Philipp M Hildebrand: Switzerland - the challenges of being and remaining a leading financial centre

Speech by Dr Philipp M Hildebrand, Member of the Governing Board of the Swiss National Bank, at the Financial Management Association (FMA), European Conference Zurich, University of Zurich, Zurich, 3 June 2004.

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I am pleased to be here this evening to reflect on Switzerland: the challenges of being and remaining a leading financial center. Moreover, I am honored to share this platform with Peter Wuffli, Walter Kielholz and Bruno Gehrig. The Financial Management Association should be commended; you have assembled three outstanding leaders and representatives of the Swiss financial industry. I very much look forward to their comments.

When I think about the Swiss financial industry, two closely linked thoughts come to mind: first, Switzerland's status as one of the world's leading financial centers and second, the important contribution of the financial sector to the overall vigor and resilience of the Swiss economy. Going forward, the key challenge for the Swiss financial industry will be to maintain its leading global status in a world of fierce competition. Because of the financial sector's critical contribution to the overall economic well-being of the Swiss people, meeting this challenge is important not only to the financial sector but to all Swiss citizens who are concerned about the long-term vitality of their economy.

Many of you are familiar with the relevant figures: roughly 10 percent of Switzerland’s real GDP derives from the financial sector. If one adds the insurance sector, that number is closer to 14 percent. That percentage has increased significantly since 1990 from a total of 10% of GDP or less than 7% for the banking sector only. Importantly, this does not take into account the many economic activities which are directly linked and in many cases dependent on a vibrant financial sector. In terms of employment, the financial and insurance sectors together employ approximately 185'000 people or 6% of total Swiss employment. The total federal and local tax contribution of the Swiss banking sector amounts to an estimated CHF 13 billion or 13% of total tax revenues. A mere perfunctory consideration of these figures should suffice to underline the importance of defending and maintaining Switzerland's status as a leading global financial center.

In a 1974 study, Charles Kindleberger traced the history of financial centers in Western countries. What is striking about Professor Kindleberger's historical findings is that nothing should ever be taken for granted. Not unlike tides, cities and countries as international financial centers rise and fall. For the most part, this rise and fall seems to reflect dynamic criteria such as transportation infrastructure, political stability and regulatory patterns. Since the 1970s, the competition amongst international financial centers has of course become genuinely global with diverse places such as Luxembourg, Singapore, Hong Kong, Dubai and, most recently, Shanghai joining the race.

Switzerland has good reasons to be confident about its ability to defend its status. Most importantly, it sets out from a position of strength. Particularly in the area of wealth management which comprises over half of the total added value of the banks, Switzerland is clearly one of the world's leading provider of services. The value of total assets managed in customer accounts in domestic banks as of the end of the year 2003 amounts to CHF 3’300 billion, of which nearly 60% is held by foreigners. According to various estimates, this corresponds to approximately one third of the world’s total private wealth managed abroad.

Much has been said and written about the various strengths of the Swiss financial center which account for the dominant global position in wealth management. Political, economic and monetary stability, know-how, traditional high quality of services provided, guaranteed protection of privacy and strict conditions ensuring the prevention of abuse are all key ingredients to Switzerland’s past and future success. In the current global market place, some of these strengths represent structural competitive advantages. The Swiss authorities and the Swiss financial sector representatives rightly

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make great efforts to defend these structural competitive advantages as much as other sovereign countries defend theirs.

Nonetheless, in a fierce global competitive environment, defense is a necessary but not a sufficient condition for sustained success. The offensive component of a comprehensive Swiss strategy must be an unequivocal commitment from politicians, regulators and financial sector representatives to competition and free markets. Such a commitment will foster innovation which will ensure the long-term viability of Switzerland as a leading global financial center. A commitment to competition includes a firm commitment to an effective regulatory system based on transparency, proportionality, predictability and an uncompromising fight against abuse. Such a regulatory framework does not stand in opposition to a commitment to free markets. To the contrary, it strengthens free markets by upholding the integrity of markets. Regulatory authorities must not loose sight of the primary aim of regulation: to uphold the integrity of markets and not to impede the functioning of markets.

Let me conclude my brief formal comments with a specific example of how innovation in the face of global competitive pressures can foster the viability of the Swiss financial center.

In recent years, hedge funds have become an important segment of the global asset management industry. Recent figures indicate that total assets invested in hedge funds are approaching the USD 1’000 billion mark. In comparison, the total size of the open-end mutual funds industry in the United States is USD 7’500 billion. According to industry figures, the annual growth rate of the hedge fund industry appears to have accelerated to a level in excess of 15% in recent years. These figures suggest that investors increasingly look for largely unconstrained investment activities with a focus on absolute return. In addition, there has been an important shift from the traditional high net worth clients investing in individual hedge funds to funds being invested in hedge funds via diversified pools and formal fund of funds structures. These pooled assets, coupled with liberalizing regulatory developments have opened up hedge funds to a more diverse universe of investors, including a wide range of institutional and retail investors.

Currently, the total size of funds invested in hedge funds via pooled structures is estimated to be approximately USD 300 billion or nearly a third of the underlying hedge fund industry. Remarkably, annual growth rate estimates of the pooled funds suggest that their expansion has proceeded at a more rapid pace than the underlying hedge fund industry. This implies that a significant portion of new assets flowing into hedge funds does so via collective asset management pools.

In a competitive environment, the Swiss financial sector has succeeded in leveraging its position as one of the world’s leading asset manager to secure an dominant position amongst collective asset management pool operators in the hedge fund industry. Though many of the early formal funds of funds were registered under Luxembourg, Cayman Island or Bermuda law, Swiss financial firms today manage a significant part of the world’s alternative asset management pools. With the growing importance of this industry in recent years, Swiss regulators are easing regulatory restrictions to facilitate not only investment control of these asset pools by Swiss financial institutions but also the legal registrations of formal fund of funds vehicles under Swiss law. Moreover, Swiss financial firms have become leaders in financial engineering to structure underlying hedge fund asset pools according to differing client demands.

The example of managed asset pools in the hedge fund industry illustrates that Swiss financial firms are competitive and capable to respond to market demands, particularly in the area of asset management. In the future, Swiss financial firms will have to rise to new challenges to secure the position of Switzerland as a leading global financial center. One such opportunity might be to provide a wide range of trust-related services to its global wealth management clients.

Regulators have an important and difficult role to play. Their primary responsibility is to safeguard the integrity of Switzerland as a financial center, thus bolstering its global standing. At the same time, they must not become an obstacle to innovation by impeding competitive Swiss financial firms to respond to rapidly evolving market developments in a vibrant global financial industry.