Thomas Jordan: Swiss banking centre – a great past and a successful future?

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the Swiss International Finance Forum, Berne, 20 May 2014.

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Introduction

History has shown that important international banking centres can develop in small countries as well as large ones. Switzerland is an excellent case in point. During the course of the 20th century, the banking centre in this country became one of the world leaders in wealth management. With the associated creation of value and employment, the banking industry was transformed into a cornerstone of the Swiss economy.

However, for some years now, the prominent international role of the Swiss banking centre has been subject to increasing criticism. Given this situation, Switzerland and its banks are confronted with a fundamental question: Can Switzerland, as a relatively small country, continue to provide a home to a banking centre whose importance is global in nature?

In my view, this is possible as long as the following three prerequisites are fulfilled: The services offered by the banks, their crisis resilience and their reputations must all be considerably above average. It is up to the banks themselves, first and foremost, to fulfil these prerequisites. At the same time, politicians and the authorities have the task of creating the business conditions which will support the banks in fulfilling these prerequisites.

With the business conditions in mind, I will comment today on four factors which I regard as essential: First, relevant and effective regulations; second, maintenance of Switzerland's economic and political stability; third, protection of the privacy of honest tax-paying bank customers; fourth, ensuring access to foreign markets.

I would like to begin, however, by talking about the economic importance of the banking industry for Switzerland, as well as the fundamental challenges faced by this industry at present.

Economic importance of the banking centre in Switzerland

The banking system is often described as the life blood of the economy. With good reason. General economic prosperity and the development of the banking industry are closely related. When intermediation between capital supply and demand works well, a significant contribution is made to the prosperity of a country.[1] It works the other way round, too. The banking centre benefits from a prospering economy, because the demand for financial services from companies and private households increases, not least in the area of management and investment of assets.

Switzerland is a prime example of the positive interdependency between financial developments, on the one hand, and overall economic prosperity, on the other. In terms of the usual indicators of the financial development of a country – such as the size of the financial sector or access to financial services – Switzerland has one of the most advanced

1 Cf. Levine 2005.

financial systems in the world.[2] At the same time, the economic importance of the banking industry in this country is above average. It generates an annual gross value added of some 6% of GDP and currently employs about 150,000 people. In addition, at least in the years before the financial crisis, the industry made a significant contribution to overall economic growth.[3] When banks are familiar with the local conditions and are also able to integrate knowledge concerning Swiss macroeconomic conditions into their business decisions, this enables them to provide particularly efficient services to the Swiss economy. It is therefore advantageous for our country to have locally established banks which make their decisions here in Switzerland.

It is not only with services which benefit companies and households located in Switzerland that the Swiss banking industry creates value added. As we all know, the industry is also very active in the international arena – on the one hand, via exports,[4] that is, through the cross- border provision of financial services from Switzerland, and on the other, through its actual presence abroad. In this respect, the most important source of income is the cross-border wealth management business for private customers. With a share of an estimated 26% of the world market, the Swiss banking centre is the leader in this area.[5] In addition, the two big banks, UBS and CS, are among the most important institutions worldwide in some areas of investment banking, such as derivatives and foreign exchange trading.

How did Switzerland, a comparatively small country, end up with a banking centre with such a wide international reach? A number of different elements may serve to explain this.

First, I would like to mention the conditions which make the banking centre attractive for international investors. They include political, legal and economic stability, reliable banks, and a convertible currency whose value remains stable. In addition, a role in the steady inflow of foreign funds was played by the banking secrecy provisions established in 1934 and the enhanced protection of privacy associated with these provisions. These advantages appear particularly striking from a historical point of view, since, after the two world wars, neutral Switzerland presented a great contrast to the surrounding countries, which were suffering from currency turmoil, inflation and an increased risk of expropriation.[6]

Second, Switzerland's prosperity and the relatively narrow local capital market – in terms of Swiss economic power – mean that Swiss investors seek investment opportunities beyond the national borders. At the same time, our economy also has a strong international focus. To a large extent, Swiss companies, households and institutional investors would be in a position to call upon the services of international Swiss banks for their asset investments and business operations abroad.

Third, the international position of the banking centre is closely related to the growth and expansion of the international business of the big banks, which has forged ahead since the 1990s.[7] This expansion was motivated, not least, by the desire to move into new, potentially profitable investment banking areas. Thus, the expansion of the balance sheets of the two

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2 Cf. Cihák et al. 2012.

3 Cf. BAKBASEL 2013. These comments here are limited to banks. Apart from banks, the financial industry also includes insurance service providers which, in Switzerland, generate 4–5% of additional value added.

4 In 2012, income from exports of bank services contributed some 20% to Switzerland's current account surplus. Cf. Swiss National Bank 2013b.

5 Cf. Swiss Bankers Association 2013. In terms of the level of total managed assets, both onshore and offshore, UBS is also currently the leading bank worldwide.

6 Cf. Straumann 2006.

7 Cf., for example, Tille 2010.

big banks in the 15 years before the financial crisis is largely attributable to investment banking.[8]

Manifold challenges for the Swiss banking centre

Since the onset of the financial crisis, however, the international operations of the Swiss banks have come under increased pressure on a number of fronts.

First, the financial crisis has shown that a large, highly developed and internationally integrated banking industry means risks as well as growth opportunities. In particular, the crisis clearly demonstrated that some individual banks are so important for the economy that they have to be rescued by the state in the event of a crisis. This is the "too big to fail" (TBTF) issue. Because of the de facto state guarantee associated with the TBTF issue, the borrowing costs of these kinds of bank are implicitly subsidised. As a result, competition is distorted in favour of these banks. In particular, however, the implicit state guarantee creates incentives to take on excessive risk. In Switzerland, this problem was particularly acute before the financial crisis. As is well known, the global expansion and exposure of the big banks in the area of investment banking meant that, in autumn 2008, UBS found itself in a precarious situation.

Since UBS was an integral pillar of the domestic loan and deposit market, the Swiss economy would have suffered enormous damage if the bank had collapsed. With the transfer of illiquid assets amounting to almost USD 40 billion to the stabilisation fund of the Swiss National Bank (SNB) and the subscription to mandatory convertible notes by the Confederation, UBS was stabilised and this danger was averted. Luckily we are now able to say that the endeavour was ultimately brought to a successful conclusion – even earning a profit for the Confederation and the SNB. Nevertheless, this supportive action clearly showed us that systemically important banks are associated not just with advantages, but also with significant risks for the general public.

Second, the reputation of the financial industry worldwide has suffered considerably in the wake of the crisis. In the general public at large, the enormous losses, the government rescue packages, the manipulation of the Libor interest rates and the suspicion of improper agreements in the setting of exchange rates, have led to a loss of confidence in the banks. This is true of Switzerland, in particular, where, after all that has occurred, questions relating to the banks' sets of values and the benefits of a large banking industry for our country are being increasingly raised.

Third, the most important pillar of the Swiss banks' export business – cross-border wealth management – has suffered major reputational damage. For many decades, the practice whereby the assets held by foreign bank customers in Swiss bank accounts included an element of untaxed wealth was tolerated internationally. In recent years, however, this situation has landed Switzerland in politically delicate situations on many occasions and involved several banks in legal disputes. A worldwide change in values and the disclosure of cases of assisted tax evasion have discredited bank secrecy as a legitimate instrument for the protection of the privacy of foreign customers. Its economic importance for the Swiss banks has therefore largely dissipated. These developments have also resulted in considerable legal uncertainty and increased the risk of individual bank export markets disappearing, either partially or completely.

Fourth, the banks are faced with higher costs and lower income as a result of structural changes. Apart from international competition, this pressure on margins is mainly attributable to tougher regulatory and legal requirements, technological advances and the continuing low

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[8] During the same period, the big banks also built up substantial off-balance-sheet positions which were attributable to investment banking activities.

interest rate environment. It can be assumed that the structural transformation in the Swiss banking industry will accelerate further.[9]

Basic prerequisites for the success of the banking centre in the future

As we have seen, it is in Switzerland's interest to have an effective banking industry located here, which can supply the economy with financial services and thereby contribute to prosperity and affluence. However, in view of the challenges I have mentioned, the fundamental question I posed in my introduction arises: Can Switzerland, as a relatively small country, continue to provide a home to a banking centre whose importance is global in nature?

To ensure that this is possible, both smaller, regional banks and larger, international banks will be needed in future. Because of the broad structure of the Swiss economy, it can be assumed that customer requirements are also very multifaceted and diverse. A mix of different kinds of banks can make a contribution to meeting these requirements as efficiently as possible. Moreover, a diversified banking structure helps to ensure that a crisis at individual institutions or in individual areas of business is better absorbed. This was demonstrated in the real estate crisis at the beginning of the 1990s and again in the most recent financial crisis. In the 1990s, the big banks were able to absorb at least part of the impact of the regional banking crisis on the economy, while during the financial crisis, the domestically focused banks, which were hardly affected, ensured that lending operations in Switzerland continued almost unimpeded.

In addition, the following prerequisites must, in my view, be fulfilled, in order that the Swiss banking centre can retain its global importance and reach. The quality of the services offered by the banks, their crisis resilience and their reputations must all be considerably above average.

Although, in principle, quality, crisis resilience and reputation are important for any financial centre, they are particularly crucial for Switzerland. On the one hand, our comparatively small country can only afford to host a relatively large international banking centre if this financial centre is extremely stable since, naturally, the resources available for emergency bank rescues are limited. On the other, an irreproachable reputation makes a major contribution to ensuring that the business operations of Swiss banks are not subject to constant political and legal pressure from abroad. And, again, excellence in service quality and products offered is essential if banks from a small country are to export their services successfully and secure significant market shares for themselves in international competition for customers.

It is above all the banks themselves who face the challenge of fulfilling these prerequisites. The banks must answer the question of how, in the long term, they can successfully provide their services – that is how a well-functioning market economy works. Allow me, nevertheless, to present a few fundamental considerations. In my view, the key to a successful future for the Swiss banks is that they focus consistently on high-quality services which offer customers measurable added value. Investment in the quality of staff and the product range is essential, especially in wealth management. This includes promoting a company culture with a focus on generating sustainable profits. In addition, robust and well-functioning risk controls are essential. All of this is necessary, if the banks are to regain the confidence they have lost and demonstrate their integrity.

Moreover, politicians and the authorities can, and should, make a contribution to ensuring that the Swiss banking centre can look forward to a successful future. At the same time it

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[9] One indicator of the ongoing structural transformation is the fact that the number of banks in Switzerland has been declining continually for years. Between 2002 and 2012, over 50 institutions, or about one-seventh, disappeared. Cf. Swiss National Bank 2013a.

must be clear that industrial policies per se – such as setting targets relating to the size or even the range of services to be provided by banks – should be avoided. We simply cannot know what impact current or future developments will have on the demand for financial services.

Politicians and authorities should therefore concentrate on creating an appropriate combination of business conditions. These should be designed in a way that provides the best possible support to the banking industry, so that it can fulfil the prerequisites for a successful future which I mentioned before.

Key factors: regulation, stability, privacy, market access

What does an appropriate combination of business conditions for the banking industry look like? I would like to highlight four factors.

First, relevant and effective bank regulations must be implemented and enforced. Allow me to elaborate on this point. Regulations are relevant if they are targeted at a specific market failure which constitutes the reason for the intervention. At the same time, the regulations must be compatible with international standards. If necessary, a “Swiss finish” must be added. The “Swiss finish” is not because we want to be a model pupil. It is needed in cases where the global minimum requirements do not guarantee the desired level of stability for Switzerland, because of our particular circumstances. Effective regulations mean that the goal which the measures aim to achieve can actually be achieved, and that compliance with the rules can be efficiently enforced and monitored. Finally, it is obvious that regulations are always associated with costs for the entities being regulated. These private costs are justified from an overall economic point of view as long as the regulations are in line with the principles I have already mentioned and thereby help to make the banking industry much more stable.

As regards Swiss bank regulations, it is primarily the risks emanating from developments in the real estate and mortgage markets which are presently the focus of public interest.

However, the most decisive factor for the long-term importance of the Swiss banking centre is the alleviation of the TBTF issue. Only if this can be done, will it be possible to provide a home to international banks in Switzerland in the long term. Thus, regulatory efforts to contain the TBTF issue convincingly in Switzerland are extremely important.

With the Swiss TBTF legislation, which is currently being implemented, we are making good progress in this respect. The package of legislation rests on two pillars. First, systemically important banks are subject to significantly higher capital and liquidity requirements with a progressive component. Second, arrangements must be made to ensure that systemically important banks are resolvable in a crisis, so that it is not necessary to resort to public funds. If these measures are implemented in full, incentives to take on excessive risk will be substantially reduced. This will diminish the likelihood of a crisis, as well as the costs to the taxpayer, should a crisis nevertheless occur. At the same time, the measures help to strengthen domestic competition, because they reduce the implicit subsidies to the TBTF banks.

However, we have not yet achieved our objective. On the one hand, the current legal and organisational structures of the two global big banks do not yet ensure an orderly wind-down in the event of a crisis, although the measures they have already announced are all steps in the right direction. On the other hand, international provisions need to be drawn up to ensure that sufficient resources are available for a wind-down of systemically important banks in the event of a crisis[10] and that rules on participation by creditors, referred to as “bail-in”, have

[10] This topic is currently being discussed under the heading of “gone-concern loss absorption capacity”, GLAC.

been established. Switzerland has every interest in ensuring that the relevant work in the international bodies advances further.

A second basic factor needed to ensure a successful international Swiss banking centre is stable political and economic conditions. As I have already mentioned, the wide-reaching stability in Switzerland, not least as regards consumer prices and the currency, was a key historical prerequisite for the international reach of the banking centre. The latest financial crisis has clearly shown that the stability associated with Switzerland continues to represent an important argument in favour of placing money with our banks. Preserving Switzerland's good reputation as a stable country based on liberal values and legal certainty has a positive impact on the reputation of the Swiss banks. This stability bonus is not simply accorded for its own sake – it is something which has to be continuously earned.

Third, the banks need to assume that bank secrecy in cross-border operations will be replaced by the automatic exchange of information (OECD Standard for Automatic Exchange of Financial Account Information). However, for honest tax-paying customers, protection of privacy and the associated legal certainty remains a legitimate concern, even under the OECD standard. In order to remain attractive as a global wealth management centre, Switzerland must therefore develop a plan within the context of this OECD standard which guarantees protection of privacy in the long term. This could create an important element of differentiation for the Swiss banking centre. It will be important to separate the issue of protecting privacy from that of tax conformity. In other words, enforcement of the legitimate protection of privacy must not be abused in order to elude tax obligations. Vice versa, measures aimed at ensuring compliance with tax provisions must not lead to any diminishment in the protection of privacy. For instance, this means that customers must know, right from the start, which data will be passed on from one tax authority to another, and for what purposes – and which not. At the same time, care must be taken to ensure that such a plan can be implemented in accordance with the international standards. This will guarantee legal certainty for customers while guarding against continual vulnerability of the future Swiss legal framework to attack.

Fourth, it is very important to ensure that Swiss banks have access to foreign markets so that they can continue creating value beyond their home market in the future. In the field of financial services, in particular, there is currently a danger of hidden market access barriers being erected as part of the regulatory reform measures being undertaken in many countries. In this context, support should be given to the proposal by the Brunetti Group that agreements be negotiated with the countries whose export potential is greatest for the preservation of market access for Swiss banks.[11] This might include reciprocal recognition of nationally defined regulations as equivalents, to the extent that this is possible. In the case of globally defined standards, care should be taken to ensure that these are actually be implemented by all the affected countries. This is the only way to guarantee that all market participants have a level playing field.

Conclusion

Ladies and gentlemen, I would like to close with the following observations. The Swiss banking industry looks back over a great past. Now, however, the banks are under pressure, both at home and abroad. State interventions and the actions of the banks themselves have, to some extent, reduced their popularity with the Swiss general public and its politicians.

Meanwhile, the legal disputes with other countries have called the Swiss banks' cross-border wealth management business into question in a fundamental manner.

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[11] Cf. State Secretariat for International Financial Matters 2014, on the measures proposed in this respect.

Nevertheless, from an economic point of view, Switzerland still has a major interest in a strong banking centre of international importance. However, great efforts are required to ensure that the Swiss banking centre can remain successful in the global arena in the future. It is the banks themselves which are mainly challenged. They must ensure that their services provide customers with value added which is well above average. At the same time, their crisis resilience must be considerably above average and their business conduct and reputations far beyond reproach.

In this respect, politicians can support the banks. However, industrial policies in the area of finance should be avoided. Support for banks should rather come through the creation of an appropriate combination of business conditions. The emphasis should be on measures which strengthen the crisis resilience and reputation of both Switzerland and its banking centre in the long term. In my view, this can be achieved if the TBTF issue is alleviated, Switzerland's stability in general preserved, and both the privacy of honest tax-paying bank customers and global market access for banks guaranteed.

I believe that all players are aware of the major efforts that this requires. I am therefore confident that in addition to looking back over a great past, the Swiss banking centre can look forward to a successful future.

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