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Abstract
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Keywords
bank secrecy, Switzerland, tax evasion, offshore

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POLICY AND FISCAL EFFECTS OF SWISS BANK SECRECY

Dr David Chaikin[*]

Bank secrecy has provided a significant competitive advantage to Switzerland in its development as an international financial centre. The 'Rolls Royce' image of Swiss bank secrecy is not merely determined by its legal components, but also by its underlying philosophy, and the perceived discretion, honesty and efficiency of the Swiss banking system. Although bank secrecy in Switzerland has been diluted by the enactment of new financial crimes, it continues to be unassailable in the case of fiscal offences. Switzerland has sought to protect its reputation by prohibiting bankers from actively assisting in flight capital and tax evasion, but this has had little effect on Switzerland's position as the world's leader in the management of offshore private wealth.

Introduction

Swiss bank secrecy has been a major competitive advantage in Switzerland's growth as an international financial centre. The concept of bank secrecy is supported by a philosophy that places importance on the private sphere of the individual. The financial privacy philosophy underpins the extraordinary success of Swiss bank secrecy. Although many countries have copied the Swiss legal concepts of bank secrecy, none of them has acquired the branding of Swiss bank secrecy.

Switzerland as an international financial centre

Switzerland is located in the centre of Western Europe, bordering five countries, namely France, Germany, Austria, Liechtenstein and Italy. It is a country with few natural resources, apart from hydro-electric power, and with a small population of 7.25 million. Although geographical location has assisted Switzerland in its financial development, it is Swiss human resources and skills which lie behind its financial success.

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Switzerland's remarkable growth as an international financial and trading centre is intimately linked with its role as a place of refuge for economic elites.[1] After the Second World War, Switzerland was one of the few countries that did not impose exchange or currency controls. This made Switzerland an attractive location for international trading. During the second half of the 20th Century many different ethnic groups left their country of origin and relocated to Switzerland so as to escape political and economic instability. This included Eastern Europeans who fled Communism and Egyptian cotton merchants who left Cairo after Colonel Nasser seized power in Egypt.

There are two key international financial centres in Switzerland, Zurich and Geneva. Zurich is the financial hub of Switzerland and the geographical powerhouse of the Swiss financial services industry.[2] It is the centre of the world's offshore banking industry in that it has the largest amount of non-resident funds under management. It is also the world's largest centre for gold trading and the third largest insurance market after London and Munich. The Swiss Stock Exchange, which has its headquarters in Zurich, was ranked 8th in terms of market capitalisation in 2002.

Geneva's international importance derives from its role as a financier of trade and its private banking companies. Geneva ranks second after London as the major world centre for international trading in commodities and semi-finished products.[3] Geneva finances much of the world's commodity trade, with Swiss banks buying risks through various financial instruments, providing credit to trading companies, and facilitating trading operations. After the de-regulation of world's oil prices in the early 1970s Geneva became the pre-eminent centre for world oil trading and financing.

Switzerland per capita has more global companies than any other country. Switzerland was placed 5th in the Financial Times Global 500 Ranking in 2003 after US, Japan, UK and France. Switzerland is also the preferred regional headquarters location in Europe for US multinational companies. Approximately 200 major foreign corporations have moved their headquarters or some parts of their headquarters to

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1 See generally, Federal Department of Finance, *The Swiss Financial Centre* (2003). Available at <http://www.eda.admin.ch/eda/e/home/foreign/ecopo/chfin.html> at 13 July 2005. Pierre Mirabaud, *The Swiss Financial Centre, Some Personal Observations* (2004).

2 *Finanzplatz: Zurich Dead or Alive?* (2003). See also website of the Swiss Stock Exchange at <http://www.swx.com> at 13 July 2005.

3 There are 350 international trading companies in Geneva with an annual turnover of US $40 Billion. See <http://www.geneva-finance.ch> at 13 July 2005.

Switzerland.[4] Furthermore, many multinational companies have outsourced their financial functions (including billing and treasury) to Switzerland because of its fiscal policy in regard to holding companies and its strength as a banking centre.

In 2004 the financial sector (excluding insurance and pension funds) contributed an estimated 11% of Switzerland's Gross Domestic Product, compared with approximately 5.8% in 1990. The financial sector is a major employer in Switzerland, contributing directly 5% of the total employment.[5] The importance of the financial sector in Switzerland's economy explains the Swiss Government's attitude to bank secrecy. In order to protect the reputation of the Swiss financial system, the Swiss authorities will waive bank secrecy in relation to financial crimes. However, the Swiss Government vigorously defends the core content of bank secrecy, in that it refuses to change its laws so as to assist other countries investigating tax evasion.

The most important reason that Switzerland is a major international financial centre is that it manages approximately one-third of global private wealth. With only 0.1 % of the world's population, Switzerland is a superpower in international banking. Switzerland has two huge world class banks, namely UBS and Credit Suisse, which dominate the offshore private banking market.

The key skills, experience, and principal business of many of the Swiss banks is asset management, that is managing money for private wealthy clients (private banking) and institutional clients (institutional asset management). This may be contrasted to banks in other countries whose main business is accepting deposits and making loans.

The provision of private banking and asset management services to foreigners is a major source of revenue for Swiss banks and is its most profitable income stream. According to data compiled by the Swiss National Bank, clients domiciled outside Switzerland had on deposit CHF 2,650 billion with banks in Switzerland as at the end of June 2005.[6] This accounted for 61% of the total assets under management (AUM) of

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4 US companies include Philip Morris, Procter and Gamble, Dow Chemicals, Du Pont, Oracle and Cisco. See Herbert Wanner, Xavier Le Clef and Hroshi Shimizu, *Global Headquarters on the Move: From Administrators to Facilitators* (2004).

5 Federal Department of Finance, above n 1.

6 Banque Nationale Suisse, *Statistique* (2005). The AUM figures are not an exact measurement of AUM. They include securities and cash, but do not include domestic deposits or non-financial assets. This is a combined statistic, covering both private and institutional clients. There is no breakdown of AUM sources by country. See <http://www.swissmoney.net> at 27 August 2005.

Swiss-based banks. The 2005 data is the highest record of AUM for foreign clients, illustrating the continuing attractiveness of Switzerland for foreign deposits.

Switzerland's pre-eminent position in offshore private banking is linked to its system of bank secrecy which has attracted both legal and illegal monies. Professor Ingo Walter[7] has suggested that the drivers of offshore private banking include tax avoidance/tax evasion, capital flight, business and family confidentiality, asset protection, insider trading, corruption and criminal activity such as illegal activities requiring money laundering. To this list may be added estate planing particularly the avoidance of heirship laws or succession laws of many European civil law countries, and politically linked crimes, such as arms trafficking and sanctions busting.

There are many legitimate demands for offshore private banking from key target markets, including traditional 'high net worth' individuals and families, entrepreneurs, professionals, executives, entertainers and artists, sports professionals, intermediaries and external asset managers.[8]

It is difficult to obtain any reliable statistics concerning the illegal demand for private banking in Switzerland. The statistical problem has become more important because of the growth of international organised crime and money laundering. This has led to increased legal risks for Swiss bankers who find it difficult to distinguish between assets which have a legal source but that are hidden from foreign tax authorities, and assets which are the product of crimes such as drug trafficking, illicit arms trafficking and financial fraud.

It would be simplistic to argue that bank secrecy alone explains Switzerland's success as an international financial centre. Economists[9] have pointed to Switzerland's strong political, economic and monetary stability, the disciplined and conservative approach of Swiss bankers, and their wide ranging banking skills and experience, especially in asset management, as providing clues to Swiss financial success. There is also Switzerland's well developed legal system and its strong regulatory framework. However, many of the advantages of Switzerland are disappearing, as is evidenced by the increased competition that Swiss banks face in the offshore private banking market.[10] This explains in part why the Swiss government and Swiss banks are

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7 Ingo Walter, *Global Private Banking* (Lecture delivered at Stern School of Business, New York University, 2002) Available at <http://pages.stern.nyu.edu/~iwalter/globe/Private_Banking.pdf> at 15 May 2005.

8 Ibid.

9 See, for example, Warren Blackmore, *Swiss Banking in an International Context* (1989) 259-61.

10 See Swiss Bankers Association, *The Swiss Banking Sector* (2004) chs 23-6.

adamant that Switzerland will not abandon bank secrecy, for it is one of the few competitive advantages that Swiss banks continue to enjoy.

Philosophical justification of financial secrecy

Although economic competitive reasons are a major rationale for Swiss bank secrecy, the idea of financial privacy has deeper cultural and historical roots in Switzerland. Privacy is a foundation principle of the Swiss legal system. The notion of financial privacy can be traced back to the civil codes of principalities that are now part of Germany and the city states in northern Italy. It is reflected in a wide range of laws affecting data protection, professional secrecy and bank secrecy.

Financial privacy is considered a fundamental right in Switzerland. It draws its strength from an underlying political philosophy that the state is a servant of the people. In Switzerland the 'relationship of the State to its citizens is reflected in her views of financial secrecy.'[11] The Swiss attitude to bank secrecy is linked to Switzerland's system of direct democracy. Unlike the situation in nearly all the democracies of the developed world, citizens in Switzerland can pass judgment on the tax policy of the government or issues such as Swiss bank secrecy, by initiating a referendum with 50,000 signatures.

Ambassador Jacques de Watteville of the Swiss Department of Foreign Affairs, argues that the Swiss approach to democracy places 'much greater degree of trust and responsibility on the individual than in other democracies in the world'.[12] Accordingly, he asserts that:[13]

It would be entirely inconsistent with the relationship of trust between state and citizen if the tax authorities had access to the private sphere of the individual without first obtaining the authorisation of a criminal court based on allegations that this relationship has been abused by the individual concerned.

The Swiss view of financial privacy is based on the notion of trust between the citizen and the state. Citizens are entitled to transparency from the state but not necessarily vice versa. Arguably, this philosophy increases public trust in the government, raises

11 Franz Blankart, Jean A Bonna and Michel Y Dérobert, 'Swiss Views on Financial Privacy' in Competitive Enterprise Institute (ed), *The Future of Financial Privacy* (2000) 204, 209.

12 Jacques de Watteville, 'The Swiss Banking Secrecy and the Fight against Financial Crime' (Speech delivered at the International Wealth Management Executive MBA Program, Schloss-Hünigen, Switzerland 18 April 2002).

13 Ibid.

confidence in tax policies, and ultimately results in a culture of tax compliance. It is not a mere coincidence that the underground economy in Switzerland is one of the smallest in the developed world.

In contrast, in countries where there is a culture of distrust between the government and its citizens, there are large underground economies, widespread tax evasion and in many cases significant secret deposits of funds abroad by residents.

According to an International Monetary Fund (IMF) study, the importance of the underground economy has increased in most of the OECD countries from an average of 10% of GDP in 1970 to 20% in 2000. The study concludes that 'the major driving forces behind the size and growth of the shadow economy appear to be an increasing burden of taxation and social security payments, combined with more pervasive state regulatory activities.'[14] One of the consequences of an increasing underground economy in a world subject to the forces of globalisation, is the movement of tax evasion and flight funds to offshore and international financial centres, such as Switzerland.

Although the Swiss financial privacy philosophy may define the relationship between the Swiss government and its citizens, it is questionable whether it should have any relevance in defining the relationship of the Swiss Government to foreigners who are not resident in Switzerland. How can a financial privacy philosophy developed according to Swiss values be used to justify Switzerland's continuing refusal to assist countries whose residents hide their tax evasion monies in Swiss banks? The Swiss argument is that their laws do not discriminate between residents and non-residents, so that financial privacy is applicable to both. Furthermore, it is a legitimate exercise of sovereignty to refuse to assist a foreign government to collect taxes which do not accord with Swiss values.

Historical overview of Swiss Bank secrecy

Bank secrecy has been protected under Swiss private law for over 300 years. The Swiss Constitution 1999[15] provides a fundamental guarantee to the private sphere of individuals, which includes financial privacy. There are several important provisions of Swiss law which also protect bank secrecy. The Swiss Civil Code grants a right to

14 Friedrich Schneider and Dominik Ernste, *Hiding in the Shadows: The Growth of the Underground Economy* (2002) 5.

15 Article 13 of the Constitution states that 'All persons have the right to receive respect for their private and family life, home, mail and telecommunications. All persons have the right to be protected against abuse of their personal data.'

personal privacy to all individuals and legal entities, and the Swiss Code of Obligations provides a contractual right to privacy.[16] The obligation of confidentiality in a contractual relationship is derived from the law of agency, particularly the duty of loyalty, or where there is no agency relationship, the duty is derived from the principle of good faith inherent in customary law. Breach of bank secrecy obligations may give rise to tortious or contractual liability.[17]

It was not until 1934 that the duty of confidentiality of banks was made the subject of criminal sanction in the Swiss banking law. The circumstances surrounding the criminalisation of Swiss bank secrecy are revealing.

In the English speaking world many academic articles on Swiss bank secrecy state that the Swiss Federal Parliament introduced statutory bank secrecy in 1934 to protect the bank accounts of Jewish depositors from Nazi confiscation.[18] This view is largely based on Swiss banking and legal sources, but has been recently questioned by Swiss historians.

There are certain well accepted historical facts.[19] In 1931 the Nazi Government in Germany introduced exchange controls and imposed capital punishment on Germans who failed to reveal their overseas assets. German customs and tax authorities resorted to espionage to obtain information concerning suspected Swiss bank accounts of German citizens. The SS put extreme pressure on German Jews, who were subject to confiscatory laws, to disclose their alleged Swiss bank accounts. In order to prevent excessive withdrawals of capital and to protect their clients against espionage, some Swiss banks introduced protective mechanisms, such as numbered bank accounts and restricting the dispatch of mail to foreign private clients.

Marc Perrenoud, a Swiss historian, carried out an extensive investigation of Swiss bank archives and Government and Parliamentary records for the period 1931-1934.

16 See Claus Schellenberg, 'Bank Secrecy, Financial Privacy and Related Restrictions - Switzerland' (1979) 7 *International Business Lawyer* 221.

17 Under Article 28 of the Civil Code and Article 97 of the Code of Obligations.

18 See eg, Anita Ramasastry, 'Secrets and Lies? Swiss Banks and International Human Rights' (1998) 31 *Vanderbilt Journal of Transnational Law* 325.

19 For a historical analysis, see Marc Perrenoud, Rodriog López, Florian Adank, Jan Baumann, Alain Cortat, Suzanne Peters, *The Swiss Financial Center and Swiss Banks during the Nazi Period, The Major Swiss Banks and Germany* (1931-1946) (2002) vol 13.

Perrenoud concluded that there is a double origin of the 1934 Swiss law on bank secrecy.[20]

Firstly, in 1933 the Swiss banks were subject to enormous pressure from their French client base after the Basler Handelbank affair, particularly because of the demands made by the French Government on the Swiss authorities. In what could only be described as a French farce, the president and vice president of Basler Handelbank, a Swiss bank, were caught by the French police with a list of names of 2,000 French clients in the trunk of their car. The names represented the elite of French society including a number of politicians, a former Minister, bishops, generals and industrialists. The tax scandal led to the Swiss banks becoming even more discreet. Credit Suisse closed its Paris branch and the Swiss Federal Court upheld the refusal of the Handelsbankers to co-operate with the French authorities in this fiscal matter.

Secondly, the Swiss banking industry suffered a spate of bankruptcies in the early 1930s which led the Swiss Government to demand a greater supervisory role in relation to the Swiss banks. The Swiss banks, which had been lightly regulated, accepted increased government intervention only in exchange for the formalising of bank secrecy by statutory guarantee. The 1934 law gave Swiss bank secrecy the same level of statutory protection as the professional secrecy of the legal profession.

After analysing the historical record, Marc Perrenoud concluded:[21]

The idea that the bank secrecy was introduced to protect the Jews persecuted in Germany is a legend which was commenced at the end of the Fifties, in particular by certain leaders of the largest Swiss banks.

According to Mr Perrenoud, the protection that Swiss bank secrecy affords foreigners was not the reason that the 1934 statutory law was introduced, but rather was one of the consequences of the law. In the late 1950s the Swiss banks created the myth that bank secrecy protected the Jews against Nazi espionage as a marketing tool to sell their services to the Anglo Saxon world.[22] This assisted the Swiss banks in their rapid growth in the 1960s and 1970s.

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20 See Article 47 of the Swiss Banking Law which is discussed below. See Marc Perrenoud, 'Les fondements historiques du secret bancaire en Suisse' in Finance & bien commun, *Observatoire de la Finance*, No 12 (Genève 2002) 31-7.

21 Newspaper article by Sylvain Besson, 'Secret bancaire, la naissance d'une mine *d'or', Le Temps* (Geneva), 12 August 2002.

22 Ibid. See also Sylvain Besson, *L'Argent Secret Des Paradis Fiscaux* (2002).

Statutory bank secrecy and its exceptions

Article 47 of the Revised Federal Law on Banks and Saving Banks 1934 (Federal Banking Act) is in the following terms:[23]

(1) Whoever divulges a secret entrusted to him in his capacity as an officer, employee, mandatory or liquidator of a bank, as a person charged by the Banking Commission with an investigation or restructuring, as an officer or employee of a recognised auditing firm, or has become aware thereof in this capacity, and whoever tries to induce others to violate professional secrecy, shall be punished by imprisonment for not more than six months or by a fine of not more than CHF 50,000 Swiss.

(2) If the act has been committed by negligence, the penalty shall be a fine not exceeding CHF 30,000.

(3) The violation of professional secrecy remains punishable even after termination of the official or employment relationship or the exercise of the profession.

(4) Still applicable are the Federal and Cantonial regulations concerning the obligation to testify and to furnish information to a government authority.

Article 47 of the Swiss Federal Banking Act provides that it is an offence for any person to disclose any information whatsoever about any matter dealt with in the course of his/her relationship with the bank.[24] The obligation of confidentiality covers all communications between the bank and client, no matter how unimportant their content. It includes knowledge of whether a person is or is not a client, no matter whether temporarily or permanent. It makes no distinction between a client who is a Swiss national or a foreigner, or is a resident or a non-resident of Switzerland. It is not limited territorially. It applies equally to business transactions conducted by the bank with the client in Switzerland or abroad. It does not cease if the person is no longer a client.

Article 47 is not a hollow statutory provision. Unlike bank confidentiality in most common law countries, a violation of bank secrecy in Switzerland gives rise to

23 The unofficial English translation of Article 47 is taken from <http://www.kpmg.ch/library/pdf/20040608_Law_Banks_and_Savings_Banks.pdf> at 10 May 2005.

24 See generally, Maurice Aubert, *Swiss Bank Secrecy: General Extent and Recent Developments* (1997) ('Aubert1'); Maurice Aubert, *Le secret bancaire suisse* (1995) ('Aubert2').

criminal sanctions. Violations of bank secrecy in Switzerland are taken very seriously and will usually result in the professional ruination of a violator coupled with a prison sentence.

Exceptions to bank secrecy

Bank secrecy in Switzerland is not absolute.[25] It is well accepted that disclosure of information which involves a Swiss bank secret is permitted in Switzerland in three circumstances:

if the customer consents to disclosure. The consent must be real and voluntary. If a foreign court compels the putative account holder to waive bank secrecy, there is considerable doubt whether a Swiss court would regard such waiver as a voluntary act;

where Swiss law provides. For example, since 1998 all banks in Switzerland are permitted, indeed are required, to file reports of suspect transactions with the Swiss Money Laundering Reporting Office; or

if the bank is ordered by a competent Swiss court to provide disclosure. There is a wide range of circumstances which empower Swiss judges to disclose Swiss bank secrets in domestic civil and criminal cases, and by extension to foreign parties.

Article 47 paragraph 4 of the Swiss Federal Banking Act provides that federal and cantonial provisions concerning witnesses and the duty to supply information is reserved. This means that bank secrecy may be set aside in Swiss criminal proceedings, and by extension to foreign criminal proceedings, where a mutual assistance request is executed by Swiss authorities on behalf of a foreign country. The main limitation is that the conduct alleged in the foreign country must amount to a criminal offence according to Swiss notions of criminality.[26] The idea is that a relaxation of financial privacy can only be justified if the conduct complained of would be unlawful, if hypothetically it was committed in Switzerland. Accordingly, the Swiss authorities can not provide any assistance in tax evasion cases because tax evasion is not a criminal offence in Switzerland.

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25 See Aubert1, ibid 5-15, for a discussion of the exceptions to bank secrecy.

26 See Article 64 (1) of the Swiss Federal Act on Mutual Assistance in Criminal Matters (1981). See generally, Swiss Federal Department of Justice and Police, *International Mutual Assistance in Criminal Matters Guidelines* (2001).

In the past 25 years Switzerland has enacted many new laws dealing with financial criminality which have had the effect of expanding the scope of co-operation with foreign countries. For example, Switzerland has penalised insider trading (since 1988), money laundering (since 1990), stock-market manipulation (since 1997) and bribery of foreign public officials (since 2000).

When introducing legislative changes to criminalise financial misconduct, the Swiss authorities will often claim that the new criminal laws do not affect Swiss bank secrecy. The statements of the Swiss government are technically correct because the new crimes do not create new exceptions to Swiss bank secrecy, but rather give greater content to the exceptions. The practical reality is different because the new crimes dilute bank secrecy in respect of conduct which previously was not criminal under Swiss law.

There is a debate concerning the extent to which Swiss bank secrecy provides legal protection to criminals. It is argued by the Swiss government that bank secrecy does not protect criminals because Switzerland gives assistance to foreign countries in tackling financial crimes.[27] In some areas such as anti-money laundering, Switzerland's legislation and regulations are considered to be stricter than other developed countries.

On the other hand, Dr Jean Ziegler, the Swiss sociologist and former prominent member of the Swiss Parliament, has argued that Swiss bank secrecy is extensively exploited by criminals with the connivance of Swiss bankers.[28] Dr Ziegler has documented abuses of Swiss bank secrecy in a number of books, which generally rely on newspaper reports and other secondary material. Although there are many foreign governmental reports which have criticised the misuse of Swiss bank secrecy by white-collar criminals, more recent reports suggest that Switzerland is no longer as attractive as a financial haven for illicit monies.[29]

It is difficult to provide an objective assessment of the role of Swiss bank secrecy in facilitating financial crimes because there is a lack of empirical data. One major issue

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27 See website of Swiss Department of Foreign Affairs at <http://www.eda.admin.ch> at 10 August 2005.

28 See Jean Ziegler, *Swiss Whitewash: Drugs, Dirty Money, and Laundering by the Swiss Banks* (1992); Jean Ziegler, Switzerland Exposed (1981); Jean Ziegler, Switzerland, *the Awful Truth* (1979).

29 See for example Jack A Blum, Michael Levi, R Tom Naylor, Phil Williams, *Banking Secrecy and Money Laundering* (1998) 17-8. Available at <http://www.cf.ac.uk/socsi/whoswho/levi-laundering.pdf> at 15 June 2005.

is that the enforcement of financial crime laws in Switzerland is not as rigorous as many western countries, particularly the United States, and the penalties imposed in Switzerland tend to be less severe than a number of European countries.[30] If enforcement and sentencing is perceived to be weak in Switzerland, this is likely to result in an exploitation of bank secrecy laws.

Swiss bank secrecy practices

The effectiveness of bank secrecy depends on the efficiency and competence of banking systems and individual bankers. Swiss bank secrecy has gained a formidable reputation because Swiss bankers fiercely protect the privacy of their customers by various practices and technological systems. The most well known measure for protecting the identity of customers is numbered bank accounts, which have been an essential part of the Swiss banking system since the 1950s.

Under the numbered bank account system, the accounts of wealthy and VIP customers are listed by number or code, or sometimes by a pseudonym.[31] The identity and other personal details of a bank customer are known only to those employees in the bank that are responsible for the relationship with the customer. Bank staff executing transactions for the bank account will only be acquainted with the number, code or pseudonym. Neither bank staff generally nor third parties will be in a position to ascertain the identity of the client.

The Swiss bank system of numbered bank accounts is an internal security measure which protects bank customers from unauthorised disclosure. It limits the opportunity of bank staff revealing secrets, or even worse, blackmailing clients by threatening to reveal bank secrets to a government of the country in which the client resides. Since the numbering system is applied to all bank customer documents, it prevents third parties such as tax authorities from identifying clients by obtaining copies of bank documents.

Swiss banks are required to identify and to know all their clients, including those with numbered accounts.[32] The system of numbered bank accounts does not affect the duty

30 For example, prison sentences in Switzerland for economic crimes are often suspended, and if not suspended, average about 18 months. See generally, Swiss Federal Office for Justice, *The Penal System in Switzerland* (2004).

31 See Nicholas Faith, *Safety in Numbers, The Mysterious World of Swiss Banking* (1982) 35-6. Edouard Chambost, Bank Accounts: *A World Guide to Confidentiality* (1983) 39-57.

32 Swiss banks have been required to identify clients including the beneficial owner of bank accounts since 1977. See Article 3 of the Code of Conduct with regard to the Exercise of

of Swiss banks to supply customer information to the public authorities by reason of one of the exceptions to Swiss bank secrecy. The introduction of anti-money laundering measures has had an impact on the utility of numbered accounts. Under pressure from the Financial Action Task Force,[33] in 2003 Switzerland amended its Money Laundering Law so as to require Swiss banks to identify the name of its customers when transferring money abroad.[34]

All Swiss banks have a private banking account network (PBAN) which provides a secure method of accessing private bank information.[35] In the case of some Swiss banks there are three levels of security in accessing numbered accounts through computer password entry. This is complemented by sophisticated surveillance and auditing systems which are designed to prevent unauthorised access to the computer of the PBAN.

Another protective measure for private banking accounts is the imposition of limitations on computer access to private banking information in both Switzerland and overseas. For example, one of Switzerland's leading banks claims that US branches of Swiss banks have no computer access to Swiss banks' headquarters PBAN. It is not clear what this means, for example, whether it is technologically impossible to penetrate the PBAN from foreign countries, or that the relevant passwords etc are not available to US-based employees of the Swiss bank.

Finally, Swiss banks insulate the identity of specific bank accounts by installing different search systems in relation to different branches of the same bank. Employees of a Swiss bank at one branch can not carry out a search of other branches to determine whether a person has a Swiss bank account. Financial privacy is further cemented by the practice of using different numbering systems in relation to bank accounts located in different branches. This led in one case to a Swiss bank misleading the District Attorney of Zurich in denying that it had a specific account number of a client in circumstances where the Swiss bank carried out a search of the

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Due Diligence between the Swiss Bankers Association and the signatory banks (Due Diligence Agreement).

33 The Financial Action Task Force is an inter-governmental policy making body which has published 40 recommendations to combat money laundering and terrorist financing. It was created in 1989 under the auspices of the G8 and consists of 31 member countries. See <http://www1.oecd.org/fatf> 20 June 2005.

34 See 'Time runs out for Swiss numbered account', *Swissinfo News* (Bern), 24 June 2004.

35 The information concerning Swiss private banking security is based on a series of confidential interviews that the author conducted in the period 1997-1999. See David Chaikin, 'Electronic Threat and Defences - Hacking and Internet Banking' (Paper presented at the 4th International Financial Fraud Convention, London, 27 May 1999).

Zurich branches of the bank, but not the Lugano branches.[36] The technological separation of branches of Swiss banks may be justified on the grounds of increased financial privacy, but this may have adverse compliance consequences.

Bank secrecy, honesty and ethics

Another component of the efficacy of bank secrecy is the customers' belief that the banker is honest and will comply with their instructions, including returning secret money when requested.[37] Clients place a large measure of trust in their bankers especially when their money is hidden from third parties. Secrecy and trust are interdependent because of several factors. Secret money often involves cash or negotiable instruments which is vulnerable to loss, theft and fraud. Secondly, clients are often reluctant to enforce their contractual rights in cases where their money is supposed to be secret. Although in Switzerland the identity of parties involved in banking disputes is not generally disclosed in court documents, in notorious cases the anonymity of parties can not be preserved. Thirdly, there is a risk that customers may lose control over their monies as a consequence of secrecy. Indeed, as a general rule the more secrecy instruments that are introduced in a banking relationship, the more difficult it is for clients to assert their legal rights. By legally distancing oneself from one's monies, one faces the risk that the money will become irrecoverable.[38] Fourthly, secret money creates a new temptation for bank managers who are not subject to the same degree of client monitoring as is the case with non-secret money. Consequently, bank secrecy imposes risks for its users in circumstances where it can be exploited by dishonest or greedy bankers.[39]

There are no studies which measure the honesty of Swiss bankers vis-a-vis other bankers. The most compelling and dramatic case pertaining to Swiss bank honesty is that of the Holocaust assets. In 1996 and 1997 class action suits were filed in New York by Holocaust survivors and descendants of the Holocaust victims alleging that

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36 See Donna Cueto, 'Swiss former execs caught lying - Chavez', *Philippine Daily Inquirer* (Manila), 12 June 1999.

37 See allegations that one of the Swiss banks in 1986 failed to act on the instructions of an agent of the former President of the Philippines, Ferdinand Marcos, prior to the freezing order by the Swiss Government. Discussed in David Chaikin, 'Tracking the Proceeds of Organised Crime: The Marcos Case' (Paper presented at the Transnational Crime Conference, Australian Institute of Criminology, Canberra, 10 March 2000). Paper subsequently published at <http://www.aic.gov.au/conferences/transnational/chaikin.pdf> at 10 August 2005.

38 See U E Ramati, *Liechtenstein's Uncertain Foundations* (1993) 17-8.

39 For a discussion of the principal-agent problem, see Ingo Walter, *Secret Money, The World of International Financial Secrecy* (1985) 165-7.

certain Swiss banks had conspired to deprive them of monies deposited in those banks prior to and during World War II.[40] The claimants asserted that Swiss bankers had manipulated bank secrecy to conceal Nazi deposits of gold looted from the Holocaust victims and to prevent the recovery of bank deposits by the relatives of Holocaust victims.[41]

The Swiss Government and Swiss bankers were stung by the strength and persistence of the claimants' allegations, which undermined the reputation of the Swiss banking system. American legal suits, coupled with the threat of sanctions against Swiss businesses, resulted in Switzerland taking unprecedented legislative and ultimately compensatory action in dealing with the Holocaust victims. The Swiss Parliament passed a law establishing the Independent Commission on Experts (the Bergier Commission) to carry out an investigation of the 'volume and fate of assets moved to Switzerland before, during and immediately after the Second World War.' A new Swiss law imposed an obligation on all banks, insurance companies and other private entities to preserve their records and to supply the Bergier Commission with all relevant documents in their possession.[42] In effect, bank secrecy, the professional secrecy of lawyers, and the official secrecy of the Swiss government and its courts, were suspended for the purpose of investigating the ownership of dormant (or inactive) bank accounts dating back to or prior to World War II.

The Bergier Commission produced voluminous reports which were critical of the Swiss banks and the Swiss Government, but found no evidence of institutional looting of Holocaust funds by Swiss banks.[43] Similarly the Independent Committee of Eminent Persons (also known as the Volcker Committee), which was established by the Swiss Bankers Association and various Jewish aid organisations, identified approximately 25,000 'dormant Swiss bank accounts'[44] as being probably connected to Nazi persecution. The Volcker Committee did not find any evidence of Swiss bank complicity in the looting or laundering of assets.[45] Although bank secrecy was

40 For the official website of the Holocaust victims' litigation against the Swiss banks, see <http://www.swissbankclaims.com/index.asp> at 15 July 2005.

41 See Stuart Eizenstat, *Imperfect Justice*: *Looted Assets, Slave Labor and the Unfinished Business of World War 11* (2003).

42 Some banks ignored these requirements. See David Sanger, 'Swiss banks "regrets" shredding wartime documents', *New York Times* (New York), 15 January 1997.

43 The reports of the Bergier Commission are found at <http://www.uek.ch> at 10 July 2005.

44 In February 2001 and January 2005 lists of dormant accounts from banks in Switzerland were published to assist in the identification of Holocaust accounts. See <http://www.dormantaccounts.ch> at 10 July 2005.

45 For a copy of the Volcker Committee Final Report, see <http://www.crt-ii.org> at 10 July 2005.

suspended, little Holocaust money was discovered by the teams of auditors employed by the Volcker Committee. This may not seem surprising because the auditors were investigating incomplete records of more than 50 years of age.

The Holocaust case galvanised opposition to the Swiss banking system and highlighted the potential risks of bank secrecy. The Swiss banks sought a settlement of the Holocaust case because it was injuring their reputation and delaying corporate plans to expand US operations. In 1999 the Swiss banks, without making any admission, agreed to pay $1.25billion as a final settlement with the Holocaust claimants.

Fiscal effects of Swiss Bank secrecy: Flight capital and fiduciary deposits

There are many definitions of flight capital.[46] The Swiss Bankers Association defines illegal flight capital as 'an unauthorised transfer of capital in the form of foreign exchange, banknotes or securities from a country that forbids or restricts such transfer abroad by its residents.'[47] According to some commentators illegal flight capital is almost always undocumented tax evasion which is characterised by a 'flight to secrecy'.[48]

There are a number of reasons why Switzerland has been a favourite destination of illegal flight capital. Firstly, unlike nearly all European countries, Switzerland did not introduce currency or exchange control laws after the World War II. This was one of many factors that contributed to Switzerland's international reputation as a safe haven for capital at a time when many countries were experiencing economic or political stress.

Secondly, Switzerland did not join the International Monetary Fund (IMF) and was not subject to Article VIII section 2b of the IMF Agreement[49] which provides that:

Foreign exchange contracts which involve the currency of a member state and are in contravention of the exchange regulations of that state set up in accordance with the terms of this agreement, shall not be enforced in the territories of other member states.

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46 See Benu Schneider, 'Measuring Capital Flight: Estimates and Interpretations' (Working Paper No 194, Overseas Development Institute, London, March 2004).

47 See Article 44 of the Due Diligence Agreement. Above n 32.

48 Raymond Baker, (Comments made at a conference on Criminal Money Laundering and Illegal Flight Capital, Brookings Institute, Washington DC, 29 September 1999). See <http://www.brookings.org/comm/transcripts/19990929.htm> at 10 July 2005.

49 The IMF Agreement can be found at http://www.imf.org at 10 July 2005.

The effect of Article VIII is that a contract between residents of two countries (which are members of the IMF) can not be enforced if the contract contravenes the IMF approved exchange control law of one of those countries. Article VIII has been described as a 'marvellous piece of legal chicanery' because a lender can not enforce a loan agreement in circumstances where the borrower has breached its exchange control laws.[50] As the provision could be avoided if one of the contracting parties was not a member of the IMF, Switzerland was often chosen as an intermediary in loan contracts involving countries with strict, complex or difficult to understand exchange control laws. Swiss banks would arrange back-to-back loans as a mechanism to avoid the adverse consequences of Article VIII.

A number of Non Governmental Organisations claim that Swiss banks have large deposits of illegal flight capital from developing countries which could be used to pay those countries' debts.[51] There is no doubt that Switzerland has been a beneficiary of flight capital but there are no reliable statistics as to the level of Swiss deposits from citizens of developing countries.

Fiduciary deposits with Swiss-based banks are sometimes cited as a proxy statistic for establishing the level of foreign deposits. Fiduciary deposits are investments (usually large cash deposits) made by foreign clients with Swiss-based banks which are then placed outside Switzerland in order to avoid the Swiss government's 35% withholding tax. Fiduciary deposits are very popular with non-residents of Switzerland who are 'unwilling to be taxed on capital income in their countries of residence'[52] and thus may provide a facility for tax evasion.

Swiss banks consolidate the fiduciary deposits of their clients by placing the investment in the name of the bank but for the benefit of and at the risk of the client. Whereas Swiss banks are required to identify the underlying beneficiary of the foreign depositor, the foreign financial institution or even the foreign branches of Swiss banks which receive the fiduciary deposits do not know the identity of the underlying foreign client. The fiduciary deposit is thus anonymous from the viewpoint of the financial institution located outside Switzerland.

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50 See Edouard Chambost, above n 31, 16-18.

51 See eg,, the website <http://www.taxjustice.net> at 15 May 2005.

52 See David Carey, Kathryn Gordon and Philippe Thalmann, *Tax Reform in Switzerland* (1999) 27. Available at <http://www.oecd.org/dataoecd/21/56/1881005.pdf>at 15 August 2005.

Fiduciary deposits in Switzerland totalled CHF455 billion (US $354 billion) at the end of June 2005.[53] The deposits came from almost every country in the world. The top sources of fiduciary deposits are the offshore financial centres of British West Indies (mainly British Virgin Islands) and Panama, which suggest that the underlying foreign clients enjoy another layer of secrecy protection.

Swiss fiduciary deposits held on behalf of residents in poor developing countries are relatively small but are sufficiently significant to demand some explanation. For example, in 2000 the largest %age growth in fiduciary deposits came from countries such as Eritrea, Albania, Sierra Leone, Benin and Zambia. When confronted with this statistic, the Bank of Zambia refused to provide any explanation for the US $27 million fiduciary deposit in Switzerland. Subsequently, in 2003 the Zambian government alleged that it had traced a US$35 million privatization payment which had been 'missing' to a Swiss bank account.[54]

Since 1977 Swiss banks have been subject to a self regulatory agreement which contains a prohibition against 'actively aiding international capital flight.' Article 7 of the Due Diligence Agreement provides specific examples of the meaning of active assistance of flight capital:- organising the reception of customers abroad; the establishment of offset transactions aimed at furthering the flight of capital; or active collaboration with person who organise the transfer of flight capital.[55]

Under the Due Diligence Agreement Swiss banks are required to comply with a standard of behaviour in relation to fiscal matters which is more rigorous than Swiss legislation. The purpose of this standard is to protect the reputation of Swiss banks and to ensure that banker secrecy is not subject to any further attacks. The Due Diligence Agreement has largely been supported by Swiss bankers because it empowers bankers to refuse to supply certain facilities to customers without fear that those clients will take their business to another Swiss bank.[56]

The Due Diligence Agreement is monitored by an independent Supervisory Board which may impose sanctions in the form of fines up to CHF 10 million. Bank auditors are required to notify the Supervisory Board and the Federal Banking Commission

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53 See <http://www.swissmoney.net> at 27 August 2005.

54 See 'Zambian payment traced to Swiss account', <http://www.swissmoney.net> at 21 March 2004; G Machona, 'Zambians open secret Swiss accounts', <http://www.afronet.org.za> at 23 March 2002.

55 For a copy of the latest version of the Due Diligence Agreement, see <http://www.swissbanking.ch> (10August 2005).

56 See Günter Woernle, *The Private Bankers of Switzerland* (2000) 46.

(FBC) of any conduct that is suspected of violating the Due Diligence Agreement. The FBC considers that the Agreement is the minimum standard that all banks must comply with, in order for the banks to guarantee that their conduct is irreproachable. Failure of a bank to comply with the Agreement is regarded by the FBC as grounds for imposing regulatory sanctions, which may include a loss of a bank licence, under Article 23 of the Federal Banking Act.

The main difficulty with the Due Diligence Agreement is proving breaches.[57] Unless a client of a Swiss bank makes a complaint and then co-operates in a flight capital case under the Agreement, it is unlikely that an auditor will suspect that a breach has occurred, let alone be able to prove it. Furthermore, the Agreement does not apply to the foreign subsidiaries, branches, representative offices of Swiss banks. This is a loophole which some Swiss banks have allegedly exploited. The enforcement record speaks for itself. There has not been one case of proved breach of the active flight capital prohibition since 1977 when Article 7 was enacted.

Tax evasion and tax fraud

Under Swiss law tax evasion is not a crime. According to Swiss concepts of tax evasion, the mere failure to report or to underestimate income or assets on a tax return is not punishable as a criminal offence. Although tax evasion is not a crime, there is an administrative procedure in Switzerland in cases of a failure to declare an element of income. Administrative sanctions may be imposed ranging from one third to three times the amount of the undeclared tax.

The Swiss attitude to tax evasion is illustrated by the lack of enforcement resources given to the Swiss tax authorities to investigate domestic cases. This has been acknowledged by the Swiss government which has stated that 'as a matter of political choice, the tax authorities (have) no powers of investigation (in tax evasion cases) so as not to penalise the person concerned. They could not search a person's premises, confiscate objects, hear witnesses or order detention. Bank secrecy remained intangible.'[58]

Consequently, persons who are responsible for professional secrecy, including bank secrecy, are not required to supply information about their clients to the Swiss tax authorities. It also follows that the Swiss banks are forbidden to disclose any

57 See Chambost, above n 31, 36.

58 Quoted in the case of *JB v Switzerland*, Judgment of the European Court of Human Rights, Strasbourg, 3 May 2001, § 59. Available at <http://www.worldlii.org/eu/cases/ECHR/2001/320.html> at 24 May 2005.

information about their clients to foreign tax agencies. Nor are Swiss authorities permitted to lift bank secrecy to assist a foreign country which is investigating tax evasion.

There is one exception to the principle that the Swiss authorities do not co-operate in purely fiscal matters. Under Chapter II of the 1977 United States Swiss Treaty on Mutual Assistance in Criminal Matters, the Swiss authorities have agreed to provide banking information in cases where the United States is investigating tax evasion offences committed by organised crime.

In contrast to tax evasion, tax fraud in Switzerland is considered a serious criminal offence punishable by imprisonment up to three years.[59] Switzerland has a narrower concept of tax fraud than many other states. Under Swiss law, tax fraud involves the use of 'forged, falsified, or substantially incorrect documents.'[60] The use of forged documents which prevents or discourages the Swiss authorities from investigating or imposing the correct tax will potentially give rise to an offence of tax fraud under Swiss law. It is not mere deception on the tax authorities that will be sufficient: the deception must be 'malicious', in the sense that the conduct must seriously impede the investigation.[61] Furthermore, statements made by third parties that are used by the taxpayer may be sufficient to constitute tax fraud in some but not in all circumstances.

The Swiss approach to tax fraud may appear to some to be 'hair splitting.' However, the consequences are important. Where there is a substantiated suspicion of tax fraud, Swiss bank secrecy may be set aside by a judge in domestic cases. International judicial co-operation is also possible, although in practice it is rare for the Swiss authorities to pass information to a foreign government in a tax case, even where there is an allegation of tax fraud.

Under Article 8 of the Due Diligence Agreement, Swiss banks are prohibited from providing 'any active assistance in cases of tax evasion or similar acts, by delivering incomplete or misleading attestations' to foreign tax, customs, currency and bank supervisory authorities. The Due Diligence Agreement also prohibits Swiss banks from altering routine records for the purpose of deceiving a foreign authority. There is a comprehensive definition of a misleading attestation, which includes providing

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59 See Article 14 para 2 of the Federal Law on the Administrative Penal Law.

60 See generally Lionel Frei, 'Overcoming Bank Secrecy: Assistance in Tax Matters in Switzerland on Behalf of Foreign Criminal Authorities' (1988) 9 *New York School Journal of International and Comparative Law* 107.

61 Paul Gully Hart, (Comments made at the 19th International Economic Crime Symposium on Economic Crime, Jesus College, University of Cambridge, September 2001).

facts in an untruthful manner by, for example, showing false dates, false amounts or fictitious rates.

There have been few reported cases of banks violating the 'active assistance tax evasion prohibition' under the Agreement.[62] The significance of these cases is difficult to assess because insufficient date is available. The identity of the Swiss bank which violates the Due Diligence Agreement is not disclosed. Nor is the customer of the Swiss bank identified, thereby ensuring that Swiss bank secrecy is protected.

Conclusions

The extraordinary success of Swiss bank secrecy can not be explained merely by its legal components. The cultivation of the 'Rolls Royce' image of Swiss bank secrecy by both the Swiss government and Swiss bankers has been assisted by an underlying financial privacy philosophy, efficient bank secrecy practices, and a perception that Swiss bankers are honest and trustworthy in their dealings with their clients.

In the past 25 years Switzerland has enacted new laws dealing with financial criminality which have had the effect of expanding the scope of Swiss co-operation with foreign countries, and diluting bank secrecy. These measures have not undermined the relative attractiveness of Switzerland compared with other international financial centres. Switzerland continues to enjoy a competitive advantage because of its fierce protection of fiscal secrets. Mindful of the reputational consequences of Swiss bank secrecy, the Swiss authorities have sought to limit their more abusive aspects, while refusing to assist foreign governments which are investigating exchange control violations or tax evasion.

62 For the period 1998 - 2001, the Supervisor Board found eight cases where the provisions relating to tax evasion and similar acts had been violated. See Supervisory Board for the Due Diligence Agreement, *Work Report 1998-2001 (2002)*.