A SAFE HAVEN?

Though the Swiss financial industry appeared to come out of the economic crisis relatively unscathed, it's not all plain sailing, says Baer & Karrer's Eric Stupp

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Viewed from the outside, Switzerland looks like a rocky island in a stormy sea of financial distress. The unemployment rate is only 4.4% compared with 9.1% in the US and the national budget closed in 2010 with a surplus, a sharp contrast to the situation in all major neighbouring countries like France or Italy. The Swiss financial sector continues to play an important role in the country's economy. It contributes approximately 10% of the country's gross domestic product.

Despite this bright picture, the Swiss financial sector did not remain unaffected by the worldwide financial crisis in 2007. In particular, UBS, the largest Swiss bank and a top-tier player in the wealth management business, reported losses of \$18.7bn (£11.7bn) in relation to US residential mortgage sector exposures for 2007 and the first quarter of 2008.

These losses made substantial state assistance necessary in the form of a convertible bond subscribed by the Swiss Government and the sale of subprime securities to the StabFund (a fund run by the Swiss central bank SNB) in order to stabilise the bank. However, such assistance was – unlike in other countries – limited in time and did not crumble public finance.

Today, the Swiss Government does not hold any financial interests in UBS anymore and made a handsome profit when it converted and sold its holding of CHF6bn (£4.3bn) in UBS mandatory convertible notes in 2009. It should be noted, however, that the StabFund still holds part of the former UBS subprime portfolio. So far, the losses of the StabFund were all covered by the equity, which had initially been provided by UBS.

It was a shock to the Swiss public that a solid national bank like UBS needed governmental and central bank support in order to survive. As a consequence, the "too big to fail" debate was particularly intense in Switzerland and has already resulted in a concrete governmental proposal in 2011 which is expected to be approved by the Swiss parliament and become law in the near future. The proposal provides that Swiss banks will, until 2018, be subject to a considerably tightened capital ratio regime which will be stricter than the planned new international minimum standard of Basel III (10.5% versus 19% equity versus risk weighted assets).

It may seem that Switzerland has finished its homework and may have nothing to worry about except for the impact of global warming on ski tourism in the Alps during winter time. Far from it!

The healthy Swiss economy induced investors to sell foreign currencies such as US dollars and euros and buy Swiss francs instead. The Swiss franc, two years ago with an exchange ratio of €1:CHF1.45, bottomed recently at 1:1. The development of the Swiss franc has a lot in common with gold. Both are seen as a safe haven in turbulent market conditions.

An over-valued Swiss franc, however, is a threat for the Swiss economy as exports become more expensive and therefore less competitive. Switzerland is highly dependant on exports as the domestic market is small. Banks also suffer. Foreign clients quite often have their accounts denominated in their home currency.

As the fees of the banks are normally charged as a percentage of the assets under management, an increase to the Swiss franc translates into a reduction in the volume of the assets under management and therefore a reduction of income generated by

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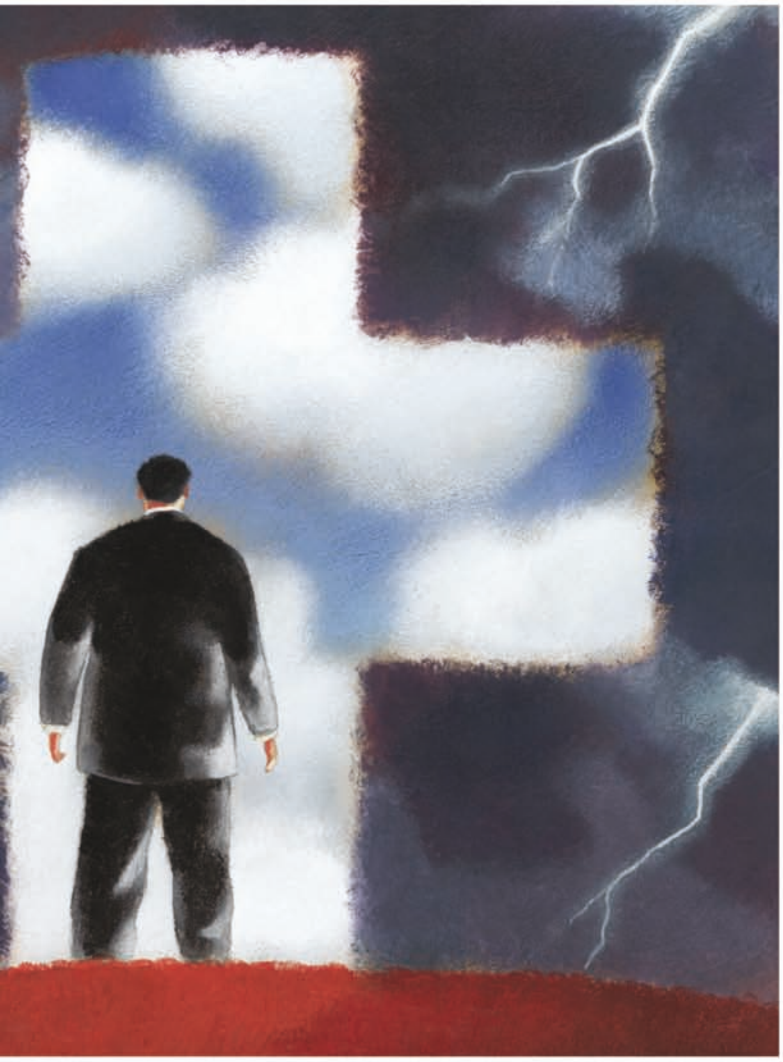

the banks.

This effect hurts the private banks as their main costs items are denominated in the Swiss franc.

The SNB announced at the beginning of September 2011 that it will interfere if the over-valuation of the Swiss franc continues and defined a floor for the currency at CHF1.20 to the euro. The announcement was a surprise to the FX markets. Since then, the exchange rate fluctuates around the SNB floor. It has to be seen whether the floor is of long-term nature as the risks remain that market participants will challenge this floor by speculating against it. One should not forget, however, that a strong currency may also help banks to have an increased influx of new money from clients as a strong currency is a sign of trust for a jurisdiction.

Market access

Switzerland plays a leading role on an international scale in the offshore wealth management business. Swiss banks hold approximately CHF5.5trn (£3.9trn) of assets under management. Roughly half of these assets belong to foreigners. It is obvious that market access is crucial in order to gain and serve clients in various countries around the globe.

The legal risks entailed in the cross-border business crystallised when the US authorities started investigating UBS and their employees on the grounds that the bank helped US taxpayers to evade paying taxes. In 2009, UBS settled its US cross-border case by entering into a costly deferred prosecution agreement with the Department of Justice. The relief for the Swiss banking sector was, however, only of short nature. The US authorities are pressuring a number of Swiss banks to release data relating to US clients. The Swiss authorities are presently negotiating a possible settlement with the US authorities as the matter entails conflict of jurisdictions issues which can hardly be solved by the banks concerned on their own.

It was a positive development that Switzerland was able to agree on a tax treaty with Germany and the UK in August 2011. The treaties provide that UK or German clients of Swiss banks may either disclose their account to their authorities or accept a withholding tax imposed by the custodian bank and wired to the country of residence of the respective clients without disclosing the identity of those clients. The treaties furthermore provide easier market access for Swiss banks in the future.

The AIFM Directive

The European Union passed a new directive called Alternative Investment Fund Managers (AIFM) Directive. The directive brings far-reaching regulatory changes for asset managers of alternative investment funds such as hedge funds and private equity funds.

In the light of the AIFM Directive, Switzerland is presently considering an amendment of the Federal Collective Investment Scheme Act. The envisaged change would make it mandatory that Swiss asset managers hold a licence from the Swiss Financial Market Authority in order to manage foreign collective investments schemes. This could impair the attractiveness for hedge fund managers to relocate – as in the past – to Switzerland. Even more importantly than the change in law as such is the modalities of how such a change will be handled in practice, in particular in terms of timing and in terms of the need to have a consolidated supervision for financial groups.

Another issue of concern is whether the private placement exemption for foreign funds, in particular to high net worth individuals and other qualified investors will – as proposed – be narrowed down making it more difficult to sell offshore hedge funds in Switzerland.

The aftermath of the financial crisis had and continue to have considerable impacts on the Swiss financial industry. It will be of paramount importance to conclude the process of adaptation of the legal parameters for the financial industry in the near future and to signal to the industry that the Swiss legal system is reliable and stable.

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