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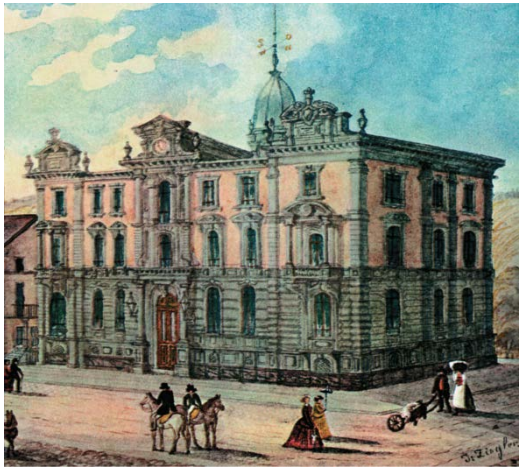
UBS

Regulating Bank Governance

1. Role of the Board
2. Risk Governance
3. Conduct Risk
4. Public Integrity

Kern Alexander,
Professor of Banking and Financial Market Law, UZH



Bank in Winterthur, est. 1862

The Toggenburger Bank, est. 1863

The Bank in Winterthur and the Toggenburger Bank merged in 1912 to form the Union Bank of Switzerland

«It is clear that the size, nature and culture of banking have changed considerably.»
(Lord King of Lothbury, 2015)

Barclays, est. 1896

1. Role of the Board

- Basel Committee on Banking Supervision (2009) identifies the board as an «essential part of bank regulatory reform» and as a critical element of risk management.

- Boards are more important as a governance mechanism for banks than for other types of firms because the directors are responsible not only for shareholders (in the case of public banks) but they also have a duty to depositors, taxpayers, and other stakeholders (Pathan, 2009, Alexander 2006).

- Additionally, because bank operations are not very transparent, information asymmetry is especially high (Haggard and Howe, 2012). As a result, the role that bank boards play is more significant, in that other stakeholders cannot see effective governance in the bank, so the directors must somehow signal that they are effective monitors.

Role of the Board

- Independent scrutiny of risk management
- Deter behaviour inconsistent with regulatory norms and standards
- Emphasise risk culture as a ‘critical focus’ of bank business strategies. Basel Committee on Banking Supervision (2009)
- «Boards should identify and deal seriously with risky culture, ensure their compensation system supports the desired culture, discuss culture at the board level and with supervisors, and periodically use a variety of formal and informal techniques to monitor risk culture». Group of 30 (2013)

Weak UBS Board oversight pre-crisis (OECD/G10 2008)

- UBS Group Senior Management identified the sub-prime issue as a major risk in September 2006, but because of weak scrutiny of the investment bank, it did not act until July 2007, when it was too late.
- Revenue growth and catching up to competitors was the dominant culture and primary causation
- Departing top managers were replaced by people from a sales background (consistent with growth), not a risk management background.
- UBS Group Senior Management took comfort from the main exposures being AAA CDOs and the investment bank assurances that the risk was well managed.
- Strong resistance from investment bank management to hard limits on the balance sheet and questionable RWAs.

'What is striking about the UBS story is that the complexity and the very nature of investment bank culture make it difficult to manage capital and risk even for highly-sophisticated organisations. No internal rules appear to have been broken, but the losses piled up quickly to around 50 per cent of stockholders equity.'

Corporate Governance – FINMA 2008/24 Controll functions of the BoD & 2008/21 OR

- «Der Verwaltungsrat sorgt mit seinen Vorgaben an die Geschäftsführung dafür, dass die Mitarbeiter aller Hierarchiestufen ihre Verantwortung und Aufgaben im Prozess der internen Kontrolle kennen und verstehen»

- «Der Verwaltungsrat stellt sicher, dass ein allenfalls auf die Mitarbeiter aller Hierarchiestufen ausgeübter Druck zur Erreichung von Zielvorgaben nicht zur Umgehung von Kontrollmechanismen führen darf. Er sorgt dafür, dass die Entschädigungssysteme keine Anreize zur Missachtung interner Kontrollmechanismen bieten.»

(FINMA Circular 2008/24, Überwachung und interne Kontrolle Banken & 2008/21 Operatioanl Risks)

2. Risk Governance – capital, liquidity and leverage

- Banks have a natural tendency to take on excessive risks and to grow in size.

- Evidence shows that **systemic risk is lower in better-capitalized banks with lower leverage**, with the effects particularly more pronounced for large banks. The significance of these results is robust to the sample, to the metric of systemic risk used, and to a range of controlled bank attributes. (Freixas, Laeven et al., 2015), Miles, Yang and Marcheggiano (2010), Freixas, and Shapiro, 2007; Laeven and Levine, 2007).

- These effects might even underestimate the true systemic risk of large banks, because **market values of bank equity during the crisis may be boosted by expectations of government support**, and because they **do not account for the social costs associated with large bank failures** (e.g., output losses and unemployment) (Ibid., Helwig 2010, Ross, 1996).

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Risk Governance weaknesses

- «The idea of a «crisis» is not on the «sell team's» mind before a crisis breaks, and all the incentives are aligned to make money for the company and for the key personalities to be seen to be driving this.» (OECD/G10, 2008)

- «Economizing on Equity». Strategy to capture excess returns to equity that is associated with high leverage.

- Managers have strong incentives to chase returns, neglecting risks for taxpayer, financial system, and creditors

Focus on «returns», not «risks».

Final Report of the Swiss Commission of experts for limiting the economic risks posed by large companies (2010)

Specific measures proposed in four core areas:

- Capital
- Liquidity
- Risk diversification
- Organisation (restructuring)

Amendments to the current too-big-to-fail provisions in Switzerland

- May, 2016: The Federal Council adopted the amendments to the previous too-big-to-fail law, thereby incorporating the recommendations in the evaluation report of February 2015 on the too-big-to-fail risks in Switzerland. The amendments entered into force on 1 July 2016.
- New requirements have to be met by the end of 2019.
- Increased ‘basic’ capital and leverage requirements (12.9% & 4.5%) for SIFIs, with a progressive component for UBS/CS of 14.3% and 5%.
- Enhanced resolution and restructuring requirements, i.e, additional ‘gone concern requirements’ of 14.3% RWA & 5% leverage ratio (debt and hybrid instruments)

Consultation on amendments to Capital Adequacy Ordinance

- April 2017, The Federal Department of Finance (FDF) initiated a consultation on amendments to the Capital Adequacy Ordinance (CAO).
- The revision should see the introduction of a non-risk-based leverage ratio for all banks, as well as new risk diversification rules.
- The consultation will last until 14 July 2017. An in-depth impact study will be carried out at the same time as the consultation.

Risk models and their limitations

«So, the key questions are: How reliable are predictions based on an understanding of past events? And how big do the safety margins have to be?»

«How can we dispel the misgivings about internal models? It would be possible, for example, to ban their use, but I doubt that this would have the desired effect.»

«My personal feeling is that we have reached the limits of the modelling approach to financial risk. Financial markets are driven by human behaviour, which is notoriously unlike the laws of physics. So, I do not think we need more models with more complexity; what we need in fact is fewer and simpler models.»

Mark Branson, FINMA CEO,
Annual Media Conference,
31 March 2015

Swiss National Bank
Financial Stability Report 2016

Regarding capital measured against risk-weighted assets, «UBS already meets the requirement and Credit Suisse is very close to meeting it.»

However, « [i]n an international comparison (cf. chart 10), the two big banks are among those with the lowest RWA density (the ratio of RWA to total asset exposure)»

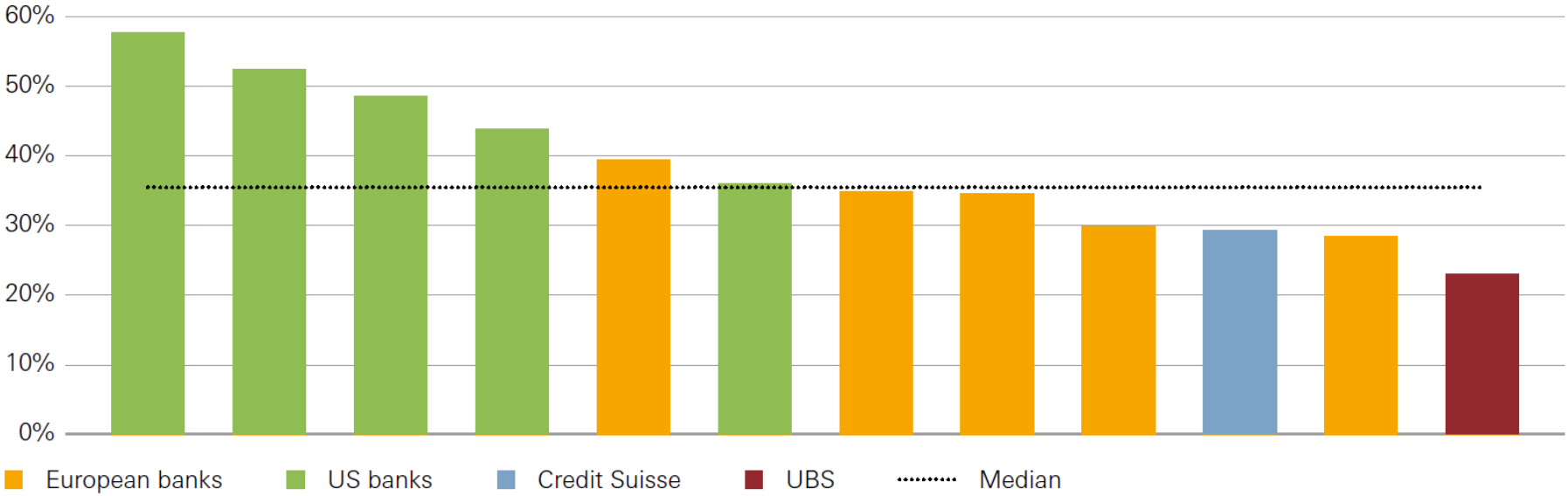
«***While leverage ratios at both Swiss big banks have improved by international standards, their Basel III Tier 1 leverage ratios are still below the average for large globally active banks. The TBTF2 going-concern look-through leverage ratio requirements imply that Credit Suisse and UBS need additional going-concern capital amounting to roughly CHF 10 billion each*** – assuming their total exposure remains constant and not taking into account any possible reductions on gone-concern requirements – such as potential future rebates granted by FINMA and reductions due to holdings of low-trigger CoCos to meet these requirements – **Credit Suisse and UBS would each have to issue gone-concern instruments in the range of CHF 20 billion to CHF 25 billion, or replace debt instruments that fall due with bail-in instruments.»**

«In an international comparison the two big banks are among those with the lowest RWA density (the ratio of RWA to total exposure)»

What the SNB actively stresses is that when TBTF2 will be in effect, the banks will need going-concern capital of 10bn CHF each, and will need to issue gone-concern instruments of 20-25bn CHF.

INTERNATIONAL COMPARISON OF RWA DENSITY

Risk-weighted assets in relation to total exposure, Q4 2015 — Chart 10



Sources: Banks' quarterly reports and SEC filings (10-Q/10-K)

Source: Swiss National Bank Financial Stability Report 2016

3. Misconduct risk: LIBOR & Misselling

LIBOR
(Salz Review 2013 Findings)

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- **Cultural deficiencies on the trading floor, indicative of a failure to embed clear ethical values**;

- Ineffective front office supervision and controls, furthered by the lack of separation or ethical walls between the trading teams and those submitting data to the LIBOR compilers

- **Flaws in the relevant functional controls** so that breaches on the trading floor were neither discovered nor dealt with on a timely basis- recognising **that until the problem was discovered, it had not been seen as presenting any material risk**

- **Performance targets and bonus arrangements for traders** which encouraged behaviour to make profit for the bank and for themselves and which may have led some to ignore the ethical or legal issues or the reputational impact on the bank

Mis-selling

Barclays persuades pensioners to invest savings into high risk funds

- Between June 2006 and November 2007 Barclays' sales agents contacted a number of pensioners, who deposited cash at their local branch, and persuaded them to put their money into high risk investment funds instead, describing the funds as «lower risk or balanced»;
- In July 2007 the investment funds were reclassified as «adventurous».
- The value of the funds dropped by almost 50% within 12 months.
- It was estimated that there could be about 5000 potential victims of misselling.
- Following protests of about 80 victims, Barclays decided to pay back victims' capital plus interest.

Mis-selling UBS Frankfrurt

- 2012: The Landgericht Frankfurt ordered UBS to pay compensation amounting 150’000 Euro to a 77 year-old pensioner.
- The Court found that UBS imposed doubled fees when selling ship fund shares to the plaintiff: It imposed a broker’s commission amounting 6,7 percent as well as an issuing premium amounting 5 percent.
- UBS had recommended the ship fund as a secure investment; however, the value of the fund shares dropped about 80 percent.
- The compensation payment corresponds to the total amount the plaintiff invested.

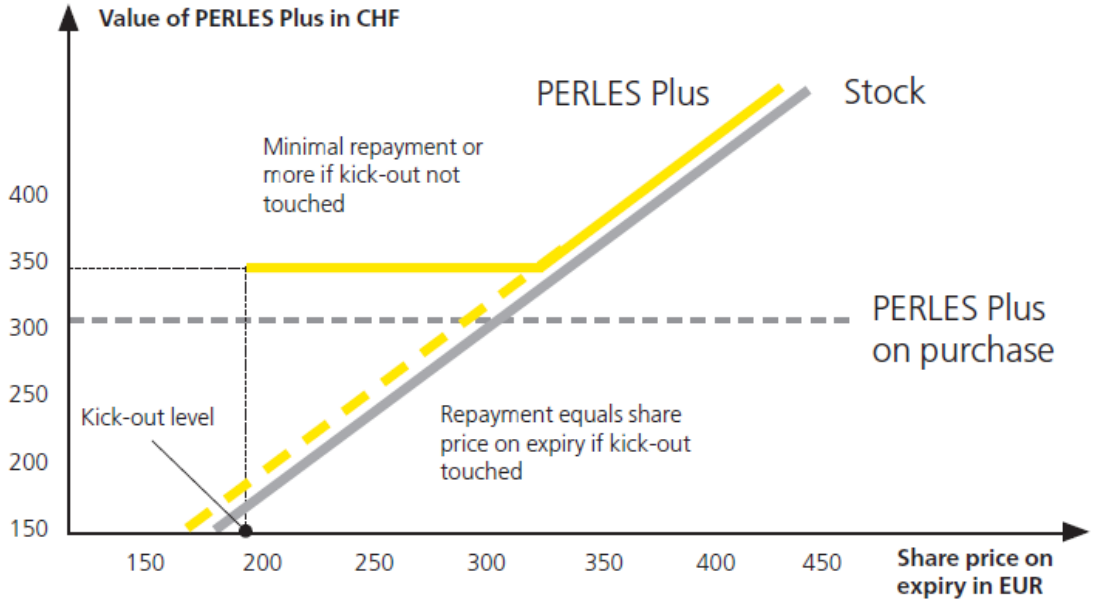
UBS Investment Bank

UBS PERLES/PERLES Plus
Investment with reduced risk.

Performance

Solutions for investors with medium to higher risk tolerance who want to benefit from the performance of an underlying without committing too much capital or taking on much administration.

Payout scenario of a PERLES Plus on an index



Ivor & Josselyn Cohen, London

UBS

From: <felix.scheuber@ubs.com>
Subject: **Perles Plus on 3 Irish Banks - Final TS**
Date: 27 November 2007 16:54:16 GMT
To: <felix.scheuber@ubs.com>

Dear Investor,
Please find attached the final term sheet of subject product. As it turned out, the timing for this issue was ideal; since Friday all three shares have rallied quite substantially and have therefore moved even further away from the (very low) Kick-Out levels.

Best regards,
Felix

aUBS AG
Felix Scheuber
Wealth Management UK & Ireland
Paradeplatz 6
P.O.Box
CH-8098 Zurich
tel. +41-44-237'2131
fax.+41-44-237'2167
E-mail felix.scheuber@ubs.com

www.ubs.com

Subject: Meeting May 27, 08
Date: Monday, May 5, 2008 18:03
From: thomas.stumm@ubs.com
To: <mercantile1@btinternet.com>
Conversation: Meeting May 27, 08

UBS

Dear Mr. Cohen

I hope you have received my previous mail below with my details.

I am looking forward meeting with you on tuesday May 27, 08 at the Bar of the Theo Randall Restaurant (Intercontinental Hotel Park Lane) at 7.30-7.45pm.

Yours sincerely,

Thomas Stumm
Executive Director
UBS AG œ Wealth Management
PO Box, CH-8098 Zurich
Switzerland

Phone +41-44-237 21 31
Fax +41-44-237 21 67
Mobile +41-79-819 16 40

thomas.stumm@ubs.com <mailto:firstname.lastname@ubs.com>

www.ubs.com <http://www.ubs.com>

Corporate Governance, Risk Management and Internal Control at Banks – FINMA

2008

- Board of directors
- Audit committee
- Internal audit
- Executive board

Circular 2008/24 «Monitoring and Internal Control in Banks»

2017

- Board of directors
- Internal audit
- Executive board
- Institution-wide risk management framework
- Internal control system
- Group structures

Circular 2017/1 «Corporate Governance, Risk Management and Internal Controls at Banks»

Individual Accountability Regime UK

- The **Parliamentary Commission on Banking Standards**, formed by the Government following the banking crisis, published its report **Changing Banking for Good** in 2013.
- Following recommendations made in this report, the **Financial Banking Reform Act 2013** introduced new rules and guidance **Strengthening Individual Accountability in Banking** – also referred to as **Individual Accountability Regime (IAR).**
- **These are intended to improve professional standards and culture in UK banks and the largest investment firms**, following the financial crisis and significant conduct failures.

- The **IAR** comprises three main elements:

1. **Senior Manager Rules**: Rules and Guidance that apply to the most senior individuals within in-scope firms.
2. **Certification Rules**: A requirement that in-scope firms certify certain employees (who may cause significant harm to in-scope firms or its customers) are fit and proper.
3. **Conduct Rules**: A set of Conduct Rules applicable to the majority of UK employees and some overseas employees within in-scope firms.

4. **Public Integrity**

- Perception of integrity of bankers and regulators
- Are bankers and regulators ethical?
- Does it Matter?
- Can they be trusted?

The Revolving Door in Switzerland

- «*Switzerland's new financial markets regulator on Tuesday appointed a senior UBS executive to head its crucial banking division, reinforcing concerns the agency is growing too close to the country's biggest bank*.», Financial Times, October, 28, 2009

- 2006: Eugen Haltiner, a top UBS executive becomes chairman of EBK

- 2009-2010: Eugen Haltiner is chairman of EBK's successor FINMA

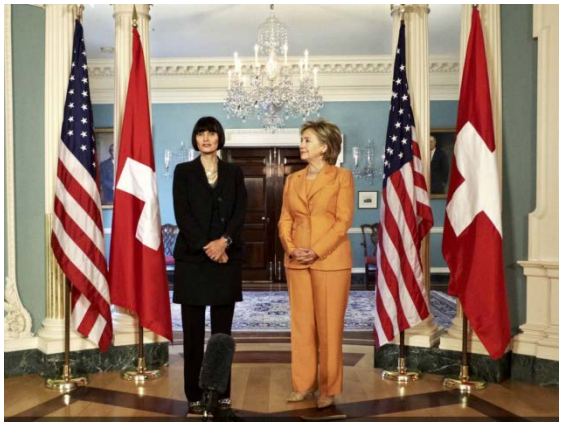
- 2010: Mark Branson, UBS's former head of communications joins FINMA as head of its banks division

- 2014: Mark Branson is appointed as FINMA's chief executive

UBS and the Tax Deal with the USA – *Integrity?*

- In July 2009, Clinton and Swiss Foreign Minister, Micheleine Calmy-Rey, announced the deal to settle tax fraud case against UBS
- 'Bob' McCann – UBS Wealth Management CEO (2010-2015)
- 2009-2014, UBS contributions to Clinton Foundation increased from a total of less than $60k in 2008 to over $600k by 2014.
- UBS also loaned $32 million for Clinton Foundation loan programme; **and paid Bill Clinton $1.5 million (2011-12) to participate in Q&As with Bob McCann**

See Wall Street Journal Report (2015)

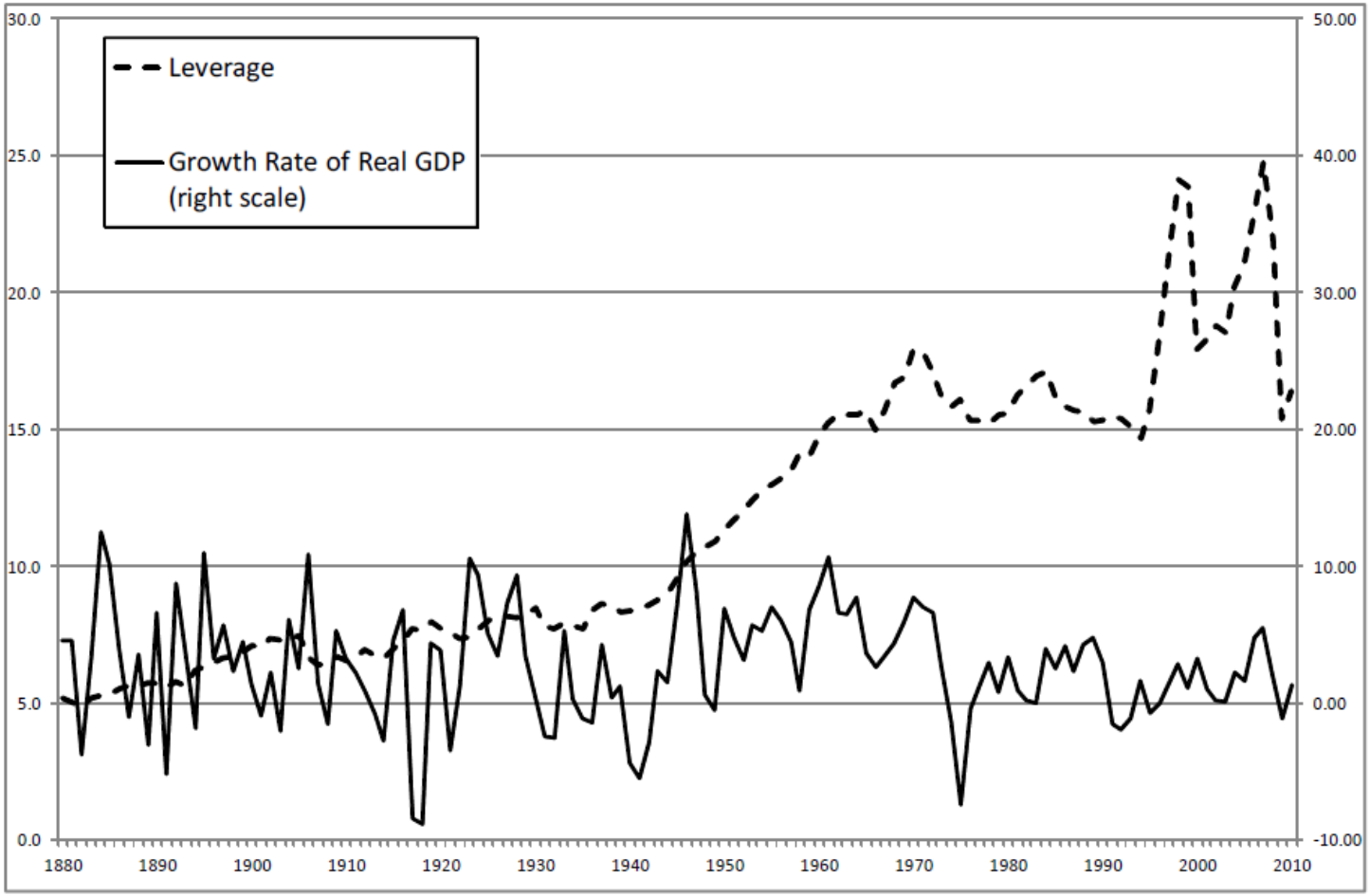


Tom Naratil,
UBS Chief Finance Officer (2015)

«UBS' … support[s] the [banking] industry associations on their positions with regard to the leverage ratio and the standardized approach as misdirected and ineffective measures to reduce complexity.»
«The long-term effects on the economy will be if we drive capital requirements higher. Loans and mortgages will be more expensive.»,
Tom Naratil

https://www.fuw.ch/article/cfo-ubs-swiss-regulation-ist-not-behind/

Leverage and GDP Growth Switzerland 1881-2010



Data definitions and sources: Leverage: discount banks, land credit banks, cantonal banks before 1906, all banks except private banks and foreign banks from 1906 (Swiss economic and social history online database, SNB historical statistics and monthly bulletin). GDP: Nominal GDP (OFS, Comptes nationaux 2008, Crise, épargne des ménages et perspectives historiques, OFS, 2011, Rédaction: Christophe Matthey). Real GDP was obtained by deflating nominal values by the CPI (Swiss economic and social history online database, SNB monthly bulletin).

Source: Georg Junge/Peter Kugler, Quantifying the impact of higher capital requirements on the Swiss economy, Draft: May 17, 2012

Junge & Kugler (2012), Admati & Hellwig (2013)

«**The evidence presented in this article shows that a substantial increase in capital requirements for the Swiss banks will have no long-run negative effects on Swiss GDP**… First, history shows that there have been periods where **Swiss banks operated under much higher capital levels and yet lending spreads and growth conditions remained unaffected.** Second, the econometric analysis confirms the presence of a strong M-M effect. **Accordingly, substantial increases in capital requirements lead to a material reduction of the required return on equity, but only to a modest increase in cost of capital for banks.** This is in line with evidence collected in other countries, in particular the USA and the UK… **The conclusion is that warnings that substantially higher capital requirements would impede Swiss economic growth are not well founded**.» (Junge & Kugler)

«**If a bank is unable to raise new equity because it has not profits to retain or cannot sell shares, there is reason to suspect that the bank is highly distressed or even insolvent**», and «supervisors should examine the loans and other assets... and asssess their values and the likelihood of future losses.» (Admati & Hellwig)

Conclusion
Regulating bank governance

- Proactive Boards in assessing and challenging risk
- «Economizing on Equity» is out. Radical uncertainty in financial markets requires «rules of thumb» or «second best approaches» for managing risk, such as leverage ratios.
- Changing culture – customers come first.
- Rebuilding trust in bankers and regulators requires honest public dialogue and public confidence in decision making.