SwissBanking

BCG
The Boston Consulting Group

September 2011

Summary: Banking in transition – future prospects for banking in Switzerland

A joint study by the Swiss Bankers Association and The Boston Consulting Group on the Swiss banking centre

Summary

The banking sector is very important for the Swiss economy, creating about 7% of direct added value and occupying a leading international position in various business areas. However, the economic and regulatory framework are changing faster than ever. This presents great challenges, but also offers opportunities. In such an environment, it is appropriate to constantly review and adapt business activities, refocusing them as required. Given the rapid growth in the complexity of the challenges, the future growth drivers in different business areas need to be considered holistically if a competitive position is to be maintained.

The Swiss banking centre generated gross revenues of CHF 58.6 billion in 2010; this is forecast to grow by 1.8% annually to reach CHF 64.0 billion by 2015 in the base forecast. That would put Swiss banking in line with the growth trend for the economy as a whole. These assumptions are based on a moderate steady trend in capital markets and the economy, plus those regulatory developments that look most probable from today's perspective. However, important distinctions can be made between the different business areas of the banking centre.

In addition to these solid, positive growth prospects the banking centre also has other sources of revenue that so far have either been scarcely addressed or not addressed at all. This study identifies and describes such opportunities. The additional potential revenue that could be accessed comes to CHF 4.8 billion for the whole Swiss banking centre by 2015.

Large parts of the Swiss banking industry are focused on the local economy and meet domestic demand. This is especially the case for the traditional retail client and corporate customer businesses, which form the cornerstone of the Swiss banking sector. In a broader context, the Swiss banking centre is an international leader, particularly in cross-border private banking and funds of hedge funds, with market shares of 27% and 30% respectively. Traditional core elements of the national framework such as the protection of financial privacy, political and economic stability, a highly educated workforce and excellent infrastructure are very important for a strong banking sector that contributes to the overall economy.

If they are to maintain their lead in a period marked by dynamic change, banks will have to tackle tomorrow's challenges today. This includes adapting their business models in good time to the changed economic and regulatory environment, refocusing their business portfolios, re-examining market priorities and being relentless in pursuing growth opportunities.

The future economic environment will see increasing multi-polarity, geopolitical uncertainty, the emergence of a broad class of wealthy people in many countries and rising competition for the Swiss banking centre. International changes to the regulatory regime will also affect all areas of the Swiss banking centre. The developments that most affect Swiss banks relate to prudential standards (Basel III, "Too Big To Fail"), transparency (the Dodd-Frank Act in the US; MiFID, UCITS, AIFMD and EMIR in the EU), remuneration systems, and tax (OECD 26, FATCA and the flat-rate withholding tax).

These changes have implementation costs that are very significant for financial intermediaries. The way the rules are structured in those businesses where the Swiss banking centre competes directly with other banking centres shifts the international competitiveness of Switzerland. At the same time, the costs of adapting to regulatory changes

and the associated structural increase in the cost of doing business and providing capital backing will alter the attractiveness of some areas and businesses. This may result in strategic or operating cuts that bring about structural changes in the Swiss banking industry. The challenge for regulators is therefore to be particularly careful to implement rule changes in a pragmatic manner.

The position of Switzerland compared to other banking centres is as follows:

- In **Private Banking** Switzerland has been harder hit by the more difficult environment for cross-border business than those banking centres where West European and North American clients are or were less important. Politicians and the banking sector have already made important strategic shifts in cross-border private banking, but further structural change looks inevitable. The regulatory tightening means that assets sourced from the former core market of Western Europe and invested in Switzerland will continue to decline. Assets from emerging markets will see strong growth and gain in importance. It will therefore be essential for individual banks to check their market focus, services and internal processes. The withholding tax/market access treaties initialled with Germany and the UK reduce the uncertainty about Swiss banks reorienting their business and operating models. The changes needed to meet stiffer international regulation will push up costs, creating a particular challenge for smaller, specialised banking centres.

- **Asset Management** is heavily focused on the local market. Apart from funds of hedge funds, today Switzerland is not an internationally relevant asset management location. The regulatory and tax environments are relatively unfavourable in Switzerland compared to Luxembourg. This covers, for example, fund registration procedures, withholding tax and stamp duty, market access/the EU passport, the general speed of implementing new directives, actual and perceived investment skills, reputation as a distribution platform, and position as a leading location for UCITS funds. Compared to London and New York as alternate international fund locations, the difference is not so much in the regulatory aspects as the restricted availability of highly qualified specialists. In view of the importance of private banking, special attention must be paid to improving the reputation as an investment centre and boosting synergies with the asset management business.

- In **Corporate Business** and parts of **Investment Banking**, particularly equities sales and trading and FICC sales and trading (which we will not go into here), the implementation of Basel III and the extra requirements for banks of systemic relevance play a key part in the attractiveness of the location, since banks in Switzerland compete directly with banks domiciled abroad. As in the past, Switzerland will set the capital requirements for its banks at a level which in parts goes well beyond Basel III (equity ratios of 10.5% to 14.4%, see Table 1). Even stricter rules have been proposed for banks with systemic relevance, taking total capital requirements to 19%. Of this, 10% has to be held in the form of hard tier one capital. These higher levels present a particular challenge for Swiss banks. The higher capital requirements result in a cost disadvantage compared to foreign banks that can operate from their home country with no need for a Swiss subsidiary holding a Swiss banking licence. Swiss stamp duty on bond issues is another structural disadvantage for Swiss banks (see Chapter 7.2).

- In **Retail Banking** the taxation on notional rental value combined with tax deductibility for interest paid on the financing of owner-occupied real estate is an issue. This arrangement is unknown abroad and in the past contributed to the relatively high level of outstanding mortgages in Switzerland. Switzerland has no legally mandated advisory

record for each session of advice, as is the case in Germany, nor has it had a UK-style Retail Distribution Review. The introduction of these rules in Germany and the UK has caused significant additional expenditure for banks. In addition, the introduction of MiFID II in the EU is resulting in increased complexity for EU banks, trading platforms and securities dealers. Increased transparency requirements, the extension of MiFID to bonds, greater advisory and record-keeping duties and the general demand for "strict equivalence" in the regulations of other countries when offering cross-border services will all be relevant for Swiss business.

Across all business areas, the future rules on capital backing, liquidity and leverage will be highly significant for internationally active banks with capital-intensive activities. Overall, the strict rules allow Switzerland to emphasise the stability and solidity of its banks, but it is crucial that the additional costs incurred do not cause too great a disadvantage in international competition. Even though stricter capital backing initially only really affects the major banks, it needs to be borne in mind that internationally competitive major banks are essential for the whole Swiss banking centre.

Banking centre	Capital backing rules - status of implementation
Germany	Prompt implementation of stricter risk coverage, increase in core capital ratio and introduction of capital buffer as per Basel III currently still unclear.
EU	The EU will largely implement Basel III. The proposal published by the Commission in mid-July 2011 has a minimum capital ratio of 10.5%, of which seven percentage points must be common equity. The EU is aiming for maximum harmonisation of the new rules in member states. The proposal therefore restricts the ability of individual states to go beyond Basel III.
France	Developments still unclear; will be adopted when USA has completed implementation.
UK	The Independent Commission on Banking has produced an interim report proposing a 10% equity ratio for retail banking activities. The ability of debt to absorb losses should also be improved.
US	As was already the case with Basel II, it is not clear to what extent Basel III will be implemented in the US. Initially, only the 19 largest banks are affected. The Fed has proposed that a further 16 institutions with assets in excess of USD 60 billion should submit capital adequacy plans. The Fed is only allowing US banks to make dividend and other payments if stress tests show that the Basel III requirements can be reached by end-2012. The Dodd-Frank Act (DFA) bans the use of credit ratings for risk assessment and imposes tighter rules for financial institutions of systemic importance. The DFA (Collins Amendment) allows regulators to insist on Basel I levels of minimum capital backing. This could potentially affect large international banks as well as US ones. Between 2013 and 2016 some hybrid securities will cease to count as core capital for US bank holding companies with assets in excess of USD 15 billion. There is also uncertainty about the liquidity requirements that will be imposed.
Switzerland	Adopting Basel III with additional increased equity requirements - expected level of capital backing needed for systemically important institutions is 19% (tier one plus tier two capital), although this will be eased by recognition of CoCo bonds (contingent convertibles[1]).

Sources: websites of the regulators/financial market supervision authorities in the countries concerned: US: Securities and Exchange Commission (SEC), Federal Reserve System (FED) Dodd Frank Act; UK: Financial Services Authority (FSA) under Lord Turner; Germany: Federal Financial Supervisory Authority (BaFin), France: Autorité des marchés financiers (AMF), Netherlands: Autoriteit Financiële Markten (AFM) and Switzerland: Financial Market Supervisory Authority FINMA, press searches, BCG analyses.

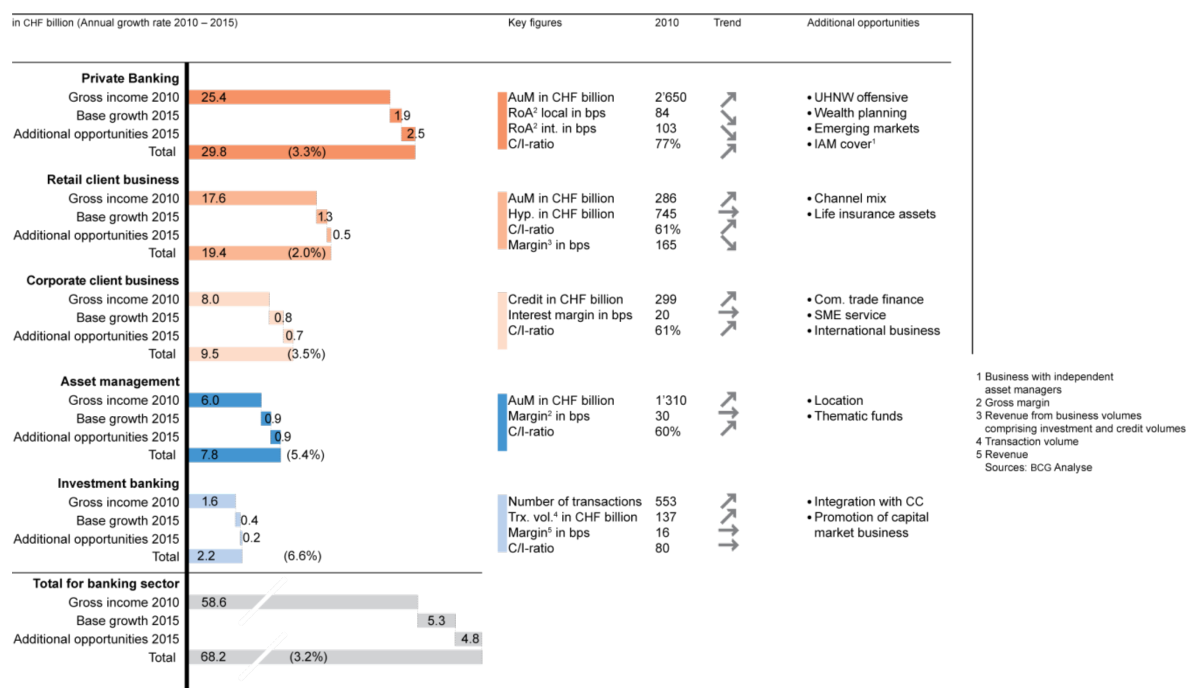
Table 1: Likely implementation of Basel III in selected financial centres

[1] CoCo bonds are mandatory convertible bonds where the trigger point for converting into equity is set in advance. They are triggered when capital adequacy falls below a minimum level. The CoCo bonds then become equity, making them part of tier one capital.

Today the Swiss banking market produces revenues of CHF 58.6 billion: 43% of this comes from private banking, 30% from retail banking, 14% from corporate clients and 13% from asset management and investment banking (see Figure 1). By 2015 revenue should have risen by around CHF 5.3 billion, an annual increase of 1.8%. These estimates are based on cautious assumptions about the economy and those regulatory developments regarded as likely from today's standpoint.

Two developments will have a significant influence on business activities. On the one hand, banks in Switzerland are facing lower margins. These are primarily the result of tighter regulation, the concentration on taxed assets and stiffer international competition. On the other hand, emerging markets are growing far faster than the traditional client markets of Swiss banks, which will lead to a corresponding demand for asset management services in future.

Figure 1: Gross income and growth opportunities in Swiss banking



Despite its modest percentage growth, private banking will remain the largest contributor to higher total revenue. Assets under management from Western Europe and North America will decline, but all in all a clear rise is expected - mainly due to further inflows from emerging markets and supported by moderate expected capital market performance. Special opportunities for continuing to grow the income basis can also be seen in ultra high net worth individuals (UHNWIs) and holistic financial planning for wealthy clients. Private banking revenues are likely to rise from CHF 25.4 billion in 2010 to roughly CHF 29.8 billion in 2015.

Future economic and regulatory trends raise the prospects for clear gains for the Swiss banking centre in asset management in particular. Expanding from being a centre for funds of funds to a full-service location for global hedge funds, increasing volumes in innovative thematic funds such as sustainability or luxury goods and gradually abolishing stamp duty could boost gross revenues by CHF 1.8 billion by 2015. All in all, it looks feasible to raise the size of the revenue pool in Swiss banking by up to CHF 10.1 billion (3.2% annually) over five years if all the opportunities are grasped.

In **private banking** additional opportunities worth a potential CHF 2.5 billion have been identified:

- *UHNW offensive:* More revenues from an improved service offering and a dedicated coverage model. Providing full family office services could also generate more revenue.
- *Wealth planning offensive:* Greater client penetration with full-service financial planning. This demands greater advisory skills in issues to do with succession planning, inheritance and protecting living standards.
- *Emerging markets*: From its position as a leading centre for cross-border asset management, Switzerland can boost asset inflows from emerging markets if it adopts a clear strategy.
- *Independent asset managers (IAMs*): The changing environment is leading IAMs to make increasing use of bank services for regulatory expertise such as reporting, tax returns and market-specific product offerings. This broader support also provides clear additional benefits for their end clients.

In the **retail client business**, realising the additional opportunities could generate another CHF 500 million of revenues:

- *Channel mix*: Reinforcing multi-channel capabilities will make it possible to address client needs that have not yet been fully addressed. This sort of cross-selling can generate extra revenues.
- *Life insurance assets:* Improved reinvestment of maturing life insurance policies.

The **corporate customer business** has potential for a further CHF 700 million of revenues:

- *Commodity trade finance:* The significance of Switzerland for international commodity trading has risen sharply in recent years. This offers Swiss banks an opportunity to get more involved in trade finance.
- *SMEs services:* Many SMEs with an internationally focussed business offer major potential for more complex products such as currency hedging.
- *Foreign business:* Offering a full range of services to large Swiss and international companies for their foreign business. This gives Swiss banks an opportunity to capture additional revenue that at present is not booked in the Swiss banking centre.

Opportunities identified in **Asset Management** amount to additional gross revenues of roughly CHF 900 million:

- *Hedge fund location:* The current leading position in funds of funds can be expanded and individual funds encouraged to relocate. Improved infrastructure, a gathering cluster effect, proximity to the large buyers in private banking and a changed tax environment in London are all supportive here.
- *Thematic funds*: Extra revenues can be generated by expanding skills to cover issues such as sustainability and asset classes like commodities. Other special themes should be developed over time.

In **investment banking** (advisory and new-issue business) another CHF 200 million of revenues could be gained:

- *Integration with the corporate client business*: Active cooperation between investment banking and the corporate client business should make it possible to offer clients a full

range of services. This could lead to more business in M&A advisory and capital markets financing.

- *Promoting the capital markets business:* To date the capital market in Switzerland has been underused as a way of raising capital. More intensive efforts could overcome reluctance. A possible gradual abolition of the stamp duty and changes to withholding tax would support this process.

Not all banks can or should take up all these opportunities. If anything, in fact, the more challenging environment suggests greater focus is needed. Overall, however, the business opportunities listed offer considerable additional potential for the Swiss banking centre - especially if they are addressed by those institutions that have what it takes to succeed: ability, resources and market access.

Capturing all these additional opportunities will require both political and regulatory improvements and better cooperation between authorities and the institutions being supervised in the interests of the banking centre. In some areas, for instance, competitive disadvantages compared to other banking centres have been noted. Improvements to the operating environment should primarily focus on the competitive disadvantages of the Swiss banking centre that have been discovered. It was also found that some banking centres run promotional campaigns. Luxembourg, by way of example, has a public-private partnership called "Luxembourg for Finance", which is an agency mainly tasked with improving the image of Luxembourg as a financial centre abroad.

The overall conclusion is that the banking centre continues to face major challenges, but definitely has options that will allow it to counteract relative growth disadvantages and margin erosion. Specifically, growth can be achieved from the following three general strategic directions:

- **Tapping in to the dramatic growth in the economies and levels of wealth in emerging markets and particular client segments** (E.g. the opportunities arising with high net worth clients with assets of more than CHF 100 million). These include focusing on business opportunities in emerging markets, expanding and positioning Switzerland as a location that provides a full service to UHNW clients, covering all the foreign business of large companies and internationally active SMEs, and actively tackling and using megatrends such as demographic change, generational shifts in established markets, growth in emerging markets, greater connectivity and new media, mobility, switches in the energy mix, environmental disasters, etc.

- **Improving the positioning of Switzerland as an asset management location**. The main issue here is to further strengthen the innovative power of Swiss asset management so as to be able to continually come up with new ideas and products that are also attractive for foreign retail and institutional investors. Product ideas may be based on the megatrends mentioned above, pick up current themes (e.g. sustainability), cover typically Swiss topics (e.g. luxury goods), be focused on certain client segments (e.g. Sharia-compliant products) or involve individual asset classes (a new generation of hedge funds and funds of hedge funds that settle in Switzerland). This applies for retail funds, but is also very important for institutional business. Strengthening Swiss asset management would also help Swiss private banking. Positioning as a centre for top-performing, innovative products would also assist private banking in standing out from other centres for cross-border asset management. From the perspective of the banking centre, potential revenue synergies depend not so much on selling in-house funds (assuming an independent range of products is offered) as on the fact that Swiss banks

and asset managers offer greater volumes of Swiss investment products so more of the value created stays in Switzerland.

- **Increasing commodity trade finance** is an attractive growth option for Swiss banks. The first aim is to benefit from the substantial growth seen in commodity trading in Switzerland and gain market share from the foreign banks that currently dominate this business (not always through their Swiss subsidiaries).

Swiss banks can continue to be successful despite margin erosion. Moderate volume growth at least is expected in all areas and, as shown, there are specific opportunities that will allow additional volume growth. Given the margin pressure anticipated in nearly all businesses, income will grow more slowly than the underlying business volumes. In addition, tapping into these growth opportunities will incur significant costs (building up new capabilities and products, covering the market, infrastructure), as will the adaptations required to meet regulatory changes. Countering the pressure on profits (net margins) will also necessitate a greater general awareness of costs in the industry. If this does not occur, profit forecasts will have to be cut for the sector, which remains very profitable compared to earlier years.

Swiss Bankers Association
Aeschenplatz 7
PO Box 4182
4002 Basel
Switzerland
T +41 61 295 93 93
F +41 61 272 53 82
office@sba.ch
www.swissbanking.org
http://twitter.com/swissbankingsba