Jean-Pierre Roth: The challenges of an international financial centre: the Swiss case

Speech by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, to the British-Swiss Chamber of Commerce, London, 26 February 2002.

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It gives me great pleasure to have the opportunity to address your distinguished assembly today. Like all the Swiss I know, I always enjoy coming to London. Even though there are considerable differences between our two countries, we have many things in common. We are both proud of our history and of our colourful traditions, we cherish our freedom and our independence. What's more, in both our countries, the financial industry has been a pillar of our economic strength in recent times.

But these days, the most striking parallelism between the United Kingdom and Switzerland can be seen in monetary affairs. Both countries are "outs": they do not belong to the Euro-zone. In Britain, the currency is still the pound sterling and, in Switzerland, we still have a preference for our franc. We thus both face the same challenge: living next to a large currency area which absorbs most of our foreign trade. This situation is new for both of us. It is of course not up to the Swiss central bank governor to speculate how long this situation will last in the United Kingdom. But as far as I can tell, there is a good chance that Switzerland will remain an island in the middle of the Euro-ocean for years to come!

Experience shows, however, that the monetary regime itself is not a central issue for the existence and the development of a financial centre. Neither in the UK, nor in Switzerland is European monetary integration considered to be a necessary or a sufficient condition for a successful financial centre. In today's global and very competitive markets, success relies more than ever on fundamental strengths and skills.

Switzerland as a financial centre

Since the early 1990s, international financial markets, along with the entire banking sector, have been undergoing profound changes. The driving force behind this world-wide trend is threefold: first, the advances made in the processing and the transmission of information; second, the trend towards the liberalisation of financial markets; and, third, the growing and increasingly diversified demand for financial services. These developments have led to a widening of horizons, to a proliferation of financial products, and to increasing international competition. Switzerland - thanks to its long tradition of openness to the world - was well prepared to face the challenges of global markets.

But globalisation and world-wide competition did not leave our financial centre untouched. Consolidation has significantly altered the structure of the Swiss banking industry. During the 90s, domestic mergers and acquisitions have reduced the number of banks by about 40 percent.

Nevertheless, despite a clear tendency towards financial market concentration, Switzerland remains a country with a wide network of small banks. Beside the two big banks, Credit Suisse Group and UBS AG, Switzerland counts over 100 regional and savings banks, 24 cantonal banks, 17 private banks and over 140 subsidiaries and branches of foreign banks. Our banking sector is extremely dense with a strong presence in all parts of the country.

The insurance sector is the second traditional leg of our financial centre. Our insurance companies have strongly expanded abroad. Here also, open markets and intense competition have led to consolidation and large units.

More than 10 years of global de-regulation have left deep and lasting marks not only on the structure of the financial sector, but also on the range of its activities. Reacting to the changing market environment and stiffer international competition, many banks have placed more emphasis on their international business and shifted their activity from balance-sheet to off-balance-sheet transactions. This is true in Switzerland as well. Investment banking and asset management have gained in importance, whereas less lucrative areas, such as domestically-oriented retail banking, have lost part of their attractiveness.

In our case, the expansion of the investment banking activities has taken the form of a number of acquisitions in foreign countries, tightening the ties between Switzerland and other financial centres.

The expansion of asset management has been much more domestically generated. Asset management is an area in which Switzerland has been traditionally strong. According to unofficial statistics, Swiss banks are entrusted with about one third of the totality of the world's assets managed by banks in other countries than those where their clients are domiciled (so-called offshore wealth management), which places them well ahead of their competitors. Indeed, asset management and private banking are the strongest segments of Swiss banking, not only in terms of market shares, but also measured by revenues.

For many observers, the success of our banks in asset management and private banking can only be explained by the existence of Switzerland's banking secrecy. I think they misunderstand the meaning of this feature. In any case, it would be short-sighted to believe that a financial centre could insure its long-term development on a single factor. A successful strategy requires strong fundamentals: a competent and dedicated workforce, reliable services and products, and efficient infrastructures. I have no doubt that you share this view with me.

Necessary characteristics of a successful financial centre

How can we explain the long-lasting development of the finance industry in Switzerland? It is not the result of some public strategy or industrial policy. Instead it is the combined outcome of a number of factors which all point in the same direction.

a) An open-minded economy

Firstly, Switzerland, as a traditionally very open economy, was well placed to benefit from trade liberalisation and financial deregulation. We are used to see our economic performance being constantly challenged and directly dependent on our ability to adjust to a changing world environment. What has been true for Nestlé, Novartis or Swatch - to name just a few - is also valid for the banks: in today's competitive marketplace, only the fittest will survive, some of them even becoming global players in the process.

b) Professional skills

Secondly, our finance industry has access to a pool of well-educated, highly-skilled, multilingual, and service-oriented workers who are very familiar with international financial markets. Private banking has a long tradition in Switzerland, and financial advisory services to foreign clients have been a part of the Swiss banking business for generations, literally.

c) Efficient financial infrastructure

Thirdly, besides the availability of a highly professional staff, there is the outstanding efficiency of Switzerland's financial infrastructure. I am referring here to the so-called "Swiss value chain" which comprises a full set of settlement and payment systems, with their individual parts harmonised in an optimum way. The entire facility consists of a trading platform, a payment-against-delivery system, and a central payment system. A fourth component, a central counterparty, is currently being developed.

It might be due to their long tradition of watchmaking that the Swiss have developed a skill to build and interconnect sophisticated settlements systems. In 1987, the Swiss National Bank launched the Swiss Interbank Clearing (SIC), the first RTGS system and precursor of many payment systems around the globe. Shortly after, the Swiss Exchange moved from a traditional "à la criée" procedure to an electronic platform including the automatic transfer of securities. With virt-x, here in London, it has now gone one ambitious step further, creating the first international fully integrated electronic exchange.

d) Stable domestic environment

Fourthly, Switzerland, with a stable political environment, also offers the legal protection that, together with trust, is so crucial in the banking business. Furthermore, the healthy social climate and peaceful labour relations also contribute to a successful banking system.

Among the elements which contribute to a favourable environment - and indeed very high on the list - I obviously also include financial stability and the strength of our currency. Switzerland enjoys traditionally a very strong current account position. Contrary to a popular belief, it is not a net capital importer, but a massive exporter of funds. With an excess of savings over investment, we transfer capital to the rest of the world. Our external surplus gives to our banks an important role in channelling funds and it strengthens their international position.

For the long-term oriented investor, moreover, knowing that the Swiss franc will keep its purchasing power and maintain its external value is, of course, of great importance, and it reflects positively onto the entire Swiss financial industry. In situations of crises, security-conscious investors too, even those with shorter time horizons, demonstrate through their actions that the Swiss franc has special merits. The fact that the Swiss franc is a safe haven currency certainly does not make the work of the Swiss National Bank any easier. We nevertheless view the continued existence of our own independent currency, which can be freely traded on world markets, as an important asset for Switzerland in general, and for its financial sector in particular.

e) Efficient supervision

To be sure, no financial centre can survive without credible guarantees as to its soundness and robustness. As we know, financial institutions are different from other firms. Due to the complex ties that exist between them, and given that the very institution of money is built on trust, fragile elements can destabilise the entire industry. They can have devastating effects on the other players, including on fundamentally healthy institutions. A prerequisite for a successful financial centre is therefore a strong banking supervisory authority.

f) Integrity

All the ingredients mentioned so far are important building blocks of a flourishing financial centre. One should not forget, however, that the most significant factor for a successful banking system is the assurance that the public, and the bank customers in particular, be honestly and fairly treated. In short, without trust there can be no lasting successful financial centre.

This is more than wishful thinking on the part of a central banker. It is obvious that it is in the self-interest of any financial centre, of its lawmakers, its supervisory authorities and of its private agents and their associations to set and implement rules and codes of conduct that match the highest standards. With market globalisation and the free flow of capital, there is a real risk that a financial centre will become involved in illegal transactions against its will. I consider reputational risk as the major challenge facing financial centres at the beginning of this century. In Switzerland this has long become conventional wisdom. Know your customer rules have effectively been implemented and constantly adapted to the evolving requirements of the market realities for many years. Swiss anti money laundering rules and regulations are widely recognised as expressions of the state of the art. I shall come back to this thorny topic in a moment.

Challenges ahead

What are the challenges ahead?

a) Market globalisation

As I mentioned at the outset, the banking sector has gone through a period of heavy restructuring during the past decade or so. Banking no longer amounts to simply accepting savings and granting loans. Business has become increasingly complex and is dominated by a dwindling number of ever-larger financial conglomerates. The trend toward concentration and the tendency toward onshore international banking can be observed in your country as in mine. The internationalisation of the banking business has led the large banks to establish major business units outside their home country. Our banks create now more jobs outside the country than in Switzerland.

Obviously, global business is the first challenge to be faced by the financial centres as well as by the authorities. A close co-operation between supervisors is essential.

The trend toward financial conglomeration poses an additional challenge for the banking industry: the tendency towards “all-finance”. More and more providers not only offer banking services, but all types of other financial services as well, notably insurance products. A single supplier offers specific advantages to the customer while providers in turn expect synergies, customer loyalty, and lower costs. It is not yet clear whether this strategy will be a commercial success, and the question is heavily debated among specialists.

What is clear, however, is that financial conglomerates are a challenge for the supervisors as well. Today, banks and insurance companies are often governed by different laws and supervised by different authorities. The absence of consolidated supervision makes it more difficult to assess the combined risk of conglomerates. With the creation of the Financial Services Authority (FSA), the United Kingdom has taken the lead in this respect. The creation of an integrated financial supervisory authority is now also being envisaged in Switzerland and in other major financial centres. A single authority could supervise all banks, securities dealers, investment funds, insurance companies, financial conglomerates and portfolio managers. This integrated supervisory authority would also play a key role in the fight against money laundering.

b) Fight against money laundering and financial crime

I come naturally to the issue which is of major importance for all financial centres today: the fight against money laundering and criminal money.

Any financial system - and the Swiss system is no exception - can be misused in order to transfer or recycle money issued from, or linked to illegal activities, including terrorism, drug trafficking, illicit trades in weapons, modern slavery, and corruption, just to name a few. To be sure, a money laundering risk already existed in the past. As a result of globalisation, however, and of the growing significance of organised crime, the risk has increased considerably in recent years, not just in my country, but in every major financial centre. For this reason, a dense network of legal regulations, controls and self-regulatory mechanisms is necessary in order to make a financial centre as unattractive as possible for criminal funds.

Switzerland has been one of the first countries to introduce strict anti-money laundering laws. They cover the activities not only of banks, but also of any other financial intermediary such as insurance companies, funds managers, lawyers and even fiduciaries.

Our experience so far has shown that an efficient fight against financial crime requires two specific rules: first, the application of strict due diligence procedures that includes careful identification of the customers, i.e. of the beneficial owners of the assets involved; second, the obligation, imposed to the market intermediaries to inform the authorities in case of any founded suspicion of money laundering. I am fully convinced that an effective fight against money laundering can only be successful if an active co-operation between financial institutions and authorities is promoted. In our view, the responsibility of the banker should prevail over an automatic reporting of transactions exceeding a certain amount.

Tracking down criminal money is even more difficult than identifying money laundering operations. The financing of criminal activities does not require large amounts and the *ex ante* identity of a criminal is not a source of pertinent information. Furthermore, funds used in the financing of terrorism, unlike cases of money laundering, very often are legally acquired. It is therefore crucial that financial intermediaries in both the banking and the non-banking sectors thoroughly verify their client relationships in order to identify suspicious circumstances. In this connection, strict observation of the “know-your-customer” principle is again of key importance.

Switzerland does not hesitate to offer international co-operation in judicial matters and to block incriminated assets. Following the decision of the United Nations to apply sanctions against the Taliban regime in 1999 and 2000, we blocked a certain number of Afghan bank accounts and froze the assets belonging to persons listed by the Sanction Committee of the United Nations. To date, 76 accounts are frozen with a total of 42 million Swiss francs.

In the United Kingdom and in Switzerland, the authorities and the banks themselves are fully aware of the utmost importance of successfully warding off criminal funds. We all realise that money laundering is not only morally unacceptable, but that it also clearly undermines the public’s confidence in our financial centre.

Unfortunately identifying money laundering and criminal money, is not an easy task, for criminal elements are not short of imagination, and continuously invent new schemes to deceive our banks and our authorities. Although Switzerland is at the forefront in the fight against money laundering, the Swiss financial centre has also suffered from a number of mishaps, especially involving politically exposed figures. The same experience has been made elsewhere: the London City as well as other centres have been misused similarly or even to a greater extent by undesirable clients. These cases stress the need for relentless vigilance.

c) Political integration and fiscal harmonisation

Let me come now to another issue of great importance to us: the movement toward tax harmonisation in Europe.

You can easily imagine that Switzerland, as an island within the EU, has close economic ties with the single market. About 80% of our imports come from the EU, which absorbs more than 60% of our exports. After the United States, Switzerland is the EU's second largest trading partner and our firms are among the most important investors in the EU (for instance, we are the second largest in the UK). As a non-EU member, we seek co-operation on the basis of bilateral agreements. A first round of agreements will be implemented this spring. A second round of negotiations will begin shortly. It covers one issue which is of major importance for our financial centre: the taxation of savings income.

Switzerland is directly affected by the EU's intention to introduce a system of automatic exchange of information between banks and tax authorities in order to enhance tax revenues on savings income within the European Union. One can of course fear that such a plan might trigger capital transfers to non-EU financial centres for purely fiscal reasons.

Our position is known: we do not want the Swiss financial centre to become a privileged haven for funds seeking to avoid EU regulations. We are thus ready to consider a reform of our withholding tax regime along the line of the EU directive. We even consider the possibility of handing over to the EU part of the tax on interest earnings of EU residents.

We have already 50 years of positive experiences with a withholding tax: it is a convenient and efficient way to collect resources without income declaration. We have never considered introducing any system of automatic exchange of fiscal information for our own citizens, and we are not ready to consider such a scheme for foreign depositors. We feel that our current system secures an appropriate balance between protection of the private sphere and safeguarding the interest of the State.

There are many misunderstandings between Switzerland and the UK about this fiscal issue. Let me recall a few points:

– First, it is wrong to say that foreigners can invest their funds tax-free in Swiss banks. We have a 35% withholding tax imposed on all interest and dividend payments made in favour of residents and non-residents.

– Second, to avoid any loophole basically due to an international failure to apply the debtor principle in withholding taxation, we are ready to reshape our system in line with the EU directive, i.e. to apply the payment agents principle in withholding taxation whenever a client of a Swiss bank is fiscally domiciled in the EU.

– Third, and this must not be forgotten, Switzerland grants full judicial co-operation to fight tax fraud.

Thus, our position is fair. With these measures - which are fiscally equivalent to the exchange of information - Switzerland cannot be accused to be a fiscal paradise attracting foreign money like an offshore centre.

With capital being extremely mobile internationally, it is evident that co-ordinated taxation policy makes sense only if it covers all the main financial centres. The EU regulation will not have to be only implemented in the member countries, but also in their many dependent and associated territories. Furthermore, it is crucial for Europe that similar measures are taken on a world-wide basis. Without a fully watertight solution, offshore centres around the globe will expand their business at the expense of Europe and this with an increasing lack of transparency and with higher global risks.

One last point about fiscal harmonisation. I live in a country that counts nearly three thousand different tax regimes. In Switzerland, every town, every canton and, of course, the federal government, all have the authority to levy taxes and to set the rates. It is part of the functioning of our internal democracy and of our decentralised political system. We firmly believe in the benefits of tax competition, which manages to keep tax rates relatively low. We regret that at the international level, any mention of "tax competition" is almost always preceded by the term "harmful". This clearly reveals preconceptions and a biased judgement.

d) Financial privacy

With tax harmonisation, banking secrecy is once more at the centre of the discussion. Allow me to add a few words on this subject. Earlier on, I did not mention banking secrecy - or perhaps should we call it financial privacy - as one of the necessary features of a successful financial centre, because I believe that, *per se,* it is not. What is important, though, as I emphasised earlier, is trust and professionalism.

Banking secrecy is the prohibition for bankers and their staff to divulge any privileged information regarding their clients or third parties. The beneficiary of banking secrecy is the client, not the bank.

Financial privacy is part of the Swiss legal structure. In my country, like here, individual freedom and protection of the private sphere are highly valued and deeply respected. In Switzerland, privacy rules are not limited to the banking sector, but they apply with equal vigour to professions such as doctors, lawyers, solicitors and the clergy.

The respect of one’s private sphere has a long tradition. Like yours, our country is based on a high value attributed to the individual and on democracy. Our state is a bottom up - rather than a top down - construction. We trust our citizens - who are often called to vote on important matters, including on those relating to taxes. We trust them when they keep their army rifle, with a full round of ammunition, at home. We trust citizens when they file their tax forms, and we trust them when they undertake financial transactions. Sure, there are occasional abuses, and these are prosecuted with determination to the full extent of the law. We do not believe, however, that these cases can be used to justify switching over to a system where big brother breathes down our neck.

Swiss people would not comprehend - and indeed they would not support - any initiative aimed at throwing out financial privacy principles simply because some dishonest people have taken advantage of them, any more than they would accept giving up medical secrecy because of a few cases of health insurance fraud. Nor could the Swiss understand - or accept - that the foreign clients of our banks be treated any differently, i.e. without the same amount of due trust and respect.

But - and this is important - banking secrecy is not absolute. It is simply not true that Swiss banks maintain secret numbered accounts whose holders are not known to anyone. Swiss banks do hold so-called numbered accounts, but a restricted circle of persons within the bank must - by law - know the name of the person(s), i.e. the beneficial owner(s) behind every account. In this regard, the “know your customer rule” is once again essential. Banking secrecy is routinely lifted in the case of criminal investigations and the Swiss judicial authorities have earned high marks for the extent of their co-operation in international criminal affairs, including those involving politically exposed persons. These facts do not mean that our country is especially attractive for criminal money. They rather show that bank secrecy rules are not an obstacle to an efficient and determined action against criminal activities. Let us be frank: the fact that some financial centres only rarely or even never register cases of suspicious transactions is certainly not a proof of integrity but rather of a lack of it.

Conclusion

Today, we find many financial centres around the globe. They all benefit from easier communication and high capital mobility. Some have a long history of banking activities, others have recently expanded, often by giving foreign investors special legal or fiscal treatment.

With its customers from all over the world, Switzerland is as much an offshore centre as London or any other significant financial centre. We do not provide special advantages to foreign investors. Our financial centre has been built on a wide range of comparative advantages: a financially sound country, a stable political and monetary framework, a long tradition of banking and an internationally oriented economy. All these points are also valid for the United Kingdom. There is a major difference in terms of specialization, however: the City is “the” market place for investment banking and a number of other financial activities in Europe, whereas Switzerland plays a dominant role in asset management.

Despite different realities and market positions, Switzerland and the United Kingdom share many common values vis-à-vis their financial centre:

– both countries believe that financial activity requires professionalism, high standards and efficient supervision;

- both countries consider money laundering and the financing of criminal activity as major threats for the long term development of their financial system and act decisively against them;
- both countries favour market competition in general and have a liberal attitude toward tax competition in particular;
- both countries are reluctant to accept over-regulation and see in the mushrooming of offshore centres a source of risk for the global financial system.

I come therefore to the conclusion that there are more converging interests than rivalries between our financial centres. Some diverging views are due to misunderstandings. With its traditions and its experience in asset management, Switzerland attaches great value to financial privacy. But, as I showed you, the protection of financial privacy is not an obstacle to an efficient fight against money laundering or the financing of terrorism, nor does it hamper fair tax competition with our neighbours if a withholding tax is implemented along the line of the EU directive. Both the disclosure of certain informations relating to bank clients and the protection of privacy in the financial sphere arise from fundamental ethical convictions that are worth protecting.

I am confident that with a frank dialogue and mutual effort to understand each other's position, the common values of the Swiss and British financial centres will again come to the forefront. In particular, it is our predominant joint interest to see the very demanding standards that we have set for our own financial industry become the world-wide accepted rules. The long history of our financial centres and the large experience of our banking industry should give us a natural leadership role in this respect.