the internal model, the insurer may use the internal model on a provisional basis unless otherwise advised by FINMA, during FINMA's review period until an official approval is issued by FINMA.

211. As part of the provisional use of the officially unapproved internal

model, FINMA may impose a capital add-on on the insurer where appropriate.

212. Based on our meeting with FINMA during our on-site visit, we understand that, provided a certain quality level is assured, FINMA is comfortable with an insurer using a provisional internal model for an interim period until the definitive model is approved.

This requires that the insurer has been engaging with FINMA on its internal model developments, and as such, FINMA is familiar with the model even if there is no final approval yet.

For each individual case, it is FINMA's midterm goal to reach a formal decision on the internal model application.

Where FINMA perceives weaknesses in a provisional internal model, FINMA may require the insurer to define and undertake additional specific scenario testing and improvements in relation to model risks and/or impose a capital add-on.

Where there are material weaknesses, FINMA will prohibit the use of the provisional internal model.

213. In view of the principle underlying the Solvency II Directive requirement that an internal model used for the calculation of capital requirements should be subject to prior supervisory approval, which is to ensure that the internal model provides policyholders and beneficiaries with protection at the same level of confidence as that provided under the standard formula, we are satisfied that FINMA has requirements that are equivalent to the Solvency II Directive requirements.

Nevertheless, it is our view that more specific and articulated controls and governance around the use of provisional internal models would be beneficial as part of best practice.

Use test

214. An internal model used for SST purposes has to be an integral part of the risk management system and strategic decision-making process of the insurer, in view of its impact on the TC, RBC and SST ratio, and the corresponding ladder of supervisory intervention.

215. In particular, Circular 2008/44 Section X(B) requires senior

management and the board of directors to have sufficient understanding of the risk internal model, its outputs and its limitations, in order to be able to gauge the implications of the internal model with regard to the insurer's risk management and capital requirements. In particular, they must know and take into account the results of the internal model in their decision-making.

Statistical quality standards

216. Circular 2008/44Section VIII(H)(b)(aa) sets out the principal requirements for the statistical quality standards of an internal model which include:

- An insurer is required to model all its significant positions and take into account all the relevant risks pursuant to the Circular.

To this end it must show the risks to which it is exposed and which relevant risks result from the individual positions and their interaction.

- Future unknown quantities such as the value of a risk factor, a position, a financial instrument or the RBC at the end of the year are to be modelled stochastically.

In particular, the risk model has to establish the common distribution function of these risk factors, define the functional dependence between the risk factors, the positions and/or the financial instruments, and enable the probability distribution function of the loss of RBC during the year to be determined.

- The methods for determining the probability distribution of the RBC have to be based on sound actuarial and financial mathematical methods.

The choice of the common distribution functions of the risk factors and the calibrations of this distribution function have to be based on realistic and credible assumptions.

The modelling of dependencies between the risk factors also has to be taken into account.

- The change in the market-consistent valuation of assets and liabilities in relation to the underlying risk factors has to be explained (risk factor mapping).

- The risk factors and the estimation methods used for their distribution parameters must be shown.

- When modelling is done in sub-modules, the aggregation of the sub-modules or the results from the sub-modules have to be explained.

- Model parameters are to be determined applying sound statistical estimation methods.

- he data used must be complete, correct and timely.

Where too little relevant data is available, expert opinions may be used.

FINMA may require an insurer to apply more prudent parameters, where the parameters used previously are not deemed sufficiently suitable for modelling its risks.

- The dataset used and the parameters derived from it must be verified at least once a year prior to undertaking the SST calculations, taking into account materiality, and updated as necessary.

Validation standards

217. An insurer is required to review and validate at regular intervals the suitability and appropriateness of its internal model taking into account its risk profile, and its compliance with the SST requirements in general, as set out in Circular2008/44Section X(C).

218. The findings of the review are to be communicated to the board of directors or senior management.

Documentation standards

219. Circular 2008/44 Section VIII(H)(d) requires an insurer to provide FINMA with self-contained documentation of their internal model which will enable a knowledgeable third party to ascertain, in a reasonable amount of time, whether the regulatory requirements for approval of the internal model are satisfied.

220. The documentation should:

- Describe the various internal model modules and the interactions

between those modules;

- Explain the methodology (theories and assumptions) on which the internal model is based, and its implementation within the insurer;

- Describe the limitations and weaknesses of the internal model;

- Indicate which positions and financial instruments or risks have not been taken into account;

- Delineate the empirical basis of the internal model. In particular, it must describe the manner in which the model parameters have been estimated, and how the datasets and other information sources have been used in the process;

- Demonstrate whether the insurer, based on its own assessment, complies with the calibration test as well as the methodology and parameter tests; and

- Demonstrate the manner in which the data quality, and in particular the quality of information pertaining to positions and exposures, is ensured.

Profit and loss attribution

221. There is no explicit SST requirement for profit and loss attribution.

222. However there is an implicit requirement for profit and loss attribution under the SST, with a profit and loss attribution being implicitly required in:

- The insurer's explanation of the change in the market-consistent valuation of assets and liabilities in relation to the risk factors (Circular 2008/44 Section VIII(H)(b)(aa)(§120));

- The analysis of the datasets and parameters used, which an insurer is required to undertake at least once a year (Circular 2008/44 Section VIII(H)(b)(aa)(§123)).

It is our view that explicit requirements for profit and loss attribution would be beneficial as part of best practice.

Partial internal model

223. In accordance with the Guidelines on SST modalities dated 1 March 2012, an internal model application has to specify and contain:

- The names of all of the legal entities for which the (partial) internal model is to be used.

- The modules and risks which are covered by the (partial) internal model.

- The reasoning explaining why and how the insurer believes that the organisational, qualitative and quantitative requirements in respect of an internal model are fulfilled.

224. In addition to requiring insurers to consider the dependencies between risks as part of their SST calculations, in the case of partial internal model applications FINMA will check as part of its internal model approval process:

- whether in the internal model part the risks are reasonably well captured; and

- whether the standard model is able to allow for the remaining risks.

225. FINMA may also require the insurer to undertake additional scenario testing specific to model risks.

226. An insurer which uses an approved internal model for its SST calculations may not replace the internal model with the FINMA standard model unless the insurer has submitted sufficient justification for this replacement to FINMA and FINMA has approved the replacement as set out in Circular 2008/44Section VIII(H)(c).

Investments

227. Swiss-domiciled insurers must be organised in a way that ensures that all material risks are appropriately measured, identified, monitored and mitigated as well as reported upon (Article 22 ISA, Articles 96-98 ISO and Circular 2008/32).

In addition, investment risks are more specifically covered in the context of the business plan to be submitted by undertakings.

This encapsulates the organisation of risk management, investment strategy, investment process and management as well as maintaining the solvency position of the undertaking.

Investing prudently

228. Under the general principles regarding investments, Swiss-domiciled insurers must submit their investment guidelines for approval (Article 4 (2d) ISA).

FINMA's assessment takes into account the prudent investor rule and considers common practices in modern portfolio management.

Tied asset rules only apply to insurers writing direct insurance business.

For reinsurers FINMA may decide, in view of the reinsurer's risk capacity and/or the aspects considered in its assessment of the insurer's investment guidelines, to impose limits on certain investments, categories or structures, possibly in combination with additional reporting requirements.

In recent years there have been several cases where such measures were applied.

Derivatives

229. The use of derivative instruments is restricted to a) the reduction of risks arising from investments and/or from liabilities towards policyholders, and b) the efficient management of investments (Article 100(1) ISO).

Risk concentration

230. If without a particular risk mitigation instrument or asset an insurer's SST ratio would be below 80%, that position is regarded as constituting a concentration and FINMA is likely to restrict the instrument or asset's eligibility to meet the SST.

For reinsurance captives there are high capital charges for exposures to counterparties exceeding 10% of available economic capital. Exposures exceeding 30% of available capital are charged with 100%of underlying capital.

231. Direct insurers are required to secure claims arising from their insurance contracts by means of tied assets.

There are no tied assets requirements for reinsurers or at group level.

Under the tied assets requirements there are explicit quantitative limits on risk accumulation and risk concentration.

Counterparty risk exposure and unhedged foreign currency exposure are restricted.

Furthermore, asset allocation has to consider the undertaking's liquidity needs.

As a basic principle, tied asset investments have to be highly liquid compared to other assets in the same asset class.

232. For each asset class a number of qualitative (economic and legal) restrictions apply.

In a quantitative sense an explicit limit system applies to investments in stocks, securitised debt, real estate, mortgages, alternative investments and derivatives other than for hedging purposes.

There are also limits within the asset classes for diversification purposes. Securities lending is allowed but restricted.

Specificities for 172

(I) Reinsurance captives

Overview

233. Reinsurers captives are not currently covered by the full SST.

Once the pending ISO revision enters into force in 2015 it is anticipated that reinsurance captives will be fully subject to the same SST requirements as other insurers without any exemption.

Size of reinsurance captive market

234. The size of the reinsurance captive market is fairly small at around

2.2% to 3.1% of the overall total reinsurance market, based on the latest available data at year end 2012 and 201313.

The figure increased in 2013, since a new reinsurance captive was licensed.

Given the complexity and the size of its risk profile the company is subject to the SST.

Most of the reinsurance captives are relatively small in comparison to the overall reinsurance market in Switzerland, with the largest reinsurance captive only making up around 0.4% to 1.2% of the overall total reinsurance market by total assets and total gross premiums respectively.

The table in §235 below sets out further details on the position of reinsurance captives in the market as at the end of 2012 and 2013.

2012 market information of reinsurance captives compared to all reinsurance companies

No. of reinsurance captives as at Dec 2012 (to insert data date)	Total gross reinsurance premiums written – reinsurance captives (CHF)	Total gross reinsurance premiums written – reinsurance market (CHF)	Total assets – reinsurance captives (CHF)	Total assets – reinsurance market (CHF)	Total Technical Provisions – reinsurance captives (CHF)	Total Technical Provisions – reinsurance market (CHF)
35 (ALL)	CHF 753m (2.2%)	CHF 34'817m (100.0%)	CHF 2'700m (2.0%)	CHF 135'626m (100.0%)	CHF 1'580m (2.1%)	CHF 74'119m (100.0%)
2 (reinsurance captives that are not exempted from SST)	CHF 417m (1.2%)	CHF 34'817m (100.0%)	CHF 701m (0.5%)	CHF 135'626m (100.0%)	CHF 586m (0.8%)	CHF 74'119m (100.0%)
1 (largest reinsurance captive)	CHF 401m (1.2%)	CHF 34'817 (100.0%)	CHF 665m (0.5%)	CHF 135'626m (100.0%)	CHF 561m (0.8%)	CHF 74'119m (100.0%)

2013 market information of reinsurance captives compared to all reinsurance companies

No. Of reinsurance captives as at Dec 2013 (to insert data date)	Total gross reinsurance premiums written – reinsurance captives (CHF)	Total gross reinsurance premiums written – reinsurance market (CHF)	Total assets – reinsurance captives (CHF)	Total assets – reinsurance market (CHF)	Total Technical Provisions – reinsurance captives (CHF)	Total Technical Provisions – reinsurance market (CHF)
34 (ALL)	CHF 1 149m (3.1%)	CHF 36'845m (100.0%)	CHF 3'865m (2.9%)	CHF 134'064m (100.0%)	CHF 1'670m (2.2%)	CHF 75'878m (100.0%)
3 (reinsurance captives that are not exempted from SST)	CHF 868m (2.4%)	CHF 36'845m (100.0%)	CHF 2'276m (1.7%)	CHF 134'064m (100.0%)	CHF 1'224m (1.6%)	CHF 75'878m (100.0%)
1 (largest reinsurance captive)	CHF 456m (1.2%)	CHF 36'845 (100.0%)	CHF 845m (0.6%)	CHF 134'064m (100.0%)	CHF 722m (1.0%)	CHF 75'878m (100.0%)

236. The number of reinsurance captives has also decreased in recent years, in part due to FINMA imposing more stringent supervisory requirements since the implementation of the ISA, which also applies to reinsurance captives.

At the end of 2013, there were 34 reinsurance captives compared to 42 at the end of 2009.

Over the same time period, there were 28 professional reinsurers at the end of 2013compared to 26at the end of 2009.

(II) Tied assets

237. There are no tied assets requirements for reinsurers.

Tied asset rules only apply to insurers writing direct insurance business.

For reinsurers, FINMA may decide, in view of the reinsurer's risk capacity and/or risk management considerations, to impose limits on certain investments, categories, or structures, possibly in combination with additional reporting requirements.

In recent years there have been several cases where such measures were applied.

238. As there are no tied asset requirements under Solvency II, the absence of tied asset requirements for reinsurers is not inconsistent with the Solvency II requirements.

239. The actions that FINMA has taken in recent years are in line with prudent person requirement under Solvency II.

Specificities for 227

240. Every single entity has to prepare an economic balance sheet under the SST.

241. That balance sheet lists assets and liabilities at market consistent values.

The SST is considered equivalent as regards principle 6.

So, if the solvency of the group in Solvency II is determined by the

deduction and aggregation method, the capital requirements and own funds as laid down in the SST would be suitable for the group calculation.

Specificities for 260

Overview

242. The solvency of a Swiss insurance group is currently measured by the group SST and the group Solvency I calculation.

Once the revised ISO has entered into force, the solvency of an insurance undertaking will solely be assessed by means of the SST.

The Solvency II directive prescribes two methods of assessing group solvency.

That is, Method I: accounting consolidated-based method and Method II (Alternative method): deduction and aggregation method.

Differing from both Solvency II methods the group SST represents a granular approach (Circular 2008/44), that is, one which results in a set of requirements for the group's various legal entities, rather than a single result for the group as a whole.

Insurance groups under FINMA group supervision have to determine the TC and RBC in principle for each legal entity of the group i.e. to perform an SST for each member of the group, including the ultimate parent.

This applies for entities in Switzerland as well as in other jurisdictions.

It should also be noted that all Swiss Insurance groups are required to calculate TC and RBC using an internal model.

243. As a possible efficiency gain FINMA can grant approval to combine some legal entities into a cluster within the SST group model (Appendix 2, Circular 2008/44).

Generally, such clustering occurs between entities within a single country as unlimited fungibility and transferability of funds within a cluster is assumed.

244. In the group SST the group is not considered as one single entity and as such there is no single group TC or RBC.

However, FINMA can request that a group calculate an SST group capital requirement based on the consolidated accounts of the group (Appendix 2, SST Circular).

The majority of the large groups in Switzerland already produce and submit the SST requirements based on the consolidated accounts in addition to the granular SST requirements.

245. One element of the granular SST is the SST result of the ultimate parent.

This SST of the parent considers all the assets, liabilities and risks of all operations in the group as is done in the consolidated group solvency calculation.

One of the key differences from the consolidated group solvency calculation is that the SST of the parent entity allows limited liability.

In addition, unlike the consolidated calculation the SST of the parent contains the effect of all intra-group transactions (if they are relevant from a risk or capital perspective).

Double-gearing

246. In the granular SST calculations, double gearing is not eliminated but rather is represented appropriately in the capital requirements of the entities involved.

This appropriate representation lies in the market consistent basis for valuation of subsidiaries and capital transfer instruments (loans and hybrid loans) and the simultaneous modelling of changes in the entities' RBC over one year.

That is, the granular approach examines the solvency of each individual entity but unlike a solo calculation it models the intra-group transactions in each participating entity within the group simultaneously.

An intra-group transaction is effectively modelled in each entity as if it were a transaction with a third party.

This means that once an item is "consumed" in one entity, it can't be used anymore in the granular SST of another entity thus avoiding double gearing because it would there be the subject of a 100%capital charge.

247. In addition, unlike the group calculation under Solvency II (method II) the SST of the parent does not add the RBC of a subsidiary to the RBC of the parent company (in which case the intra-group arrangements must be eliminated).

The RBC of the subsidiary is instead part of the RBC calculated for the parent as the SST of the parent contains as an asset the economic net asset value of the parent entity's participations in other group entities.

This allows the issue of internal creation of capital within the group to be addressed.

Group capital fungibility and transferability

248. In the SST granular approach two assumptions are applied:

- Upstream fungibility/transferability: a parent can sell a subsidiary at market price.

That is, to get liquid assets it is not necessary for the parent to take assets or capital out of the subsidiary, something which may be restricted by laws, capital requirements, rating agencies and other factors.

Thus the SST assumes full upstream fungibility/ transferability.

- Downstream fungibility/transferability: The SST assumes that in both normal and stressed situations a subsidiary does not get more capital than what has been agreed in a legally binding contract such as a guarantee or reinsurance contract.

249. It should be noted that within clusters full transferability and fungibility is assumed.

Therefore, FINMA considers the appropriateness of this assumption in approving the clustering of entities for theSST calculations.

Solo deficits

250. Group solvency is assessed based on the information provided in the set of SST ratios for the group entities, therefore solo deficits will be clearly visible at group level.

In addition, if a subsidiary shows a SST ratio of less than 100%, then this

situation might be visible in the balance sheet of the parent (in the form of that subsidiary having a low net asset value) and in the target capital of other entities which have in place an intra-group transaction with that subsidiary.

Risk mitigation techniques and diversification

251. At present, the group SST has to be performed twice a year (Article 202 ISO).

With the revised ISO, it is foreseen that insurance groups and conglomerates will have to report only once a year in future, in line with requirements for solo entitites.

A key characteristic of the granular group SST is that the effect of capital and risk transfer instruments (be it group internally or with external counterparties) are captured in the calculation of the individual RBC and TC.

From that it follows that risk mitigation techniques such as reinsurance cover and guarantees are allowed for in the TC under certain circumstances.

Reinsurance cover would typically reduce the TC of the cedent and increase the TC of there insurer.

252. In terms of diversification the key beneficiary in the SST granular approach is the parent company.

Subsidiaries are assets of the parent which have a value and a risk.

That is, they contribute to the available capital and the target capital of the parent.

Therefore, there is diversification between these assets to the extent to which the values of the subsidiaries would not move in parallel.

Group risks

253. If FINMA believes that in particular cases there is a need to assess the group solvency also with an SST on a consolidated basis it has the right to request the group to produce this.

The group SST and Solvency II both aim to capture all risks in an insurance group, including the risk that only emerges because there is an insurance group.

They differ in the sense that Solvency II requires a single solvency capital requirement considering the group as one economic entity, while the group SST follows the internal legal structure of group together with the internal transactions to derive a set of capital requirements for the entities of the group, with the possibility of supplementing this with an SST on consolidated accounts for specific groups where necessary.

254. In terms of contagion risk, the risk of having to support other entities in the group would be taken into account only insofar as there were legally binding agreements between entities.

Reputational risk is not captured in the SST (though elements relating to compliance and other relevant aspects are covered from a qualitative perspective under the Swiss Qualitative Assessment).

Concentration risk is captured in the SST and companies are required to report on it as part of the SST reporting requirements.

Furthermore, supplementing this is the requirement that groups report on concentration risk to the supervisory team (separate to the SST reporting).

255. The technical result of the group SST is a collection of solvency ratios as opposed to a single ratio as is produced under the two methods prescribed under Solvency II.

However, the group SST can be described as a group-wide model as it simultaneously models each entity within a group incorporating the mutual interactions between each entity including intra-group transactions and internal ownership.

Group internal model

256. As a stand-alone jurisdiction, Switzerland performs group supervision under applicable Swiss law.

This also means that group internal models are approved on a unilateral basis under Swiss law, rather than through a formal college decision based on Solvency II.

There is a lot of exchange and discussion with the other supervisors involved, however.

In terms of such engagement the key requirements from FINMA's perspective are the rules on cooperation and information exchange, including the guarantee of professional secrecy.

Joint inspections

257. To date FINMA has not conducted joint inspections in Switzerland.

FINMA representatives stated they are very open to conducting such inspections as part of international cooperation as set out under Articles 42and 43 FINMASA.

Non-compliance with minimum capital requirements by entity within group

258. FINMA would not take direct action against a subsidiary in another jurisdiction.

It would expect that this action would be taken by the local supervisor, possibly after consultation with FINMA, but most probably according to the rules of the local solvency regime.

However, FINMA could take supervisory action towards the Swiss domiciled entities of the group, in particular the group's parent entity, to induce compliance by the non-Swiss entity with the SST requirements.

259. Where a supervised person or entity violates provisions of the relevant Financial Market Acts or if there are any other irregularities, FINMA shall ensure the restoration of compliance with the law (Article 31 FINMASA).

If a Swiss insurer did not respond voluntarily to supervisory concerns, FINMA would be authorised to issue binding rulings and oblige the supervised entity to take specific measures.

FINMA also has the power to appoint an independent and suitably-qualified person who may act in place of the management bodies for the supervised entity (Article 36(2) FINMASA).

From an administrative point of view, FINMA can ultimately revoke the insurer's licence to do business. FINMA may also trigger criminal

prosecution for various charges.

260. The granular group SST consists of the set of SST ratios for the legal entities of the group, i.e. there is no group TC.

However, if a group additionally determines an SST TC on consolidated accounts, this may be smaller than the sum of all the entities' MCRs 14 due to diversification effects between the entities. For example this could occur with a set of monoline insurers, each with a portfolio with low diversification.

EIOPA advice

Articles 172/227/260

261. The SST uses a total balance sheet approach and market consistent valuation.

Its requirements in relation to technical provisions, own funds and internal models are seen as equivalent to Solvency II, although in relation to internal models we note that Solvency II envisages no use of provisional internal models and includes explicit requirements for profit and loss attribution.

262. The SST sets capital requirements at an equivalent level to Solvency II and accurate and timely intervention is taken in cases of non-compliance.

Although there is no explicit requirement under the SST to quantify capital requirements for operational risks, this is addressed qualitatively, particularly through the SQA, and with additional scenario testing and/or capital add-ons where necessary.

As a result we are satisfied that FINMA currently have equivalent requirements to the Solvency II Directive requirements to address operational risks, recognising the intricacies of operational risks and the limited effectiveness of capital requirements when addressing such risks.

Article 172

263. We note that Swiss regime will fully cover reinsurance captives once the pending ISO revision enters into force.

Article 227

264. Taking into account the overall picture, we conclude that the Swiss supervisory regime is equivalent to the Solvency II Directive requirements with respect to Principle 6and 7.

Article 260

265. The Swiss Solvency Test for groups differs in approach to the consolidated and deduction and aggregation methods prescribed under Articles 230 and 233 Solvency II Directive respectively.

That is, there is no one group solvency ratio but rather a set of solvency ratios for each entity within the group, including the parent.

This is deemed equivalent to Solvency II because unlike a collection of solo calculations it simultaneously models all interactions between each entity rather than stripping out the intra-group transactions.

This is a group-wide model, taking the group internal structure into account rather than ignoring it.

In addition, similar to the consolidated group solvency calculations under Solvency II, the SST of the ultimate parent entity considers all the assets, liabilities and risks of all the group's operations.

As a result we regard the Swiss supervisory regime as equivalent to Solvency II with respect to Principle 12.

Principle 8 - Parent undertakings outside the Community: scope of group supervision

Objective - The supervisory authorities of the third country shall have a legal or regulatory framework for determining which undertakings fall under the scope of supervision at group level.

The scope of supervision at group level shall at least include all undertakings over which a participating undertaking, as defined by Article 212 of Directive 2009/138/EC, exercises dominant or significant influence.

The scope may exclude undertakings where this would be inappropriate to the objectives of group supervision.

266. The definition of an insurance group according to Article 64 (c) ISA encompasses all entities that, among other criteria, form an economic unit or are linked in some other way by influence or control.

The wording of this article, complemented by the definition of 'control' provided by FINMA during our on-site visit, is equivalent to the criteria for inclusion in the scope of group supervision laid out in the Solvency II Directive and Directive 83/349/EEC (to which the Solvency II Directive refers for the definition of relationships of control and influence).

At the same time, in exceptional cases FINMA has the power under Article 199 (4) ISO to exclude an entity from the scope of the group for the purpose of solvency assessment, if their inclusion would be misleading.

Even though the Solvency II Directive allows an exclusion of entities from the scope of general group supervision, this is currently not foreseen in the Swiss regulation, which can from our point of view be regarded as a conservative approach.

Furthermore according to Article 64ISA group supervision includes all entities of a group irrespective of their activities, including operating and non-operating holding companies.

267. According to Article 65 ISA, FINMA may subject an insurance group to group supervision, where the group is managed from Switzerland or where it is managed from abroad but no equivalent supervision is exercised there and the touch points to Switzerland are strong enough for FINMA itself to exercise effective group supervision.

In light of FINMA's proven willingness to take on the role of group supervisor, effective group supervision is provided for in the first scenario and in the second, within the boundaries of what can be reasonably expected from FINMA.

Where another authority also claims the role of group supervisor, FINMA is to come to an agreement with it on responsibilities, procedures and content of the group supervisory arrangements.

To date no such arrangements have needed to be made.

268. The carrying out of cross-border inspections is detailed in Article 43 FINMASA.

Although this article does not include any obligation to consult the relevant home country authority prior to carrying out an inspection,FINMA emphasises its openness to dialogue when planning a cross-border inspection and has provided examples of its communication and cooperation with foreign authorities.

In order to further facilitate information exchange in this respect, FINMA has signed bilateral Memoranda of Understanding (MoUs) with all the members of the EEA and EIOPA.

269. According to FINMA, no group entities are currently excluded from group supervision, but rather they are granted different levels of supervision according to their perceived riskiness.

Although there is no specific legal obligation for FINMA to inform the relevant foreign authority if an entity is excluded from the scope of group supervision, FINMA emphasises that from its viewpoint this follows from the general concept of cooperation.

Against the background of the examples of supervisory cooperation presented to us as well as FINMA's MoUs with EEA members, it can be concluded that this does not represent a matter of concern.

EIOPA advice

Article 260

270. In consideration ofthe observations laid out above it can be concluded that the supervisory regime of Switzerland is equivalent to Solvency II with regard to Principle 8.

This conclusion takes into account the numerous practical examples of cooperation and information exchange with other supervisory authorities that FINMA provided during the on-site visit.

Principle 9 - Parent undertakings outside the Community: cooperation and exchange of information between supervisory authorities

Objective - Third country supervisory authorities shall be empowered by law or regulation to enter into coordination arrangements to ensure that the requirement in Article 261(2) of Directive 2009/138/EC can be met.

Determination of the group supervisor

271. In respect of the rules and guidelines regarding the determination of a group supervisor, there will inevitably be differences in wording and possible interpretation between regimes.

EIOPA will therefore recognise a broadly similar approach to determining group supervision as equivalent, providing this does not prejudice the proper exercise of supervisory responsibilities under Solvency II.

Therefore where a third country has been assessed as equivalent, it is essential that there be cooperation between all supervisors concerned prior to decisions on group supervision being taken and communicated to insurers.

Rights and duties of the third country group supervisor

272. The group supervisor's responsibility for the coordination and dissemination of information is based on Articles 67 to 70 ISA.

Here, the group supervisor acts as coordinator in the assessment of the group from a quantitative and qualitative perspective, local supervisors are involved through early information sharing, including sharing of information received from local supervisors during group-wide assessments.

The group supervisor's responsibility for review of the group's financial position is based on Article 25 ISA, which requires a consolidated management report for groups, including annual accounts, and a supervisory report.

Currently, all group reports fall under either US GAAP, IFRS or Swiss GAAP FER reporting standards.

The responsibility for planning and coordination

273. FINMA makes use of supervisory colleges, and also, where appropriate, bilateral cooperation.

The planning and preparation of supervisory colleges is carried out through preparatory steps (checklists to be filled out by all participants and forwarded to all) that are followed by the supervisory college meeting.

This in turn may lead to action points for the group supervisor or the local supervisors.

As a legal basis for this FINMA refers to Articles 6 (2), 42 and 43 FINMASA.

In practice, FINMA has shown that it is in a position to fulfil its coordination tasks (for instance through means of teleconferences and similar).

Framework for crisis management

274. Article 67 ISA in conjunction with Article 22 ISA requires insurance groups to be organised in a manner that allows all relevant risks to be identified, limited and monitored.

Circular 2008/32 specifies principles for an adequate corporate governance framework including risk management, which FINMA also applies to crisis management as well contingency and succession planning.

FINMA has shown that emergency plans are set up for each college.

It has also provided evidence of the effective sharing of relevant information.

The assessment of the application for a group internal model

275. As a stand-alone jurisdiction, Switzerland has a unilateral group supervisory approach.

This also means that group internal models are approved on a unilateral basis, rather than through a formal college decision.

There is a lot of exchange and discussion with the other supervisors involved, however.

Third country applicable regime as to the establishment and functioning of cooperation mechanisms

276. FINMA is not subject to any specific laws or regulations in this respect. As a legal basis the very general legal provision of Article 6 (2) FINMASA and the legal provisions for information exchange under Articles 42 and 43 FINMASA are applied.

Article 6 (2) FINMASA, which states that FINMA fulfils the international tasks related to its supervisory activity, is not elaborated upon in subordinated legislation or rules.

The Board of Directors of FINMA decided, however, on 19 November 2009 on FINMA's cross-sectorally applicable policy on supervisory colleges. FINMA has evidenced that it does in practice fulfil its obligations to manage cooperation in this area.

Willingness to submit information on intra-group transactions

277. Here, the rules governing international cooperation and information exchange (Articles 42 and 43 FINMASA) are the basis for cooperation on intra-group transactions through bilateral mechanisms and supervisory colleges.

In large groups the complexities resulting from such intra-group transactions are regularly reviewed and discussed. Particular attention has been paid to them during the financial crisis.

Exchange of prior information on decisions that could affect the solvency of entities situated in an EEA Member State

278. Based on cooperation through bilateral mechanisms and supervisory colleges, under the rules governing international cooperation and information exchange (Articles 42 and 43 FINMASA), FINMA does monitor the exchange of prior information on decisions that could affect the solvency of entities situated in an EEA Member State.

The solvency situation is monitored continuously.

Willingness to change the content of written coordination arrangements

279. To date no coordination arrangements have been concluded, since there has been no need to do so.

However, FINMA circulated a draft coordination agreement for their College meetings in 2013 and 2014, and started the discussion about the introduction of such agreements.

Conclusion of the coordination agreements is envisaged during 2015. FINMA refersto the general provisions of Articles 6, 42and 43FINMASA as

a legal basis, if there is a need to conclude such arrangements.

EEA Member States' participation in the validation process of group internal models

280. The validation process for internal models relating to the cross-border activities of a group involves all relevant supervisory authorities and is based on the cooperation regime embodied in Articles 42and 43FINMASA.

Willingness to support restrictions on free assets for supervised entities

281. Based on the general mechanisms for cooperation through bilateral mechanisms and supervisory colleges within the parameters set out in Articles 42 and 43 FINMASA, there is willingness on FINMA's part to support such restrictions on the free assets of supervised entities, provided the analysis of the solvency situation of the group as a whole and of the various legal entities or clusters of that group shows that such action is required and justified.

Third country requirements applicable for the setting up of cooperation arrangements

282. A college of supervisors or similar cooperation arrangements can be established, composed at a minimum of all relevant authorities for the group's supervision, under the following criteria:

- Relevance and/ or materiality of the entity within the group
- Significance of the entity for the local market
- Risk level in a particular entity
- Role of the supervisory college and its relevance to the particular entity.

283. Based on its general supervisory mandate and cooperation empowerment, FINMA has established global supervisory colleges for all insurance groups with international activities.

284. To address EEA specific issues (e.g. to discuss Solvency II implementation topics) of Swiss groups with EU presence, European Supervisory Specialised Teams (ESST) have been introduced as part of the

FINMA supervisory colleges.

285. The supervisory colleges of Swiss-based insurance groups meet in person at least once a year in Switzerland.

In preparation for these college meetings, all participating authorities are asked to summarise the financial and solvency position of the insurance group's operations in their country, report on intra-group transactions and highlight current issues.

This information is then distributed to all participants.

The most important issues are presented at the meeting and are discussed amongst supervisors.

286. At these college meetings the insurance groups present themselves to the supervisors.

The topics are pre-agreed with the supervisors and discussed with the management of the insurance group.

The annual in-person college meetings are complemented by quarterly college conference calls if deemed appropriate.

In addition, all involved supervisors are provided with ad hoc information if material events or changes take place (e.g. acquisition, mergers, crisis situations, etc.).

In 2013 FINMA held in-person supervisory colleges for Swiss Re, Zurich Insurance Group, Swiss Life, Bâloise, Helvetia and Nationale Suisse. Supervisors from all the countries in which the groups are active were invited to participate.

287. When a college of supervisors or similar cooperation arrangement is established, the functioning and organisation of these mechanisms may be based on written arrangements, including provisions regarding the obligation to cooperate, exchange of information and decision-making processes.

288. In order to ensure the efficiency and effectiveness of supervisory colleges, insurance group-specific MoUs and/or confidentiality agreements are in place, if no generally applicable MoU exists between the participating supervisory authorities.

Standard confidentiality agreements have been set up by FINMA, and FINMA requires them to be signed prior to participation in a college.

FINMA provided evidence of such agreements during the on-site visit.

Dispute solving mechanism

289. FINMA stated that there have not been any disputes to date. If one were to occur, the aforementioned cooperation mechanisms would be applied.

Exchange of information and cooperation between third country supervisors and EEA supervisors in going concern circumstances and crisis situations

290. Articles 6, 42 and 43 FINMASA operate as a legal basis for this information exchange and cooperation.

FINMA has evidenced that it facilitates communication by sharing the contact details of all the supervisory authorities involved and the persons in charge.

MoUs and/or confidentiality agreements allow FINMA -particularly with regard to crisis situations -to share relevant information immediately by email, interim conference calls or ad hoc face-to-face meetings.

General supervisory powers to require insurers to submit necessary information

291. To ensure that FINMA obtains all relevant and necessary information from a group, one Swiss-based company is designated by FINMA as point of contact for the supervisory authority.

This legal entity is tasked with complying with the group's obligations to provide information (Article 191 (3) ISO).

The duty to provide information to FINMA applies to all companies of the group (Article 71 ISA).

FINMA has evidenced that in practice it supervises compliance with these legal duties.

In cases where such information from an insurer/group is incorrect, FINMA is able to ensure correction by practical means without having to implement strict legal sanctions.

EIOPA advice
Article 260

292. Generally, FINMA is empowered by Articles 6, 42 and 43 FINMASA to enter into cooperation agreements and to maintain procedures of information exchange with other supervisory authorities on the basis of strict professional secrecy.

With reference to the provisions for equivalent prudential regimes for group supervision set out under Articles 260 and 261 (2) Solvency II Directive, which in turn include the obligations spelled out in Articles 68 and 247 et seq. Solvency II Directive, Article 6 FINMASA can only operate as a very general legal basis for the tasks of group supervision.

Equivalent requirements to those provided for in Solvency II are not clearly spelled out in legislation or in other subordinate legal provisions.

The Board of Directors of FINMA has, however, adopted a cross-sectoral policy on supervisory colleges on 19 November 2009.

This policy has been translated to insurance group supervisory colleges and is published on FINMA's website.

Together with Article 6 (2) FINMASA this provides an equivalent framework to that set out under Solvency II.

293. On the other hand, FINMA has provided broad evidence that a practical approach equivalent to Solvency II is implemented in day-to-day supervisory practice through FINMA's organising and taking part in colleges, as well as several EIOPA surveys, and through effective data exchange among college members.

FINMA has also demonstrated that it does strictly adhere to the obligation for professional secrecy.

294. We find FINMA equivalent with regard to its co-operation and exchange of information with other supervisory authorities.

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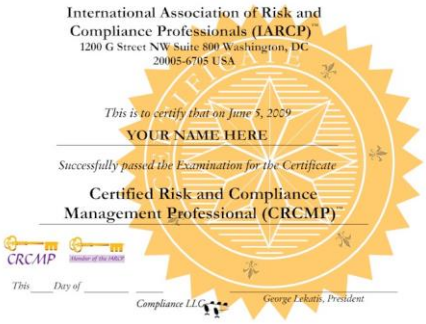

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