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Challenges For Swiss Trust Industry

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Leaders of the 20 large developed and emerging countries – or G20 – have recently agreed an action plan proposing measures to improve the supervision of the financial system, a move that has particular implications for businesses such as the Swiss trust industry.

Two G20 action areas are particularly relevant to the Swiss trust industry. The first one foresees enhanced supervision of the actors of the financial system through a reinforcement of regulations. The second one relates to the protection of the financial markets' integrity. This signals the wish of the G20 to increase the pressure on non-cooperative tax havens and to promote the exchange of information as regards countries that do not abide by the international standards concerning transparency and bank secrecy.

It is reassuring to read in the G20 declaration that regulation will remain the national regulators' prerogative. Nevertheless, the absence of regulation does not seem to be a suitable alternative in view of the new ambitions displayed by the G20 countries. This situation is the position in which the Swiss trust industry currently finds itself.

Trust companies are not subject to any specific regulation apart from the federal Anti-Money Laundering law that applies to financial intermediaries. It is even more difficult to uphold this position because all reputable, competing jurisdictions regulate trust companies and license this type of activity. This is the approach of countries like Singapore, Mauritius, the British Virgin Islands, Jersey, Guernsey, the Cayman Islands, Cyprus, Bermuda and the Bahamas.

Currently the Swiss Federal Financial Market Supervisory Authority also has more urgent priorities than regulating the trust industry. This is the reason why the Swiss Association of Trust Companies, created in July 2007 on the initiative of certain professionals, presents a real opportunity in the current financial crisis context. It aims to play a prominent role as self-regulating body by developing a credible system, based on the quality and integrity of its members yet respecting the specifics of the Swiss market, without falling into over-regulation, as is arguably the case today in the Channel Islands.

The financial crisis has also refocused the debate on the reorganisation of the financial system around the combating of tax havens. Switzerland should not feel targeted by the recent G20 criticism of non-cooperative tax havens because it lacks the determining features of a tax haven, namely low or non-existent taxation coupled with an opaque legal system. Nevertheless, Switzerland is classified as a country with excessive bank secrecy by the

Organsation for Economic Co-operation and Development. In this respect, if the notion of a non-cooperative tax haven is broadened, Switzerland could find itself in the line of fire.

Growing uncertainty

As for exchanges of information aiming to combat tax evasion and fraud, the OECD encourages countries to implement a system of "upon request" information exchanges which is generally based on a bilateral agreement. Under the pressure of its European partners, it is revealing to observe the swiftness with which the UK has entered into a certain number of agreements of this type with its dependencies and overseas territories (the British Virgin Islands, Bermuda, the Cayman Islands, Isle of Man and the Channel Islands).

In doing so, the UK steps into the breach opened already several years ago by the US. These agreements generate a growing uncertainty over the confidentiality of wealth structures managed "offshore". It is worrying to observe the web being woven by the UK and the US, especially bearing in mind the practice of automatically exchanging fiscal information within the Group of Seven countries.

Benefit to Switzerland

This situation benefits the Swiss trust industry because wealthy families using these types of structure seek confidentiality for their affairs even if these structures are not aimed at tax mitigation. The Hague Convention on Trusts that came into force in Switzerland in July 2007, and the circular on the taxation of trusts, offer an attractive legal and fiscal framework.

A trustee based in Switzerland can manage trusts that are governed by an Anglo-Saxon system of law. With banking confidentiality under increasing pressure, the use of trusts as a legitimate succession and fiscal planning tool creates a wealth of opportunity in Switzerland within Europe. The significant market of UK resident, non-domiciled individuals perfectly illustrates this situation.

Switzerland is not alone on the next point but must, as a jurisdiction, take heed. The activity of a trustee isn't without risk, especially in these times of financial crisis. Warren Buffet's famous quote "it's when the tide goes out you see who's been swimmin' naked" applies equally to the trustee as the legal owner of the trust assets. As such, the trustee has to invest the assets prudently and diligently so that the investments made do not diminish in value and generate the revenue that can reasonably be expected.

Given the complexity of modern asset management, the trustee will generally delegate it to a professional, a bank or an independent asset manager. The trustee must ensure that the chosen asset manager has excellent qualifications and a sound reputation. He must also be impartial in the selection process which ideally should involve a "beauty parade". The trustee should provide clear and precise investment objectives. He should regularly monitor how the portfolio is managed and, if necessary, replace the asset manager. In the event of a loss, the trustee must be able to explain the investment process and justify the decisions taken to the beneficiaries of the trust. As a result, a trustee that fulfils its fiduciary obligations, in particular with regard to investments, offers effective protection for family wealth especially in situations of extreme volatility and irrational stock markets.

This is predicated upon the trust company having the right skills and tools to fill this role. More than ever in challenging times, it is necessary to put in place internal mechanisms for dealing with potential conflicts of interest. Should one reconsider investment profiles or for that matter the existence of the portfolio management mandate, change the depository bank, split the deposits among several banks, or even crystallise losses on "in-house" products and move to cash? These are questions that arise in the current context.

Uncomfortable situation

The losses made on portfolios undoubtedly put pressure on trustees' invoices, especially if the crisis has not been managed proactively. This situation will force the trust companies to reconsider the cost benefit of maintaining trust structures for smaller clients. These same losses can also lead the beneficiaries of the trust to claim against the business for bad asset management. As the claim will have to be brought by the trustee, trust companies that have parent banks may find themselves in an uncomfortable position vis-à-vis their own bank, which could cause them, in certain cases, to resign as trustees.

There are many consequences of the financial crisis for the trust industry in Switzerland. With an increase in regulation and transparency requirements on the one hand and greater complexity in the management of fiscal and investment risks on the other hand, some actors in the market will have to review their business model or be confronted with deepening difficulties. That said, the future of the trust industry in Switzerland lies clearly ahead of it, which cannot be said of all competing "offshore" jurisdictions.