Snowed under

Switzerland used to take pride in its big banks. Now it's not so sure

HAD Bradley Birkenfeld worked for a small Swiss bank, his tales of smuggling diamonds in a toothpaste tube—among other ways of helping American clients fool the taxman—would have merited only a line or two in the newspapers. But Mr Birkenfeld was employed until 2006 by UBS, Switzerland's biggest bank and the world's biggest wealth manager, looking after SFr2.8 trillion ($2.7 trillion). In his seven-page confession to a Florida court last month he claimed he was just a cog in a tax-evasion machine run by UBS. The world's press went to town.

For UBS the allegation—true or not—could not have come at a worse time. It is just one battle in the war to save its business model and perhaps its independence. Since April 1st, when it revealed that write-downs on its American mortgage-related assets had reached $38 billion, the bank has been fighting to sustain its share price and its credibility. This week the price dipped under SFr20, 70% below its peak in June 2007, as one leading shareholder dumped 2.3m shares.

There are rumours of more write-downs to come, thanks in part to UBS's exposure to threadbare monoline bond insurers. On July 1st UBS said it was getting rid of four members of its non-executive board, part of the old guard who saw the bank get into this mess. But they cannot be replaced until shareholders meet, on October 2nd. Change at UBS happens slowly: Marcel Ospel, the chairman who presided over its rise and fall, announced his resignation on April 1st and was replaced on April 23rd, but spent his last day at the bank only on June 30th.

Rumours abound that UBS, or parts of it, are for sale. On June 27th the bank felt obliged to deny rumours that it intends to sell PaineWebber, its American broker. Lazard, an investment bank, is advising it on a medium-term plan, which could involve a separation of investment banking and wealth management—a reversal of the "one bank" model propounded not only by UBS, but also by Credit Suisse, the other big Swiss bank.

In this model, investment-banking products are sold to wealth-management clients, and wealth-management products to investment-banking clients. This is fine in theory, but sceptics say the benefits do not justify the risks of running a high-octane investment bank. And these days, with greater demands for price transparency, there are fewer advantages to keeping the trades internal. "Investment banking and asset management might as well be separate," says a former UBS manager.

Much of these two banks' business, in trading and investment banking, is already conducted outside Switzerland. Indeed, the Swiss Federal Banking Commission (EBK) has made no secret of the fact that it would be happy to see some of the high-risk investment banking go offshore, even if that means Switzerland loses rank as a global financial centre. If either UBS or Credit Suisse failed, the economy would be wrecked. To discourage any hope that the government would rescue either should it become insolvent, the Swiss deposit insurance scheme is capped at SFr4 billion per bank and covers only deposits held in Switzerland.

The EBK does not have the staff or skills to keep tabs on the big Swiss banks, although matters may improve with the creation of a new super-regulator next January, to be presided over by Eugen Haltiner, the EBK's chairman. It has generally relied on the maxim that Swiss banks should carry more capital than their foreign peers do, as a kind of insurance premium. But, like regulators elsewhere, it also put too much trust in the banks' own risk-based models. "The EBK has never said boo to the big banks," says a former UBS board member. It is hardly a good sign that Mr Haltiner worked at UBS until 2006 and used to report to someone now on its board.

However, the EBK's co-regulator, the Swiss National Bank (SNB), is now saying boo. It wants to strengthen risk-weighted capital measures that have been in operation, under the Basel 2 capital-adequacy rules, since the beginning of this year. It is also proposing a maximum "leverage ratio", a limit on the ratio of a bank's gross assets to its capital.

The suggestion is a slap in the face for both UBS and Credit Suisse. Their leverage ratios have grown dramatically in the past ten years. Philipp Hildebrand, vice-chairman of the SNB, points out that the two banks' combined assets amount to seven times Swiss GDP. In no other rich country ▸▸

do bank assets tower above the economy to such a degree (see chart).

Credit Suisse retorts that the leverage ratio is "outdated", because it ignores the risk-reducing effects of matching assets to appropriate liabilities. "We manage banks according to Basel 2, not Hildebrand 1," spat Tobias Guldimann, the bank's chief risk officer. A crude leverage ratio also makes no distinction between risky and stodgy assets—unlike Basel 2, which ties capital charges to the dangers of banks' positions. Measuring those risks is not easy, however. If risk models were perfect, there would be no need for a leverage ratio, "but they are not", says Mr Hildebrand. For what it is worth, Credit Suisse can claim that its models did slightly better than UBS's: so far it has sacrificed a mere SFr8.5 billion to the subprime crisis.

A maximum leverage ratio would certainly cramp the two big Swiss banks. Only Deutsche Bank, Germany's biggest, has a comparable capital-to-assets ratio. In America all regulated commercial banks already have to meet a leverage ratio, and will do so even when Basel 2 rules apply there from next January. Sheila Bair, chairman of the Federal Deposit Insurance Corporation, one of the many bodies that regulate American banks, insisted on it. Analysts at Keefe, Bruyette & Woods, an investment bank, say that UBS and Credit Suisse would have to shrink their assets by SFr500 billion and SFr300 billion respectively to meet American benchmarks.

Ideally, stricter rules on capital would be applied not in Switzerland alone but more generally, in order to prevent regulatory arbitrage. Basel 2 does allow national supervisors to add extra measures to improve a bank's risk management, but a harmonised approach is unlikely in the near term. For example, although American commercial banks are subject to a leverage ratio, American investment banks are not. And differences in the accounting standards used in America and elsewhere lead to different leverage calculations.

If Switzerland did go it alone, the authorities would introduce the measure over the next few years rather than all at once, and exemptions would probably be made for mortgages and retail loans. And before getting to that stage the two big banks, especially UBS, first have to show that they have come through the crisis.

Thin end of the wedge

For Switzerland's smaller private banks the subprime difficulties experienced by UBS have so far been a boon: banks such as Julius Baer and Vontobel have seen money surge in over the past few months. But UBS's problems with the American authorities threaten Swiss banks as a whole.

America, the OECD and the European Union are always ready to attack the Swiss private banking model, with its notorious secrecy, as an unsporting competitor. Now UBS has given the American authorities an opportunity to demand details about banking clients. The Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) are getting unprecedented co-operation from their Swiss counterparts, with the nice distinction that the Swiss will help in cases of tax fraud but not tax evasion. (Tax evasion is not a criminal offence in Switzerland.) Forgery of documents places the Birkenfeld file in the tray marked "fraud".

The DOJ is investigating whether UBS helped American clients avoid taxes. This week a judge ruled that the Internal Revenue Service (IRS) could require UBS to identify American taxpayers with accounts not declared to the taxman. The SEC is looking into a separate question: whether UBS's sale of American securities to American clients obliged it to register as a broker-dealer. Martin Liechti, a senior UBS banker, has been detained in Florida since April. Moreover, other UBS bankers from the Swiss-based unit which had been selling securities to American clients are no longer travelling to the United States. Other Swiss banks are also said to have stopped transatlantic trips.

At stake is UBS's status as a "qualified intermediary" (QI) under agreements, signed since 2001, between the IRS and foreign sellers of securities to American residents. At worst, UBS's QI status could be cancelled, making it virtually impossible for the bank to serve investors in America. UBS has said it is co-operating with these investigations.

Swiss officials were in Washington, DC, last month to assist the Americans. Avoiding confrontation is paramount, because American enforcers can exact punishment well beyond their own borders. Although the OECD has rather less clout than the United States, it does Switzerland little good to be on the organisation's list of places in which it believes too little is being done to combat "aggressive tax planning".

Germany also has Switzerland in its sights, in an investigation of data stolen from a Liechtenstein bank and bought by its secret service from the thief. Germany's offensive may be the more troubling: the Swiss have more to lose there, because America has proved a harder market for outsiders to crack. "[The German investigation] rocks the principle of client confidentiality to the core," says Sebastian Dovey of Scorpio Partnership, a consultancy.

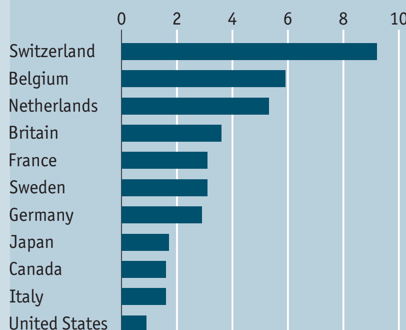
Swiss bankers insist that they are fully compliant with international agreements and that banking secrecy is not absolute: they will breach it for cases of severe crime, such as money-laundering or financing terrorism. But they will not give out names and account data willy-nilly in response to "fishing expeditions", says Michel Dérobert, secretary-general of the Swiss Private Bankers Association. Swiss officials have been advising their American counterparts on how to extract information, given this constraint.

The big question is whether UBS can remain independent and intact. Banks that have slipped up have often become takeover targets. NatWest was devoured by Royal Bank of Scotland after making relatively minor errors in managing equity derivatives. The old Union Bank of Switzerland, after a similar gaffe, sought refuge with Swiss Bank Corporation, to form today's UBS. ABN AMRO, under attack by activists for its failure to provide shareholder value, was carved up by three predators.

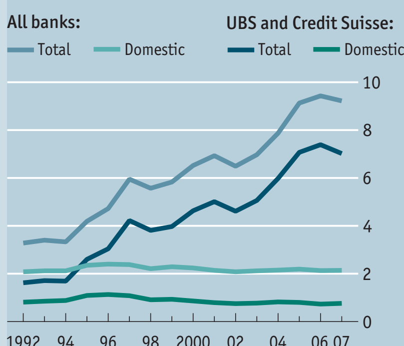
UBS is in a worse state than any of those were: despite a world-beating wealth-management arm, its business model is dented and its board has not come up with a new strategy. Predators are rumoured to be circling. What may save UBS is the generally sorry state of its industry: few would-be buyers have the ready cash for such a large deal. Hiving off divisions will also take time and money. UBS is more likely to soldier on alone, shrinking its business and licking its wounds. The newcomers on the board may help, of course, but they will not arrive until October. That seems a long way off. ■

A view of the mountain

Ratio of banks' assets to GDP, 2007



Ratio of Swiss banks' assets to GDP



Source: Swiss National Bank