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## The Atlantic hurricane hit Switzerland at full force

First there was the US Federal Reserve's ill-advised monetary policy, then came the real estate and financial crisis in America, followed by a serious banking crisis in Europe. Finally, the waves of the "financial tsunami" hit the real global economy. Switzerland, with its open economy and powerful financial centre with banking giant UBS, was hit hard. Banking confidentiality is facing "the beginning of the end". By Rolf Ribi

The most severe recession for decades in the global economy was preceded by the US Federal Reserve's "policy of cheap money". As Chairman of the Federal Reserve Board, Alan Greenspan introduced very low interest rates, triggering two major speculative runs – firstly on the Internet market ("new economy") and later on the real estate market. In June 2003, he dropped the base rate to a record low of just 1%. American consumers were encouraged to borrow, including for the purchase of real estate. Cheap mortgages provided practically 100% finance for homes. The number of such mortgages increased astronomically.

When interest rates started to rise in 2004, lots of mortgage holders got into trouble. Forced sales of homes caused prices to drop on the housing market. This also left mortgage lenders facing difficulties as they were forced to make value adjustments in their balance sheets. The situation deteriorated sharply in 2008 when big names like Bear Stearns and Merrill Lynch were sold, and the insurance group AIG was placed under state supervision. At the height of the crisis, America's fourth-largest investment bank, Lehman Brothers, filed for bankruptcy on 15 September, taking other banks down with it.

One of the reasons for the great banking crisis in the USA was that the banks' troubled mortgage claims were transferred out (instead of being entered in the balance sheets), bun-

dled based on risk, turned into securities and traded on the stock market. The new financial products were virtually impossible to rate and were a major reason for the real estate and banking crisis.

### Banking giant UBS on the brink

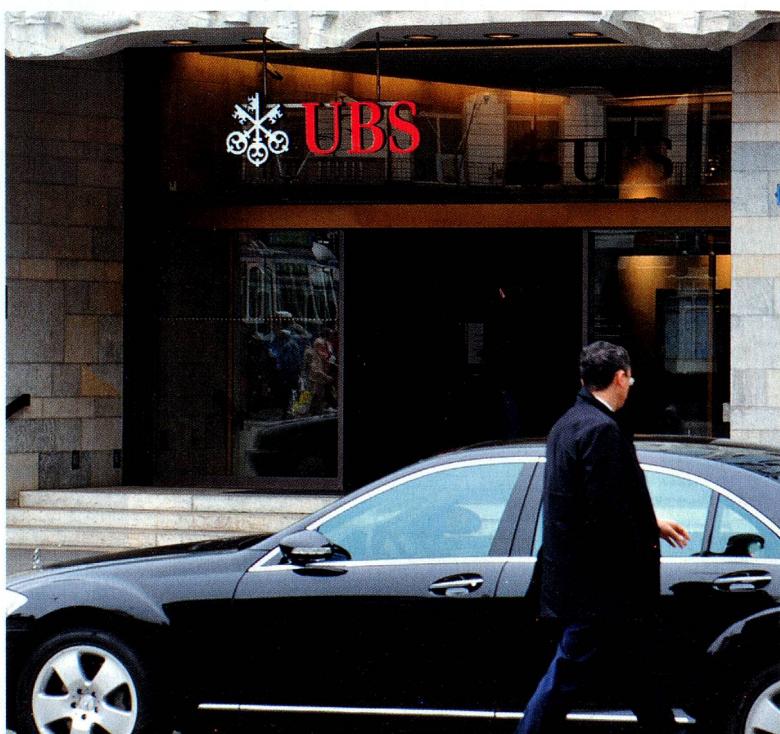
In 2004, UBS was still considered the safest bank in the world. This universal bank, with its headquarters on Zurich's Bahnhofstrasse, was the world leader in asset management. But its managers at the time also wanted to turn UBS into the world's top investment bank, making it bigger than the famous names on Wall Street in New York (investment banking involves supporting companies with IPOs and trading in securities). In summer 2005, the Swiss bank was a major player in this high-risk market with re-packaged

American mortgage products. In 2006, the American real estate crisis erupted. Investors lost confidence in the non-transparent securities, causing their prices to plummet. A real "financial tsunami" (Alan Greenspan) swept across the Atlantic in 2007.

At UBS headquarters in Zurich, nobody seemed to want to acknowledge the extent of the crisis or the imminent collapse of the bank. Even the most senior authority at the time for monitoring the banks did not become suspicious, despite the bank's enormous exposure on the US mortgage market. The leading rating agencies continued to classify the bank's credit standing as high. When the historic financial crisis hit in summer 2007, there was more than CHF 100 billion in American credit securities on UBS' books, more than twice the equity capital. In the October, Switzerland's biggest bank was forced to announce a loss of CHF 4 billion for the first time. More bad news followed in December 2007 with write-offs of a further CHF 12.5 billion on American mortgages. Hugely devalued investments had to be written off and sold by autumn 2008, with losses of almost CHF 50 billion.

UBS' situation had become critical by late autumn 2008. Other banks would only lend UBS capital on a short-term basis, in the end overnight at most. More and more customers withdrew their assets from the bank.

Frantic attempts by the bank's senior management to find financially powerful private investors proved unsuccessful. The government was the last hope. The Chairman of the UBS Board of Directors requested financial help of up to CHF 68 billion in three letters to the Federal Council, the National Bank and the banking supervisory authorities. This was an admission of failure on an enormous scale. The billion-franc rescue package from federal government and the National Bank was made up of CHF 6 billion (repayable) in new equity capital from federal government and up to USD 60 billion from the National Bank (for the transfer of illiquid



Switzerland as a financial centre has been hit hard by UBS.

American securities). This was state intervention on the largest scale ever seen in Switzerland – it equates to each of the nation's seven million citizens assuming risk of almost CHF 10,000.

In June 2009, it became apparent that federal government would retain its CHF 6 billion loan to UBS for the time being. After six months, the authorities had the right to sell the loan directly, or to change it into shares and then sell it. What stopped federal government from getting rid of the UBS risk? The terms of the loan are favourable. The interest on it is set at a good 12.5%, and at the current rate that would actually produce a profit of CHF 800 million for the federal coffers. But the Federal Council is not yet convinced that the bank has recovered. According to the National Bank, UBS still has exposure of USD 24 billion in critical loan markets.

#### Huge pressure from America ...

Offshore banking (the management of assets outside the customer's country of origin) and the protection of private clients through banking confidentiality made Switzerland's financial centre the world leader in asset management. However, the outflow of private assets is a thorn in the side of the US government and its tax authorities. Under the "Qualified Intermediary Agreement", UBS had to undertake to reveal the assets of its American customers in US securities. The bank attempted to gain authorisation from these customers to report names and investments to the US tax authorities. But the majority of American customers refrained from disclosing this information. When former senior executives at the bank revealed the illegal practices they often used to win new customers to the US courts, offshore business with "undisclosed" customers became like "walking a tightrope". Faced with large-scale investigations against it by the judicial authorities and the threat of losing its licence, the bank decided to cooperate.

The wind had also changed in Switzerland. In October 2008, the Swiss federal tax administration responded to a request for administrative assistance from the US and passed on the bank data of 300 American UBS customers. "It was primarily a matter of averting the threat to the bank's existence. The risk was justified and real", said Eugen Haltiner, Chairman of the Swiss Federal Banking Commission. He added that the bank had evaded American tax law and the cases concerned involved tax fraud. UBS agreed to a settlement with the US judicial authorities and paid USD 780 million in fines. However, this does not rule out possible criminal proceedings against the bank.

Shortly afterwards, the American tax authorities brought a civil action against UBS in Florida demanding that it reveal all 52,000 names of US customers whose assets managed by the bank total almost USD 15 billion. It looks likely that UBS will be in the dock in Florida in mid-July. "UBS' fate will be decided in Florida. A victory for the tax authorities would break the bank's neck. The bank's core business, asset management, would be hit badly" (so writes the "NZZ am Sonntag"). "Berne" and the bank are now hoping that the (wealthy) American customers suspected of tax evasion will turn themselves in to the US tax authorities.

#### ... and from the European Union

The European Union has joined the USA in exerting tremendous political pressure on Switzerland. "Tax havens are a scandal. The international community will no longer put up with Swiss banking confidentiality", said former German Finance Minister Hans Eichel. The current German Finance Minister, Peer Steinbrück, has been even more outspoken: "We must use the stick with Switzerland as well as the carrot. Transactions can also be taxed to put pressure on Switzerland."

The European Union and Switzerland concluded an interest agreement in 2005. This obliges all Swiss banks to impose a retention tax (25% currently, 35% from 2011) on EU citizens' interest earnings. This only affects interest earnings from private foreign assets, and not income such as dividends of legal entities. This means the assets of foreign customers of Swiss banks remain anonymous, protecting banking confidentiality. Within the European Union, the interest tax agreement with Switzerland (and with the EU countries Luxembourg, Belgium and Austria) is only seen as a limited-term transitional solution. This worries Federal Councillor Hans-Rudolf Merz: "A low front is heading our way from Brussels. The European Union is working towards an automatic exchange of information on fiscal matters. That would spell the end of our banking confidentiality. And we don't want that at any price."

#### Black day for banking confidentiality

"Switzerland has become a paradise for foreign capital on which tax is not paid. The uproar from foreign governments is understandable." These are not the words of a critic of the banks, but of private banker Konrad Hummeler. He says that around 30%, or CHF 1,000 billion, of the CHF 2,800 billion or so of foreign assets in Swiss banks is untaxed "black money".

Things finally came to a head on Black Friday, 13 March. Under intense pressure from the major countries in the European Union and the USA, Swit-



Chairman of the UBS Board of Directors, Kaspar Villiger, is trying to win back the trust of its customers.

erland recognised the OECD standard on administrative assistance in fiscal matters. Switzerland will now provide foreign tax authorities with assistance not only in cases of suspected tax fraud, but also in cases of suspected tax evasion. The long-standing Swiss tradition of differentiating between tax evasion (a legal offence punishable with a fine) and tax fraud (falsification of documents punishable through criminal proceedings) no longer applies to foreign customers. The "beginning of the end of banking confidentiality in its current form" will have repercussions: "Switzerland will in future no longer be a safe haven for money from tax evasion" ("Neue Zürcher Zeitung"). "The handover of customer data to the Americans has made investors nervous. We are unfortunately unable to send a clear message out to them." (Yves Mirabaud, a private banker from Geneva).

#### Switzerland on the "grey" list

Switzerland's "good conduct" with regard to international assistance on fiscal matters, based on the OECD's model agreement, has so far done little to relieve pressure from abroad. At the summit in London on 2 April, the twenty leading economic nations put Switzerland on a "grey" list. Switzerland has recognised the OECD standard, but has not yet implemented it. "Switzerland in the G-20's vice" was the headline in the "Neue Zürcher Zeitung". If Switzerland does not comply with the OECD standard, "it will be threatened with economic sanctions. Such a disastrous outcome must be avoided under all circumstances".

The Federal Council wants to implement the OECD standard through amended double taxation agreements with foreign states. These govern the provision of Swiss administrative assistance "in specific cases of tax evasion". The intention would be to put the first agreement of this nature to Parliament and, in the case of a referendum, to the people for a decision. However, this democratic approach may take

too long for the USA, Germany and the other countries ...

#### Deep recession in Switzerland

"The significant global downturn has hit Switzerland badly", the Swiss National Bank announced in spring. Jean-Pierre Roth, Chairman of the National Bank, said: "We anticipate a considerable fall in economic output of up to 3% this year." This would be the sharpest fall our economy has experienced since the 1975 oil crisis. In June, federal government's chief economists predicted that the economy would contract by 2.7% this year and by 0.4% next year. The unemployment figures are unusually high for Switzerland – 3.8% unemployed this year, rising to 5.5% or 240,000 jobless next year.

Switzerland's financial centre has been unable to avoid the crisis. With overall losses of over CHF 30 billion, 2008 has been one of the worst years ever for all those working in Swiss financial organisations. Most of the losses can be attributed to UBS (CHF -36.5 billion) and Credit Suisse (CHF -2.2 billion). 6,000 jobs had been lost at the big banks by this summer, with the figure set to rise to a total of 10,000 by the end of 2010.

On the basis of the main article concerning the economy in the Federal Constitution (Article 100), the government and Parliament have agreed three recovery plans so far

to boost the economy. The first set of measures, launched in November 2008, and the second set, from last February, primarily concern public works projects, while the third set in June focuses on combating youth and long-term unemployment. Federal government has committed almost CHF 2 billion to boosting the economy, which is relatively little by international comparison. Urs Müller, an economic researcher from Basel, comments: "The economic recovery plans agreed abroad will have a greater impact on our economy than our own measures."

#### Hope for change

"I see 2009 as a lost year. But various arguments would suggest a global recovery in 2010", explained the chief economist at Deutsche Bank, where Josef Ackermann, a Swiss citizen, is CEO. Low commodity prices, low interest rates and the economic recovery plans (above all in the USA and China) are set to produce stability relatively quickly by means of global trade. Switzerland is still being hit badly at the moment owing to the major significance of the financial sector and the heavy dependence of engineering and the chemical industry on foreign markets.

However, the current recession must also be seen in the context of the bigger picture. The Swiss economy has achieved annual growth of almost 3% in recent years, creating around 290,000 jobs. In the worst-case scenario, economic output will fall to 2006 levels. Since 1950, so in just two generations, real Swiss gross domestic product has increased by 4.5 times and by 2.8 times per capita. This indicates the extent to which Swiss prosperity has increased.

(Article written on 30 June)



The financial crisis has cost thousands their jobs; job centres are overrun again.

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