New rules covering the regulatory audit of financial institutions

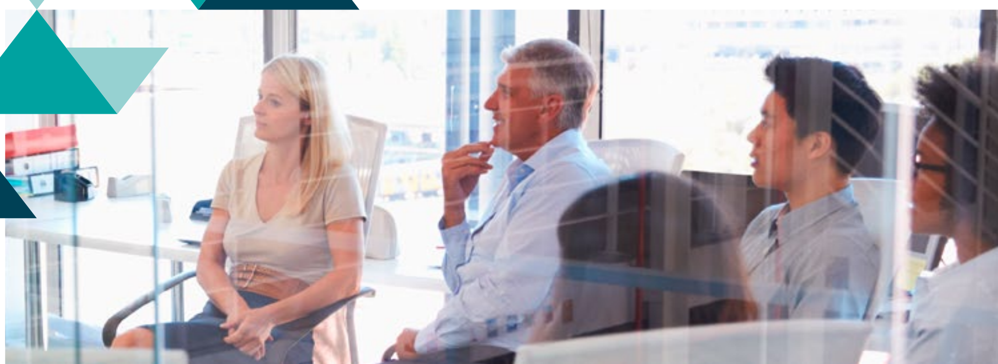
FINMA circular 2013/3

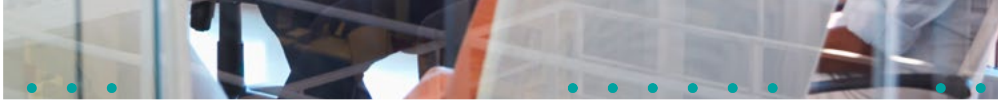
Switzerland has a unique system of supervision of the financial sector, where audit firms perform supervision duties on behalf of the regulator – FINMA – also known as the "dual system". The value of this well-established system has been recognized and confirmed over time. In recent years however, criticism have risen both at an international and national level, mainly related to the lack of clear instructions from the regulator to auditors, and a certain inability of the supervision system to identify and prevent major issues affecting the marketplace, despite the increasing efforts and costs associated to the regulatory supervision. In response to those challenges, FINMA has first issued a circular on audit activities in 2013, which has been revised in 2018 affecting audit periods starting on or after 1st of January 2019.

The main driver of this revision initiated by FINMA is to further align regulatory risks with audit activities covering financial institutions, and improve the efficiency of the dual system. With this revision, FINMA also aims to benefit from *"…audit procedures with a sharper focus on substantive issues [which] will maintain an appropriate level of protection and improve the quality of audit findings. Regulatory audits will be adapted to the risk situation of supervised institutions and, in a forward-looking manner, to the prospective challenges that these institutions could face in the future"*. These ambitious goals have also to be looked at in parallel with the strong message communicated by the regulator, which is to reduce the supervision costs of the financial sector up to 30%.

Among the changes the new circular includes, we can highlight the fact that, while the general audit approach is valid for all banks and collective investment schemes, it has been further differentiated according to the size and complexity of the entities. Systemic banks will have a continued and enhanced direct involvement of FINMA both in defining the audit strategy with the audit firm, as well as having direct audits from FINMA. This is not the case for smaller banks which do not have a higher risk profile or material weaknesses in their organisation and will benefit from less frequent audits. FINMA's more focussed approach also translates into less frequent audits: according to the perceived level of risks, certain activities of the banks will never be audited, or only every 6 years, while areas with a high risk will be audited every 3 years and only the very high risk areas will be covered by an annual audit. There are however certain exceptions to this general rule, for example for anti-money laundering or IT related areas which will be covered more often according the perceived risk by the regulator. FINMA also counts on an enhanced coordination with internal audit of the banks, also easing the restrictions introduced in the previous version of the circular. Finally, FINMA has simplified reporting formats and has further increased digitalisation of its reporting processes with the introduction of its digital platform "EHP", for both the supervised institutions as well as the audit firms.

The first experiences gathered with this modified approach show that the changes are not as simple to apprehend and implement as initially foreseen. Firstly, the transitory dispositions, which require an audit to be performed for areas where the last intervention was a critical review in the last 3 years, create volatility. As a result, the expected reduced coverage does not necessarily materialise in the first year, or if it does, there generally is a catchup to cover remaining audit areas in 2020 and 2021 depending on the past coverage. This volatility is expected to stabilise in year 2022 and onwards but this may affect the sustainable cost reduction goals expressed by the regulator. Also related to the newly reduced coverage, it is now possible for management companies of collective investment schemes, as well as custodian banks, that based on the rotation of the audit areas and the risk appreciation, there is no audit work performed for a given year. This is a particular challenge, as the specific setup of the collective investment schemes in Switzerland involves various parties which also rely on the results of existing regulatory audits for their own supervision. In the absence of regulatory audit for a given year, will counterparties and clients accept the absence of assurance, or will this create a specific need of assurance? Experience shows that for the first year of implementation, the "annual coverage" solution is preferred in the area of custodian bank audits and management companies.





Another very important change for the stakeholders, is that the level of assurance obtained through the external audit firm, will be reduced over time, sometimes even not having any coverage to rely on, compared to what they used to obtain in the past. This reflects FINMA's ambition to reinforce and clarify the role of the external audit firm as FINMA's "prolonged arm" for supervision tasks, and not necessarily for other stakeholders. For Board members, this means that they will have to clearly understand the level of assurance they will obtain from the regulatory audit, and should they want additional coverage (to a comparable level as in prior years) they will have to anticipate and organise additional assurance in areas of importance to them, either through their internal audit or by appointing the external audit firm for additional work to obtain appropriate assurance. In that respect, the coordination between internal and external audit is even more important as in the past, so that governing bodies have a clear understanding of the coverage they will be able to rely on.

The digitalisation efforts of FINMA, through the use of its EHP platform, are still at an "early days" stage. While the platform offers a stable transmission and archive solution for providing FINMA with various documents, it still necessitates numerous manual inputs with no capabilities to export or import data into the FINMA required documents. The submitted documents can be extracted by users from the platform, unfortunately they are not in a user-friendly format and require additional work to meet the quality standards expected by governing bodies and executives of the supervised institutions. By so doing, FINMA has transferred part of the administrative work of data collection to the Banks and external audit firms, unfortunately this does not really serve the objective of increasing efficiency of the supervision and brings additional risks of error to the process.

In conclusion, FINMA's efforts to modernise and improve the quality and efficiency of its supervision system are understood and broadly welcomed, considering the pressure and transformation ongoing in the financial services industry. The current reform was largely driven by FINMA, with a lead and a pace which contrasts with what we have experienced in the past, and this was probably necessary to change a well-established practice. First experiences however show that the new system has many areas of improvement and will have to be further worked on in order to achieve the ambitious goals set by FINMA. To this end, the key to a successful and fast transformation is to re-instore the dialogue and to bring all parties to work towards improving the system together.

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