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research article

Big Bank, Small Country: Switzerland, the Financial Crisis and the European Union

—Justin Thomas Schubert (Edited by Jennifer Lee)

In today's globalizing world, events in the United States can affect even a small, mountainous country an ocean away, Switzerland, pressuring it to deny its core principals. The Swiss are fiercely proud of their country's sovereignty, which is seen in their policy of neutrality, their impenetrable banking secrecy, and their determination not to join the European Union (EU). This historic Swiss desire to be a "special case," or *Sonderfall* in German, was put to the test between 2007 and 2009 when the global financial crisis hit the country's largest bank, UBS, almost causing it to fail. There was speculation that if this occurred, Switzerland would be forced to join the EU, the twenty-seven nation union that surrounds the country. However, the government's response, most notably the creation of the SNB-StabFund, allowed the Swiss to weather the crisis and maintain its *Sonderfall* position in an otherwise uniting Europe.

Sonderfall Schweiz: Special case Switzerland

Despite its central location in Europe, Switzerland distances itself from fellow European nations both politically and economically. It has held a consistent foreign policy of strict neutrality, even during both world wars. To keep this position, the country has an incredibly capable defensive army. Economically, Switzerland focuses on maintaining a stable environment to attract foreign investors. Their famous (and infamous) secret banking industry has resisted external pressures for decades (although this is slowly changing). Even though standoffish at times, the Swiss are not completely isolated. They have trade, research, and financial agreements with the EU and other countries. The one union the Swiss truly oppose joining, however, is the European Union.

At first it may seem odd for Switzerland not to be in the EU, but a closer look at its history will explain why. After World War II—ironically in the Swiss city of Zürich—Winston Churchill first mentioned the idea of a "United States of Europe," originally meant to secure peace on the continent, especially between Germany and France. As Switzerland was not active in the War, there was no immediate incentive for it to join such a union.

Over time, this united Europe idea evolved to be less about maintaining peace and more about economic cooperation. In 1957, just six years after the European Coal and Steel Community was established, the treaty of Rome was signed, which created the European Economic Community (EEC), which later became the European Union (EU). The agreement established an advisory assembly comprised of members from individual national parliaments. Currently, the EU has twenty-seven member countries.



A map showing Switzerland (orange) surrounded by countries in the European Union (green.) Non-EU countries are in grey.

In response to the forming EU (or EEC then), the European Free Trade Association (EFTA) was established in 1960 for countries who wished to engage in free trade but opposed supranational institutions. Today, many of the founding EFTA

member states have gone on to join the EU. The only remaining EFTA countries not in the EU are Switzerland, Norway, Liechtenstein and Iceland.

Later on, the European Economic Area (EEA) was established. It is an agreement between the member states of EFTA, excluding Switzerland, and the EU. The Swiss people voted directly against joining, as Switzerland puts many decisions up to a national referendum. It was close: 50.3% voted against joining. Experts believe this was because EEA membership was seen as a step towards joining the EU. In 2001, in another national referendum, 76.8% of the population voted against joining the EU (Swissvotes).

Switzerland's policy towards further European integration continues to be "economic integration without political participation" (Bronska, 2008). The EU is solely an economic union in theory, but this is debatable in practice; economic integration naturally leads to political integration. Although not officially a "United States of Europe," the EU is still a political commitment for member states. Indeed, many countries struggled with giving up partial sovereignty in order to join the EU, but most saw the economic benefits of membership and overcame these reservations. Switzerland, on the other hand, has resisted, wanting to keep all decision making in Bern and not outsource any of it to the EU parliament in Brussels.

In more recent years, the EU has also become a vehicle for helping integrate former Communist Eastern European countries with the West, by improving living conditions, jump starting their economies, and building up their infrastructures. Switzerland clearly has no need for such assistance. As one of the richest countries in the world, boasting a complex infrastructure and highly educated workforce, Switzerland would not receive much funding from the EU. In fact, if the country were to join, it would likely be a core financial supporter of the recently added EU countries and their EU-funded endowments.

Clearly, there is an historical pattern of guarding Swiss independence. This does not, however, mean that Switzerland is entirely anti-European integration. Following "economic integration without political participation" (Bronska, 2008), Switzerland has a great number of bilateral economic agreements with the EU. However, participating in any program that takes away national sovereignty, such as monetary union or EU membership, is strongly opposed. It is this persistent opposition that was tested during the 2008 financial crisis with the potential bankruptcy of UBS.

The Swiss Banking System and Trouble at UBS

The Swiss banking system, like those of other countries, consists of a central bank, in this case the Swiss National Bank (SNB), and a private banking sector. The SNB is an institution similar to the US Federal Reserve Bank (FED); it is in charge of monetary policy. It is not a bank that people off the street can go to for financial services. Banks, however, can be clients of the central bank, holding accounts, taking out loans, etc. In effect, a central bank acts as a "bank for banks."



The author at a friend's house in Ostfildern, Germany, 2009.

The Swiss private sector has many regional banks and two larger institutions: UBS is the largest, followed by Credit Suisse, considered to be a "small" big bank. UBS is the product of a 1998 merger between the Union Bank of Switzerland and the Swiss Bank Corporation (SBC). The merger created a new entity and "transform[ed] SBC and Union Bank of Switzerland, two predominantly Swiss banks, into the global institution that is UBS today" (Leitz, 2008, 4). The new bank rapidly grew to a size where it needed to look abroad to invest; the US, the world's largest financial market, was a logical choice. In 2000, UBS acquired the US brokerage firm PaineWebber, which greatly increased the scope of its business within the US market.

Two years before the merger was final, a paper entitled *The competitive impact of the UBS-SBC mergers* by Damien Neven and Thomas von Ungern-Sternberg from the University of Lausanne, warily pointed out that "barriers to entry in retail banking are significant, so that high concentration should be a source of concern. . . . By the standards of the US practice, the concentration resulting

from the UBS/SBC merger would be simply unacceptable and by a wide margin.” They concluded that “divestiture is the most common remedy in banking and it seems to be effective. Given the concentration entailed by the proposed merger, nothing less than a full divestiture of one retail network seems adequate.” This meant selling or breaking up at least one sector of the bank. Essentially, even early on, there was speculation UBS’s getting too big could mean trouble.

As early as April 2002, risk managers at UBS headquarters in Zürich were studying the bank’s growing trades in US mortgage securities. The group discovered that \$24 billion had been invested in the US mortgage market, no small sum by any means (Hässig 2009). Risk managers cautioned that the bank’s stakes in the US mortgage market were illiquid, that is, not easily sold off if times got tough. The problem was, times did get tough; there was a financial crisis.

Other banks in Switzerland, not as tied to US mortgage problems, were not as severely affected by the financial crisis. The SNB 2009 Financial Stability Report states that, “during 2008, both Credit Suisse and UBS took measures to strengthen their resilience. In addition to reducing risky positions and overall size of their trading portfolio and balance sheet, they raised sizeable amounts of capital,” but the important fact is that “Credit Suisse managed to do so without financial support from the public sector.” During 2008, it soon became clear that, unlike Credit Suisse, UBS would not be able to bring itself together.

The SNB-StabFund

If UBS were to fail, the Swiss economy would have been greatly hurt; the bank was “too big to fail.” Considering the recent crisis, many argue the largest financial institutions in an economy are so interconnected that a government cannot allow them to declare bankruptcy because that would have a disastrous effect on the overall economy. To avoid this, the Swiss needed to take action.

On October 16, 2008, after much discussion, the SNB announced an agreement with UBS, which set up the Swiss National Bank Stability Fund, or SNB-StabFund. This allowed UBS to transfer up to \$38.7 billion in “toxic” assets to a legal entity created solely to isolate the bank’s financial risk (Stability Report 2009). The SNB controlled this fund, and also pumped money into the bank.”

Preventing UBS from going bankrupt was essential to Switzerland’s national insistence on independence. Because of the bank’s large role in the Swiss economy, letting it fail would have greatly hurt the Swiss economy. Although the exact extent of the damage can never be known, it can be argued that the country could have been forced to join the EU in order to recover. As Hans-Juerg Fehr, a Swiss lawmaker, stated: “We [the Swiss] can’t afford to stay outside the EU any longer.... [The assault on the banks] wouldn’t be as great if Switzerland had the EU covering its back.” (Gallu et.al. 2008) Joining the EU, however, would have forced the Swiss to surrender their *Sonderfall* position.

To understand what risk Switzerland faced, it is helpful to examine Iceland. This was another small, anti-EU nation with a healthy economy. When the crisis hit, estimates put their banking assets at 800% of 2006 Gross Domestic Product (GDP), meaning these banks were too big to fail. The country allowed three of its major banks to declare bankruptcy, and the results were catastrophic: their national currency, the Icelandic Kronor, fell sharply in value (from around 60iKkr/\$ to around 140iKkr/\$), and market capitalization (a measure of aggregate value of companies) of the Icelandic stock market dropped over 90% (Edmond et. al., 2009). Fearing default, some countries, namely the English and Dutch, froze Icelandic assets, further exacerbating the crisis. Iceland’s GDP plummeted and the country experienced a severe recession. Economists dubbed this the most crippling economic meltdown a single country has ever experienced (“Cracks in the Crust”).

In a 2008 report, *The Icelandic Banking Crisis and What to Do About It*, Willem H. Buiter and Anne Siber stated that a “convincing case for Iceland becoming a full member of the euro area [requiring EU membership] as soon as possible can



Ice skating in front of the Swiss National Bank (SNB) in the capital city of Bern. The SNB sits next to the Swiss Parliament, or Bundeshaus (not shown in photo.)

be based solely on financial stability arguments: only the [European Central Bank] and the Eurosystem can act as a viable lender of last resort and market maker of last resort for Iceland.” In 2010, after much debate, Icelandic authorities took this advice. The country is currently on a “fast track” towards EU membership, estimated to be complete in 2012. The Icelandic story—a once strong economy left in financial ruin with no viable alternative but to join the EU—was exactly what Switzerland wanted to avoid. As the former head of the FED’s finance division Edwin Truman said, despite all the economic turmoil, “the good news is that Switzerland isn’t Iceland” (Gallu et.al. 2008).

Aftermath: What Can We Learn?

In the aftermath of the financial crisis, world leaders are trying to decide the best way to prevent a repeat occurrence. There has been debate on whether a bank that is “too big to fail” is, essentially, too big to exist. Finance theory often stresses the importance of diversification, in this case not having too much of an economy invested in a single bank. Swiss officials were perhaps more alarmed with the concept of “too big to fail” than were other European authorities, principally because UBS and Credit Suisse are quite large in proportion to the national economy. In 2008, Swiss GDP was \$488 billion (World Fact Book: Switzerland). This figure is dwarfed by UBS, whose worldwide held assets equal to around \$1.84 trillion (UBS 2008 Balance Sheet Q1).

Many countries “bailed out” large banks, offering government aid to keep them from going bankrupt. In the UBS case, a bailout seemed to be a wise decision for Swiss national interests, but it has drawbacks. Bailout money is public money, derived from tax payers who do not appreciate footing the bill. Moreover, failing banks given preferential treatment through government assistance then compete against banks that may not be failing because they used more risk-averse business strategies. It would seem, then, that it is wiser to invest more riskily, since the government will save anyone who fails. This is certainly not the right message to send.

In its 2009 Financial Stability Report, the SNB said it “wanted to develop a better approach than bailouts to deal with crises at big banks whose collapse would threaten the whole financial system.” Vice president of the SNB, Philipp Hildebrand, said that “if significant progress is not achieved within a reasonable time frame, measures that address the size of the banks should also be examined” (Dougherty, 2009). He was referring to breaking up the banks. This idea was brought up in the US as well by Alan Greenspan, who advised “if they’re too big to fail, they’re too big,” and noted that “in 1911 the US broke up Standard Oil—so what happened? The individual parts became more valuable than the whole. Maybe that’s what we need to do [with banks].” This is easier said than done, as a spokesman for Credit Suisse, Alex Biscaro, commented: “systemic issues need to be solved on an international level.” (McKee, Michael & Lanman). If only certain countries restrict their banks’ sizes, this creates an unfair advantage. Capping how large banks can become also deprives the industry of a driving force: the ability to grow.

The remaining alternative was to let the banks fail. This would hurt the economy initially, but the country should eventually be able to bounce back. The problem is the uncertainty of what living standards people would experience and for how long. The US economy is facing sluggish recovery when it usually booms after a recessionary period. If the world’s largest economy is limping with government intervention, what chance would a small country have without it? One need only look at Iceland.

The financial crisis severely tested Switzerland’s history of independence from the rest of Europe, and especially its aversion to joining the EU. The SNB-StabFund, though not a perfect solution, allowed the country to keep its big bank, UBS, from failing and thereby maintain its *Sonderfall* status in a Europe politically uniting around it.

I would like to thank everyone involved in the process of producing this article. Especially, I would like to express my gratitude to Dr. Benjamin Cole, who served as my thesis advisor during the International Affairs capstone experience. Thanks also to my parents who continue to support my global expeditions.

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Author Bio

Justin Schubert calls Manchester, New Hampshire, home, but his international interests have taken him to Europe several times during his undergraduate years at the University of New Hampshire. In May 2011 he will graduate with a double major: a Bachelor of Science in business administration with an option in international business and economics, and a Bachelor of Arts in German and international affairs. He is a member of the University Honors Program.

Justin learned both French and German before studying in southern Germany, near the Swiss border. He was there in 2009 during the financial crisis, which led to the topic of his senior thesis (done as a junior) for Dr. Benjamin Cole's International Affairs capstone course in spring 2010. Justin found the wide range of thesis subjects in the course very interesting. For him, choosing a specific research subject and selecting what to include was a challenging part of the research process.

Mentor Bio

Justin first met Dr. **Benjamin Cole** in his Global Issues course in 2008. Dr. Cole has been at the University of New Hampshire for three years and is currently Hood House Lecturer in International Affairs. His areas of teaching and research are international and comparative politics, specifically the politics of democratic transition, political instability, and economic development. (Next fall he will teach a new course which combines science fiction literature and international relations.)

Dr. Cole mentors many undergraduates for independent studies, senior and honors theses, and research projects. About mentoring Justin he said: "I learned a lot about banking policy and practice in Switzerland! Justin brings a unique blend of intellectual ability, business acumen, and genuine interest to his study of the 2008 global economic crisis; and I found this blend to be interesting and engaging. It was particularly intriguing to learn from Justin's research just how close Switzerland was to true disaster."

After seeing Justin's "top-notch" presentation at the 2010 Undergraduate Research Conference, Dr. Cole encouraged him to publish in *Inquiry* "because writing for a journal like *Inquiry* forces students to learn the skill of concision without losing a broad audience. This skill is invaluable both for graduate school and the job market."