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Private Banking Switzerland: from Yesterday to the Day after Tomorrow

Eight theses on Swiss Private Banking

Our study is aimed at supporting private banks in successfully positioning themselves in the challenging Swiss private banking industry.

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Foreword

Dear Reader,

no stone has been left unturned in Swiss private banking: business models, regulatory requirements, competition, costs, margins and client behaviour have changed fundamentally. So many have already prophesied the end of Switzerland as a private banking location.

This situation has prompted us to prepare an overview of the most prevalent opinions on the current state of private banking in Switzerland. As part of this study, we have divided these views into eight theses. Using the annual reports from 2006 to 2013 of some 90 private banking institutions of various sizes as well as other public data, we have reviewed whether these theses can be confirmed – or not.

The aim of this study is to provide you with an overview of the state of the wealth management sector and to create clarity regarding assumptions, facts and arguments. However, gloom and doom has no place here. Yes, Swiss private banking will have to undergo some fundamental changes in the coming years. Not everyone will be successful at this. But private banks will emerge from this process stronger, and the global reputation of Switzerland as a financial centre will rebuild itself.

We hope you enjoy reading this study.

Martin Schilling
Head Corporate Finance Financial Services Switzerland

Automatic exchange of information
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EIGHT THESES ON SWISS PRIVATE BANKING

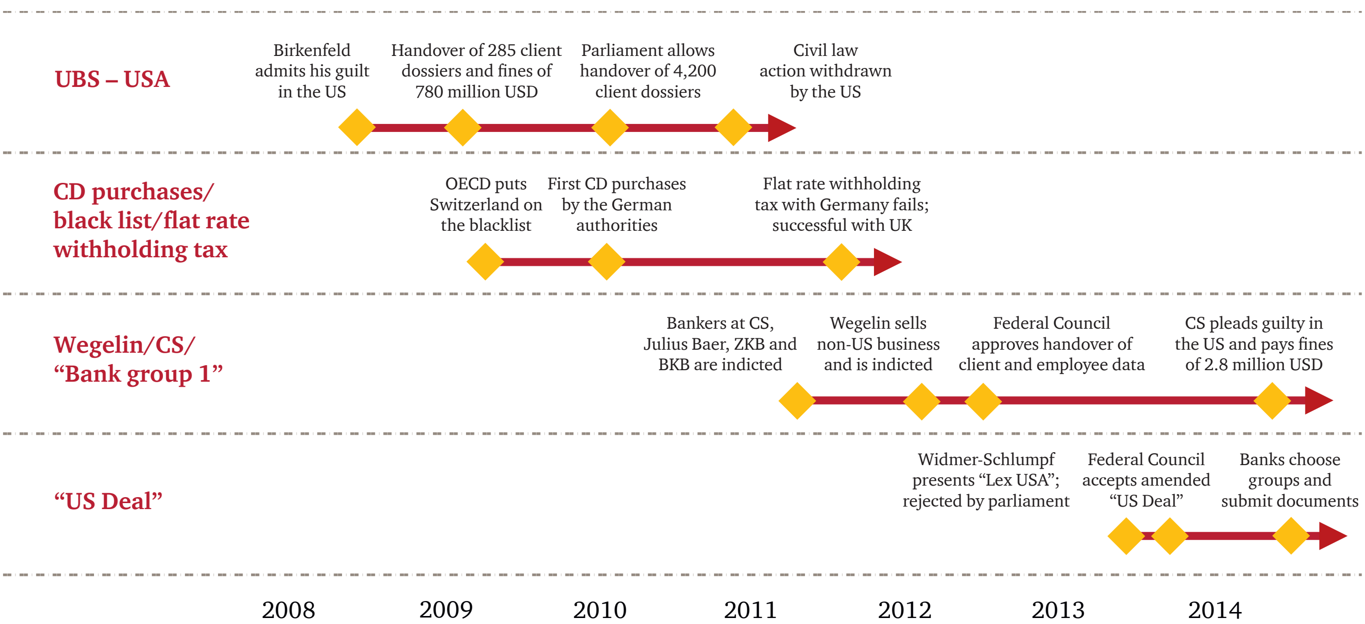
In this study, we look at eight prevalent market opinions on the state of the Swiss private banking industry. We looked into how true they were in the past, and venture a prediction for the future.

	Theses	True 2006 to 2013	Will be true in future
1.	Switzerland is becoming less important as a private banking location.	✓	✗
2.	The gross margins in Swiss private banking are falling.	✓	✗
3.	Personnel costs per employee in Swiss private banking are declining.	✓	✗
4.	The fines paid as part of the US tax programme are a massive burden on the equity capital of Swiss private banks.	✗	✗
5.	The number of banks with operating losses is increasing.	✓	✗
6.	The size of a private bank is becoming a more important factor for success.	✓	✓
7.	The number of banks in Swiss private banking is falling.	✓	✓
8.	The number of people employed in Swiss private banking is declining.	✓	✓

THESIS 1: *"Switzerland is becoming less important as a private banking location."*

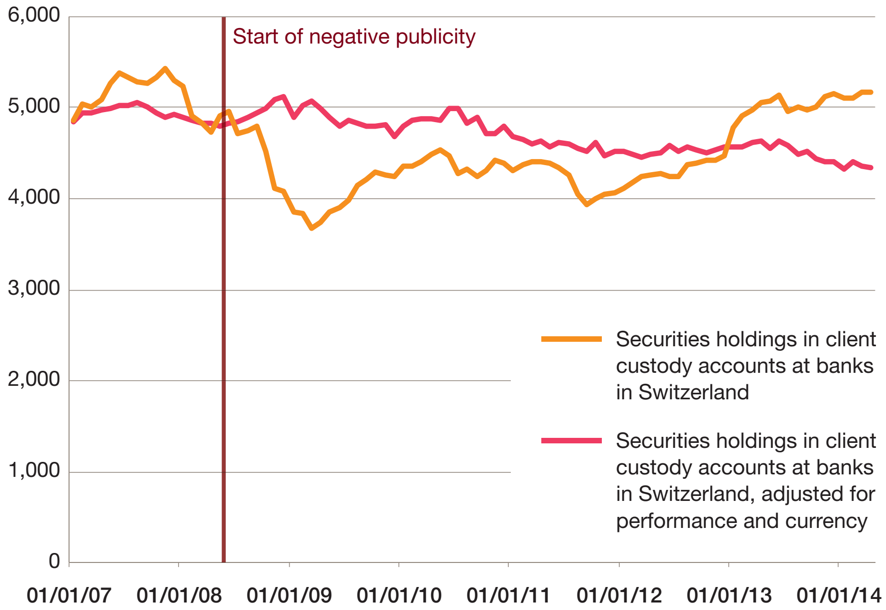
The admission by Bradley Birkenfeld in mid-2008 that he helped US citizens evade taxes unleashed a spiral of negative reports on Swiss private banking. The spate of stories continued in subsequent years: CDs with client data, failed withholding tax treaties, the genuflection of a major bank in the US.

Fig. 1: Chronology of the negative headlines about Swiss private banking



Sources: NZZ, PwC

Fig. 2: Adjusted and unadjusted securities holdings (in billion CHF)



Analysis

In order to evaluate the significance of Switzerland as a private banking location, we analysed the securities holdings in client custody accounts at Swiss banks. These are very close to the total assets under management in Switzerland and are published monthly by the Swiss National Bank (SNB). Figure 2 shows that while securities holdings fell by about a quarter between 2007 and 2011, they had almost returned to their 2007 level by the first quarter of 2014.

The SNB data includes securities holdings from institutional as well as private clients from both Switzerland – as well as foreign-domiciled clients. It also includes performance and currency effects. We have excluded these effects (see study design, page 18) in order to derive the proper net new money flows. The in that way adjusted data show that assets under management trended upward through 2008 and then clearly declined by some 600 billion CHF – almost at the same time as the negative reports. However, this decline had other causes than solely the flight of assets abroad:

- The decline is to a certain extent due to higher cash holdings, which are not included in the securities holdings. From 2008 to 2014, balance sheet amounts due to customers rose by more than 20%, or 300 billion CHF. This corresponds to more than half the decline in securities holdings during the same period.
- In view of the knowledge that securities holdings of Switzerland-based clients remained approximately constant from 2008 to 2014 and foreign-domiciled institutional clients brought 50 to 100 billion CHF net new money to Switzerland during the same time period, we estimate that just around 350 billion CHF in net assets under management from foreign-domiciled private clients have left Switzerland over the last six years. The tax assessment of cross-border clients that resulted from the international demand for more tax transparency certainly accounts for a large part of the net new money outflows. However, net new money outflows in association with the settlement of the tax situation are not that serious for a bank since it is quite possible that concerned clients remain clients of the bank. Moreover, this is a one-time effect and could even have a positive impact in the future. This is because, following the settlement of the tax situation, some cross-border clients will bring their money back to Switzerland, as it will then be possible to use it without any restrictions. Overall, we estimate that up to 100 billion CHF net new money outflows are related to fine payments in the context of the declaration of untaxed money. Thus, only a relatively small amount of around 250 billion CHF are outflows from clients that have ultimately terminated their relationship with banks in Switzerland and transferred their money back to their home countries or to another financial centre.

What we think

The Swiss private banking centre has faced enormous challenges since 2008. While global assets under management have risen, performance and currency-adjusted securities holdings in client custody accounts at domestic banks have fallen. We estimate the net outflows of assets under management from foreign-domiciled private clients in recent years to be around 350 billion CHF, whereas around 100 billion CHF of this sum is presumably related to fine payments in the context of the declaration of untaxed money. This is significantly less than what has been peddled in many corners. The banks will be able to attract net new money if they succeed in bringing regularised assets back to Switzerland by emphasising their high-quality service and strong performance. After all, clients with tax-compliant assets are much more demanding than clients with untaxed assets. And if Swiss politicians pull the banks out of the international crossfire and manage to create unfettered access to the EU market, Swiss private banking will once again generate positive headlines.

✓ True 2006 to 2013

✗ Will be true in future

THESIS 2: *"The gross margins in Swiss private banking are falling."*

It is becoming more and more difficult for Swiss private banks to maintain their gross margins. This is due to the poor state of income-side profitability drivers. Following the financial crisis, investors reduced their trading activity and switched from complex products with high margins to higher cash holdings. In addition, since the Federal Supreme Court of Switzerland's ruling in October 2012 banks have been obligated to pass retrocessions on to their clients (or have clients actively waive them), reducing another source of income. Finally, the interest business is also generating less revenue in the current low-interest environment.

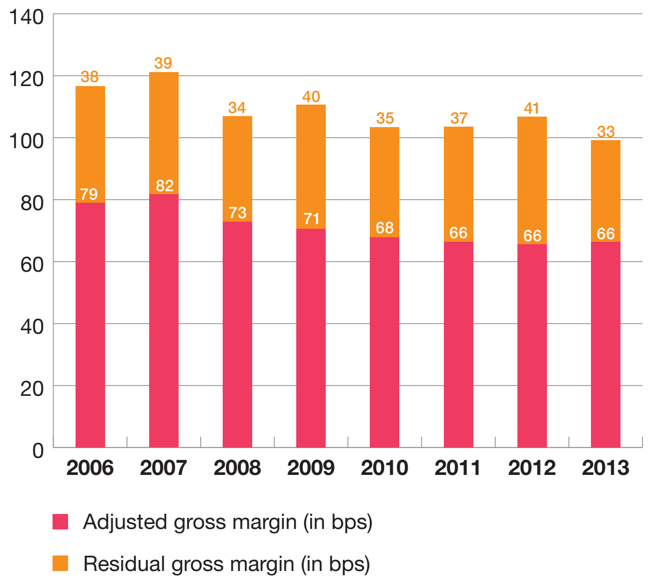
Analysis

The gross margin of Swiss private banks (see study design, page 18) fell by 15% from 2006 to 2013 (see Fig. 3). After reaching more than 120 basis points (bps) in 2007 – a record year – it dipped below 100 for the first time in 2013, down to 99. The most important earnings driver for a private bank is its commission income. If one were to divide the gross margin into income from the commission business (adjusted gross margin) and income from interest, trading and other business activities, the adjusted gross margin from 2007 to 2010 would drop sharply as a result (2007: 82 bps; 2010: 68 bps). Since then it has levelled off at just under 70 bps.

While the adjusted gross margin does not appear to be eroding further, the decline in the gross margin in recent years mainly stems from the interest and trading business. Trading income fell sharply between 2009 and 2010 and has since failed to recover in spite of the good performance of stock markets. Interest income fell by around 20% in 2013. This is due not only to the lower interest margin, but may also be connected with the fact that mortgage and Lombard loans did not keep pace with the growth in assets following the very good year on the stock markets in 2013.

Today, smaller banks are the ones facing challenges. Competition is becoming increasingly international, as Switzerland has lost one of its unique selling propositions with the relaxation of the banking secrecy. Stiff competition will keep margin pressure high; indeed, many banks already find it difficult to attract new assets without special conditions, which in turn puts pressure on their gross margin.

Fig. 3: Composition of the gross margin (in bps)



What we think

The profitability of Swiss private banks has clearly decreased. While this was due to lower commission income until 2010, from 2009 onwards interest and trading income has also been on the wane. Competition has increased since the relaxation of the banking secrecy. However, the adjusted gross margin has stabilised at a low level, and interest rates are already near zero and therefore cannot fall much further. We therefore expect the gross margin to climb slightly in future. This development will also be influenced by the ability of banks to justify higher fees through top service quality and good performance. Finally, the stock exchange will also play a role in investors' willingness to trade and assume risk.

✓ True 2006 to 2013

✗ Will be true in future

THESIS 3: *"Personnel costs per employee in Swiss private banking are declining."*

Measured in terms of the cost-income ratio, profit generation in Swiss private banking has decreased in recent years. This is mainly due to lower income and more stringent regulatory requirements. When profit generation in a sector is lower, this normally has an impact on employee compensation.

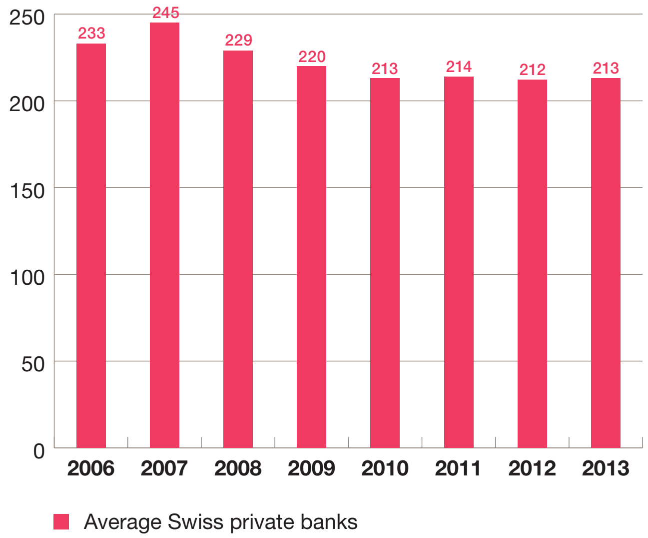
Analysis

The average staff costs per employee (fixed salary, bonus, pension benefits, ancillary benefits) decreased from around 245,000 CHF in 2007, the peak year, to 213,000 CHF in 2010 (–13%); see Fig. 4. Staff costs have more or less settled at this level.

The highest average staff costs of around 227,000 CHF per employee in 2013 are paid by institutions in Geneva – clearly more than at comparable banks in Zurich (205,000 CHF) or Lugano (179,000 CHF). Staff costs have fallen more sharply in Zurich than in Geneva or Lugano. Private banks under foreign control have likewise reduced their costs per employee somewhat more sharply than institutions with domestic owners.

While the data that has been reviewed shows a decline in staff costs in Swiss private banking in the three most significant Swiss financial centres, there has not been the sharp drop in wages that had been postulated in some circles. Compared to 2007, staff costs have decreased much less than income, as manifested in a corresponding deterioration in net profit generated. The lower level compared to the peak year of 2007 is primarily the result of lower bonuses in subsequent years. More recently, demand for specialists – particularly for compliance, risk management, treasury and financial analysis specialists – has grown sharply. The demand for front-office staff has been less strong in recent years. Thus, while salaries in general have come under pressure, this is not the case for client advisors with attractive portfolios whom banks wanted to retain for the longer term. In the front office, the wage gap between top performers and other staff has been more pronounced.

Fig. 4: Staff costs per employee (in 1,000 CHF)



✓ True 2006 to 2013

✗ Will be true in future

What we think

The staff costs per employee in private banking have decreased compared to 2007, the peak year. Despite this, we expect wages to start climbing again slightly in the coming years. The jobs that will be in demand in future are compliance specialists and risk managers, as private banks in Switzerland will have to adapt to a competitive environment that requires more transparency as part of the automatic exchange of information and phasing-out of banking secrecy.

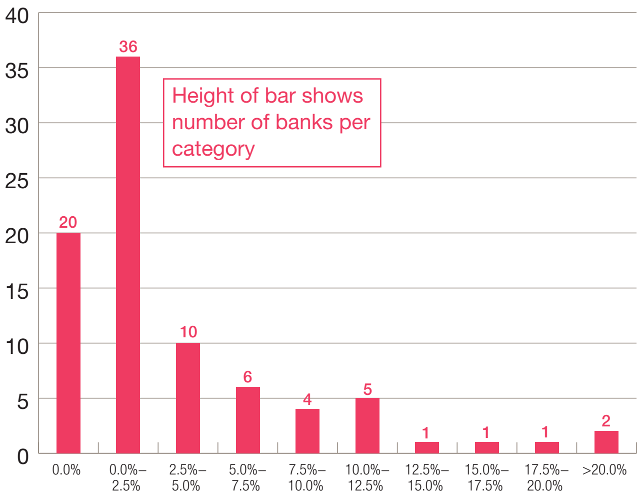
THESIS 4: *"The fines paid as part of the US tax programme are a massive burden on the equity capital of Swiss private banks."*

According to the Program for Non-Prosecution Agreements or Non-Target Letters for Swiss Banks, published by the US Department of Justice on 29 August 2013, Swiss banks have been asked to put themselves into one of three categories: 14 banks were automatically put in category 1, more than 100 banks see themselves in category 2, and around 170 banks have classified themselves in category 3/4 or are not participating in the US tax programme.

In newsletter 56 dated 10 January 2014, FINMA determined that participation in the US tax programme would entail costs for investigations and, potentially, fines for banks. The banks would have to estimate these costs in a comprehensible manner and enter them as provisions for the financial year 2013.

Numerous industry experts, media representatives and observers have predicted a significant burden for Swiss banks. Some have called the US tax programme a "fuse" for consolidation in private banking.

Fig. 5: Provisions as a percentage of equity capital (as of end 2013)



Analysis

We analysed the 2013 provisions in the category "Other provisions" for the companies in our study and compared them to their equity capital as of the end of 2013 (see study design, page 18).

Fig. 5 makes clear that the burden the US tax programme is expected to have on Swiss private banks does not threaten their existence. Of the 86 banks reviewed, 20 have not formed "Other provisions" for fiscal 2013 at all. At 36 banks, the new "Other provisions" corresponds to up to 2.5% of their equity capital. At 20 banks, the amounts are between 2.5% and 10% of their equity capital. They exceed a quarter of equity capital (31.0% and 50.8%) at only two banks.

What we think

The legal, audit and consultancy costs as well as fines as a result of the US tax programme will have an impact on the financial results of Swiss private banks but not overly burden most banks. In general, the amounts for "Other provisions" as a percentage of equity capital are low. However, Swiss private banks have likely been conservative in forming their provisions in order to avoid an implicit admission of guilt. As a result, the actual burden is expected to be clearly higher. However, the US tax programme will not trigger a wave of consolidation within the sector. Yet the costs of the US tax programme, which are set to be in the millions, could act as a "fuse" for the exit from the Swiss private banking business, particularly for smaller foreign banks that generally question the sense of private banking in Switzerland.

✗ **True 2006 to 2013**

✗ **Will be true in future**

THESIS 5: *"The number of banks with operating losses is increasing."*

Gross profits are a good indicator of the operational profitability of a bank. They reflect the banks ability to operate their core business profitably. They are not prone to one-off effects (e.g. provisions, write-downs) and therefore fluctuate less. A positive gross profit is a ratio of operating expenses to operating income of less than 100%.

Analysis

We looked into whether the number of banks with a cost-income ratio of more than 100% has changed over the years. Figure 6 shows that ratios of more than 100% first started appearing in 2008.

Pressure on the offshore business has risen since 2008 and appears to have increased the cost-income ratio in the sector over the long term. Since then, the proportion of operationally unprofitable banks has fluctuated from 14% to 19%. The extraordinary aspect of this is that 13 of the 14 banks involved managed assets of around 3 billion CHF or less in 2013.

Fig. 6: Operational efficiency (cost-income ratio [CIR])

✓ True 2006 to 2013

✗ Will be true in future

What we think

While thesis 5 proved true for the years 2006 to 2010, it does not apply for the entire period of the study. It therefore involved only a temporary weakness. We believe that the proportion of unprofitable banks will decline in the medium term. We believe this for the following reasons:

1. Operationally unprofitable banks cease banking activities.
2. Operationally unprofitable banks are bought up and merged with other banks.
3. Even if the banks are unable to reduce their operating costs appreciably, their commission, interest and trading income is likely to increase again in the medium term (see page 10).

THESIS 6: *"The size of a private bank is becoming a more important factor for success."*

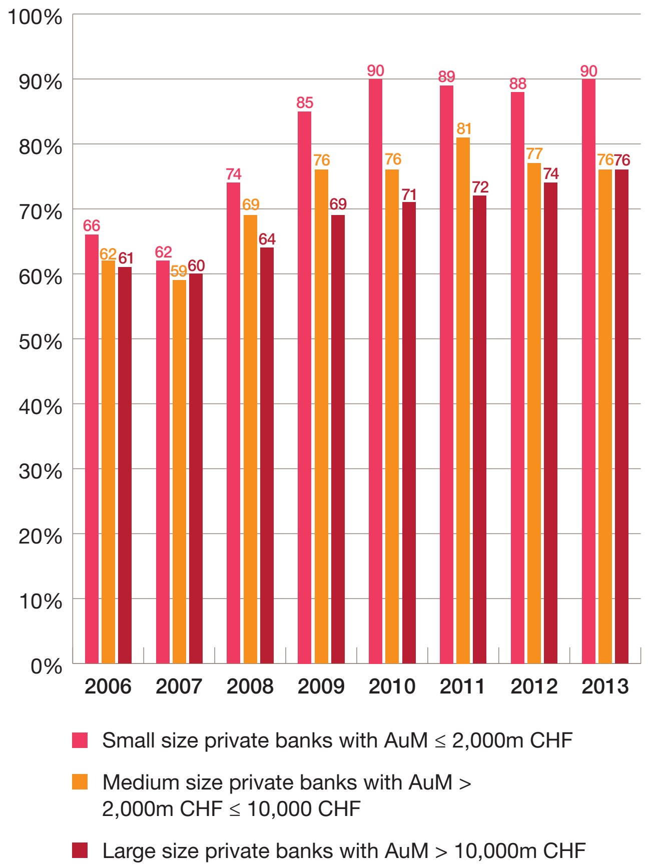
The costs associated with implementing regulatory requirements as well as higher product and service quality have risen in the last few years. In addition, clients have large volumes of low-yield cash in their custody accounts and there continues to be little interest in complex, high-margin products. As a result, operating income per employee is currently about 40% lower than it was in 2007, while banks have only managed to reduce their costs by around 10%. As a result we can observe increasing cost-income ratios. Accordingly, the critical size of client assets that a bank must manage in order to operate profitably has increased.

Analysis

The increasing importance of size can be seen in the cost-income ratio of private banks of differing sizes.

Figure 7 shows that the cost-income ratios of banks with client assets of up to 2 billion CHF has risen much more sharply than the ratio of their competitors with more client assets. However, there are also small banks that operate profitably. Thus, size is a key factor for success in private banking, but not the sole determinant.

Fig. 7: Cost-income ratios (in %, excluding write-downs)



What we think

The cost-income ratio of smaller private banks has risen much more sharply than that of large banks. This trend will strengthen. A private bank must have a volume of at least 1 billion CHF per offshore market in order to operate profitably there. This threshold is closer to around 3 billion CHF for the onshore business. This means that banks must focus on a few target markets; in particular, smaller providers cannot operate profitably in ten or more markets. Swiss private banks will no longer be able to sell a standard product globally as "Swiss private banking"; individuality, that is taking into consideration the special regulations in each single market will be key. Banks will require a business model that takes account of the individual aspects of regions and countries in their products, their client advisors and their services. For example, foreign clients will expect tax statements from their Swiss private banks that are accepted by the services in their home countries.

✓ True 2006 to 2013

✓ Will be true in future

THESIS 7: *"The number of banks in Swiss private banking is falling."*

The aftermath of the financial crisis is forcing banks to modify business models: In the face of cost and income pressure, some small banks were forced to capitulate or seek larger partners in order to survive. Others focused on wealth management alone and gave up their bank status in order to avoid the more rigorous requirements associated with it.

Analysis

The number of banks in Switzerland has fallen since 2006: from 331 to 283 at the end of 2013, which corresponds to a decrease of 48 companies, or 15%; see Fig. 8. This negative trend was seen mainly among regional banks and savings banks (–18%) and among banks under foreign control (–23%). The number of banks that specialise in stock exchange, securities and asset management business has remained more or less constant since 2007, thanks to reclassifications to this group and newly established institutions.

Liquidations and cooperation agreements to ensure existence mainly involve smaller and medium-sized banks. Mergers are taking place in order to supplement the service offering or to exploit synergies. Small institutions frequently decide to give up their banking licence and convert themselves into an independent external asset manager. There were significantly fewer new banking status registrations in 2012 and 2013.

Fig. 8: Number of banks in Switzerland by bank group

		2006	2007	2008	2009	2010	2011	2012	2013	Change 2006–2013 in %
1.00	Cantonal banks	24	24	24	24	24	24	24	24	0%
2.00	Big banks	2	2	2	2	2	2	2	2	0%
3.00	Regional banks and savings banks	78	76	75	70	69	66	66	64	– 18%
4.00	Raiffeisen banks	1	1	1	1	1	1	1	1	0%
5.11	Commercial banks	7	7	–	–	–	–	–	–	n/a
5.12	Banks that specialise in stock exchange, securities and asset management business	52	48	48	49	47	46	47	47	– 10%
5.14	Other banking institutions	4	6	9	9	10	12	13	14	250%
5.20	Foreign-controlled banks	120	122	123	123	122	116	103	93	– 23%
5.00	Total other banks	183	183	180	181	179	174	163	154	– 16%
7.00	Branches of foreign banks	29	30	31	33	32	32	28	27	– 7%
8.00	Private bankers	14	14	14	14	13	13	13	11	– 21%
	Total banks	**331**	**330**	**327**	**325**	**320**	**312**	**297**	**283**	**– 15%**
	Added	4	11	5	12	7	5	2	1	
	Left	10	12	8	14	12	13	17	15	
	Total change	(6)	(1)	(3)	(2)	(5)	(8)	(15)	(14)	

Source: Swiss National Bank (SNB), Banks in Switzerland 2013

The following observations are limited to bank groups 5.12 (banks that specialise in stock exchange, securities and asset management business), 5.20 (foreign-controlled) and 8.00 (private bankers). From 2006 to 2010, the decline in banks mainly involved banks that specialised in stock exchange, securities and asset management business. This decrease may be the result of liquidation/closure, consolidation or relinquishing of bank status; see Fig. 9.

The decrease in the group of foreign-controlled banks was particularly high in 2012 and 2013. There have been an increasing number of closures since 2011. One reason for this tendency have been financial problems of the mother companies. Because of stricter laws in the cross-border business, some of the foreign banks further came to the conclusion that it is no longer worthwhile for foreign banks to operate branches in Switzerland; see Fig. 10.

There were no new foreign-controlled banks established in Switzerland in 2013, and in 2012 there was only one. While Switzerland has lost some of its lustre when it comes to establishing banks compared to other financial centres, Swiss banks – and thus their banking licences – continue to be taken over by foreign-controlled banks. In this sense, Switzerland has apparently not lost any of its attractiveness.

Irrespective of the number of banks, the focus on a few key markets represents a strategic option for a bank. The number of asset deals, in which only certain client portfolios are transferred, has therefore risen considerably since 2013. This is also the case because the buyers only want to accept clients with properly taxed assets and do not want to be responsible for the entire infrastructure.

The group of private bankers lost two institutions in 2013. One involved the sale of a private bank and the other a conversion to a stock corporation.

Fig. 9: Reasons why "banks that specialise in stock exchange, securities and asset management business" left group 5.12

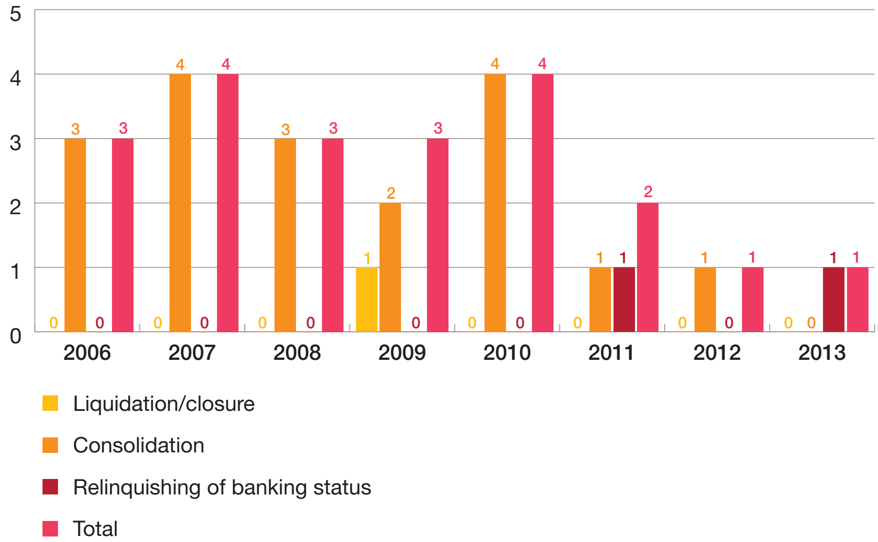
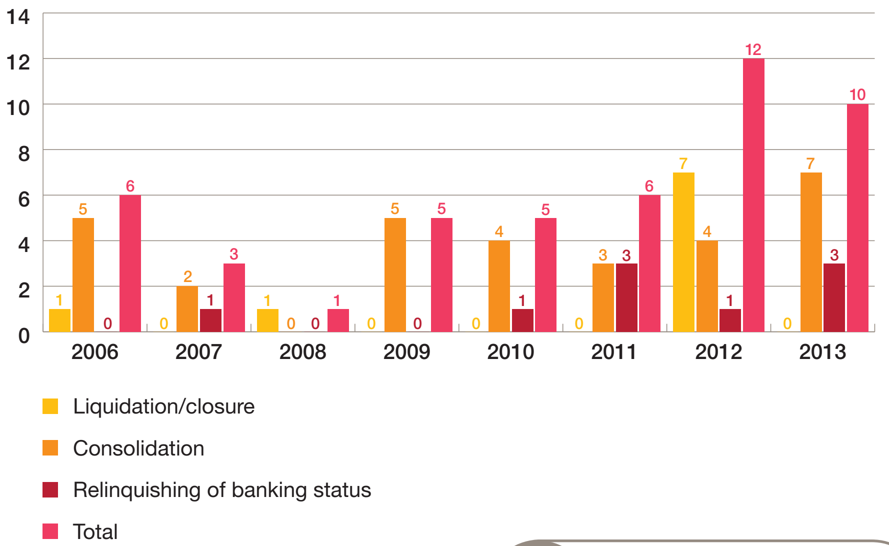


Fig. 10: Reasons why foreign-controlled banks left group 5.20.



✓ True 2006 to 2013

✓ Will be true in future

What we think

The number of banks in Switzerland has shrunk over the last few years; this trend is most evident among regional banks and savings banks as well as among foreign-controlled banks. With respect to the group of foreign-controlled banks, the trend looks set to continue because they are most strongly affected by the new regulations, the compliance changes and the margin erosion in private banking. We also expect to see a decline among banks that specialise in stock exchange, securities and asset management business, as the focus on a few markets will not be successful for all banks. We anticipate that, in future, there will be about one-fifth fewer banks whose core business is private banking.

THESIS 8: *"The number of people employed in Swiss private banking is declining."*

In order to reduce costs, a bank can reduce personnel. According to our estimates, there were just under 50,000 employees in the private banking industry in Switzerland before 2008. This figure stood at just under 45,000 at the end of 2013.

Analysis

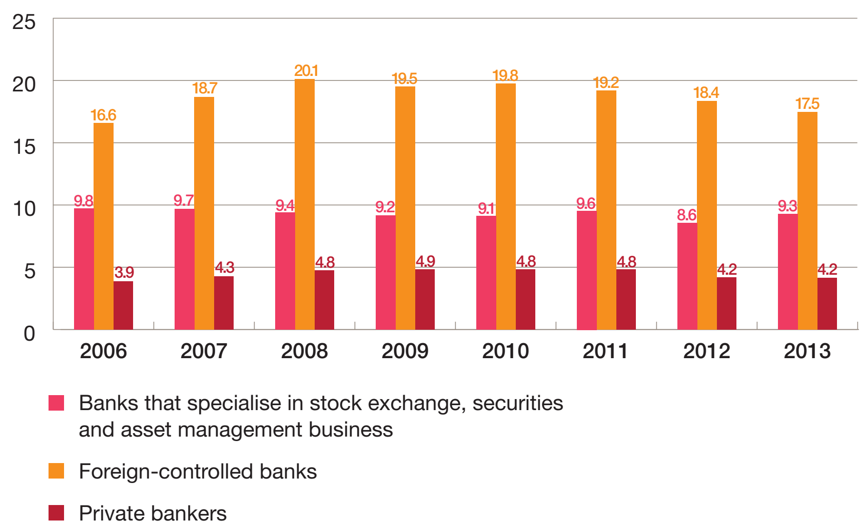
The statistics of the SNB show that the slight decline in the number of employees mainly occurred at foreign-controlled banks; see Fig. 11.

Headcount at foreign-controlled banks fell from 20,000 employees in 2008 to 17,500 in 2013 – a decrease of 12.5%. At banks that specialise in stock exchange, securities and asset management business, the figure fell slightly from its high of 9,750 employees in 2006 to 9,300 people in 2013. Without the two reclassifications of banks from other groups, at the end of 2013 this figure would have been approximately 16% below the high in 2006. There has been no reduction in recent years at the private banks that still exist.

There are various reasons for the decline in full-time equivalents in Switzerland:

- Falling margins have led many banks to reduce employees primarily in back-office functions (e.g. settlement, clearing) and IT.
- There is no information as to how full-time equivalents are divided between back-office and front-office functions. In our experience, private banks try to maintain a ratio of 20% to 25%.
- Back-office and IT functions are increasingly being outsourced. The comparison of outsourcing and insourcing may have moved the banks to reduce their full-time equivalents in these areas.
- The positions that were reduced in Switzerland were not simply outsourced abroad. The number of employees working abroad for banks in Switzerland fell even more sharply.
- When there are mergers and takeovers, the synergies are mainly realised through the reduction of back-office personnel.

Fig. 11: Headcount (FTE 1,000) in Switzerland



✓ True 2006 to 2013

✓ Will be true in future

What we think

The number of full-time equivalents in private banking has fallen slightly since the financial crisis and will fall further. However, the decline in the number of full-time equivalents is less than the decline in the number of banks. To date, it has mainly been foreign-controlled banks that have been affected. This development is due to cost-related and operational optimisation measures as well as to outsourcing, specifically in back-office and support functions. The general decline in full-time equivalents employed in back-office and support functions may be offset by the growing need to recruit specialists for regulation and compliance functions as well as the build-up in the number of client advisors.

Study Design

This study looks at the eight most common positions regarding the current state of Swiss private banking. Using a quantitative analysis, we evaluate whether these theses are supported by facts as of the current date. This analysis is based on the annual reports of some 90 banks of various sizes that primarily operate in private banking in Switzerland. The observations cover the period from 2006 to 2013 and incorporate other publicly accessible data from the SNB and the economic research institute BAK Basel.

Details regarding our calculations:

Performance and currency effects (see page 9)

The SNB divides the securities holdings in client custody accounts at banks in Switzerland into various securities categories. We calculated the performance of the respective securities categories using internationally recognised benchmark indexes. For the category "Collective investments" we simply assumed that the performance of these was split 50/50 between stocks and bonds. For other securities and structured products, which combined make up less than 5% of the securities holdings, the stock performance was used.

The SNB further divides client custody accounts according to the respective reference currency: Around 50% of client custody accounts are denominated in CHF, and 20% each in EUR and USD. The remaining 10% are in other currencies. In order to calculate the currency effects, we assumed 50% were in CHF, 25% in USD and 25% in EUR.

Gross margin (see page 10)

For the gross margin, the total income is set in relation to the average assets under management over the year.

Adjusted margin (see page 10)

For the adjusted margin, the income from the commission and service business is set in relation to the average assets under management over the year.

"Other provisions"(see page 12)

For our calculations regarding thesis 4, we used the category "Other provisions" or – if this was not shown – the category "Provisions for other business risks". A small minority of the banks booked the provisions in this category. The option discussed of forming provisions under "Reserves for general banking risks" is not permitted.

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