

BANKERS'
Law



Professor Graham Roberts - Demise of Banking Codes

Matthew Swan - The new Security Interests (Jersey Law)

Katsuhiko Fujihira and Shinsuke Kaneko - Amendment of Commodity Exchange Act

Peter Isler and Patrik Peyer - Future of Private Banking in Switzerland

Reports on ICC's Winter Trade Finance Conference and ISDA's Regional Conference

The Future of Private Banking in Switzerland - an Outlook from a Legal Perspective

Peter R. Isler (left) and Patrik R. Peyer (right) (Niederer Kraft & Frey, Zurich) examine recent initiatives in the Swiss private banking sector.



Introduction

There have been misjudgements made in the Swiss banking sector in recent times, and nobody doubts that, as a result, the pressure imposed on banks and on private bankers by foreign governments, as well as Swiss politics and regulators, has increased significantly during the last couple of years. The aim of this article is, however, not to deal with the cause of the economic crisis, nor with the effect the crisis has had on the private banking sector. Rather, the focus is on the future of private banking in Switzerland and the article aims to give a short survey on the challenges faced by this important sector of the Swiss economy and the resulting opportunities that are likely to arise from a legal perspective.

The analysis is conducted on the basis of two major initiatives of the Swiss regulator, the Swiss Financial Market Supervisory Authority (hereinafter the "FINMA"), and on a report of an experts commission established by the Swiss Federal Council in the aftermath of the economic crisis:

- the FINMA position paper on legal and reputational risks in cross-border financial services (hereinafter the "Position paper on legal risks") dated 22 October 2010¹;
- the FINMA discussion paper on regulation of the production and the distribution of financial products

to retail clients (hereinafter the "Discussion paper on distribution") dated October 2010² and

- the final report of the commission of experts for limiting the economic risks posed by large companies (hereinafter the "Too-big-to-fail report") dated 30 September 2010.³

FINMA Position Paper on Legal Risks

Traditionally many Swiss wealth management banks have largely based their business models on providing cross-border financial services to private clients who are not resident in Switzerland. As the legal and reputational risks associated with such cross-border financial services have increased significantly in recent years, FINMA has issued a position paper addressing this situation and expressing its expectations in relation to financial service providers active in this field of business.

The Swiss Financial Market Supervision Act, which is applicable to supervised financial institutions in Switzerland (i.e. banks and insurance companies), does not contain any provisions that the relevant financial service provider must observe foreign law. However, supervisory rules require supervised institutions to identify, mitigate and monitor

¹ The FINMA Position paper on legal risks dated 22 October 2010, can be accessed via the following link: http://www.finma.ch/e/finma/publikationen/Documents/positionspapier_rechtsrisiken_e.pdf.

² The FINMA Discussion paper on distribution dated October, 2010, is only available in German, and can be accessed via the following link: <http://www.finma.ch/d/regulierung/anhoerungen/Documents/diskussionspapier-vertriebsregeln-20101110-d.pdf>.

³ The Too-big-to-fail-report dated 30 September 2010 can be accessed via the following link: <http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en>.

all risks in an appropriate manner. This clearly includes an obligation on such institutions to identify and mitigate legal and reputational risks arising out of their cross-border operations.

In its position paper, FINMA leaves no doubt as to the fact that in the future it will, as part of its supervisory work, increasingly assess whether the relevant financial service providers are aware of the risks inherent in their cross-border operations and whether these institutions take appropriate measures to mitigate such risks. As such, Swiss private banks will in the future have to understand the potential legal and reputational risks for each individual target market, to take effective mitigation measures and, accordingly, to comply with the relevant foreign law when doing cross-border private banking out of Switzerland. This is a paramount consideration, not only to protect clients' interests but also the bank itself.

FINMA Discussion Paper on Distribution

In the aftermath of the Madoff and Lehman cases, which also involved many banks and other wealth managers in Switzerland, FINMA initiated at the beginning of 2010 an investigation into the distribution of capital-protected structured products to retail clients. As a starting point, FINMA analysed the risk profiles of the financial products in the market and compared those with the risk profiles of the clients in question. As a result, FINMA identified several shortcomings whereby the considerable information gap and the imbalance of power between financial service providers and retail clients emerged as FINMA's main concern. FINMA concluded in the Discussion paper on distribution that such shortcomings and weaknesses were not adequately dealt with by the laws in force.

As a result of the above analysis, the Swiss regulator promoted, with the Discussion paper on distribution, a debate on the subject of enhancing client protection. In summary, FINMA suggested the following actions and measures for discussion:

- to introduce and amend, at a product level, an obligation to produce prospectuses for investment products as well as follow-up publications, both to inform clients about the characteristics of the products, potential returns and losses, as well as risks associated with the products in question;
- to address the shortcomings and weaknesses of the applicable law by introducing harmonised rules of business conduct at the point of sale for all financial service providers;
- to protect retail clients against products that are unsuitable for them by obliging the financial service provider to provide an in-depth explanation of the

products and investment strategies as well as the costs, taxes, etc. associated with a specific transaction before a contract is concluded; and

- to introduce stricter and more consistent regulation of cross-border distribution of foreign financial products in Switzerland.

It is foreseeable that the discussion, which the Paper has initiated, will culminate either in new supervisory measures introduced by the Swiss regulator or even in the enactment of a new law for the financial service sector by the Swiss legislator. Such measures would aim to strengthen Switzerland's role as a major financial centre but could also help to improve access to foreign markets for Swiss financial service providers.

Too-Big-To-Fail Report

The private banking sector in Switzerland consists, on the one hand, of a large number of small and mid-size banks, but on the other hand the market is still dominated by a small number of very large companies. The global financial crisis has shown that a significant threat to a State's entire economy can be posed by these systemically important banks, in the event that they encounter serious financial difficulties. It became apparent that a government cannot allow such institutions, which pose a systemic risk, to fail, if the maintenance of the systemically important functions is in serious danger. Effectively this results in an implicit state guarantee that these institutions are "too big to fail".

The Swiss Federal Council established in November 2009 an expert commission which was assigned to examine the question of limiting the economic risks posed by those companies deemed to be too big to fail. In the final report, which was presented in September 2010, the expert commission suggests specific measures to mitigate the economic risks. Due to the complexity of the problem these measures were divided into the following four core areas:

- (i) *measures to strengthen significantly the liability coverage of systemically important banks*, such as the creation of a capital buffer by issuing capital instruments with loss-absorbing capacity (e.g. CoCos, contingent convertible bonds) (report, section 3.3);
- (ii) *proposals concerning liquidity requirements*, including for example countercyclical components, allowing liquidity buffers to be built up during periods of strong economic growth, which can be used if a stress situation occurs for which banks must have sufficient liquidity to cover the estimated outflows over a period of at least one month (report, section 3.4);
- (iii) *measures to improve the diversification of risks* by introducing requirements to reduce institutional interconnectedness

with a primary focus on avoiding bank dependency on too-big-to-fail institutions (report, section 3.5); and

(iv) guidelines for the preparatory organisational measures to maintain systemically important functions in the event of crisis, which area has, compared to the first three areas, not a preventive effect but covers precautionary measures to mitigate the consequences of an insolvency scenario (report, section 3.6).

From a private banking point of view, primarily two global players in Swiss private banking are affected by the measures suggested by this Too-big-to-fail report. However, the report also has, in certain areas, an impact on the whole private banking sector. To mention only one such area, the Too-big-to-fail report points out that there are clearly risks associated with transactions in over-the-counter (hereinafter “OTC”) derivatives. To mitigate such risks, the report suggests as a key measure the introduction of central counterparties. This would lead to a situation where contracts in the OTC market would still be negotiated between two market participants. However, claims and obligations under the contracts in question would be assigned to a central counterparty, who would be responsible for settling the transaction correctly, receiving collateral from the parties and offsetting claims and obligations of a single counterparty under other contracts. The experts commission expects that this mechanism would significantly reduce open positions and thus the credit risks to which each of the market participants are exposed. In addition, this system would, most probably, also reduce contamination effects that could otherwise spread from a failed market participant to other participants.

As is convincingly stated in the report, the clearing of OTC derivatives through a central counterparty would imply that products should be largely standardised, which requires, in turn, that market participants co-operate with the FINMA to find appropriate levels of standardisation for the various types of OTC derivatives by aligning contractual terms and operational processes. In accordance with international initiatives (i.e. Basel III), it is to be expected that the clearance of OTC derivatives through a central counterparty would incentivise banks by providing for lower capital requirements compared to OTC derivatives settled bilaterally between market participants.

Conclusion

In view of the above-mentioned developments on the legal and regulatory front, it is apparent that private banking in Switzerland is currently going through a period of fundamental change. Those changes will lead to an increase in the duty of care of financial service providers and their employees in relation to their clients. These developments ought, however, to be accompanied by the creation of new opportunities for such firms, with the improvement in access to foreign markets for Swiss financial service providers being just one example.

The ultimate goal must be to strengthen again the traditionally excellent reputation of the Swiss private banking sector and to attach the label “Swiss quality” to all services provided by banks and other wealth managers in Switzerland to their national and international clients. 