

All eyes on UBS

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By Dan Slater | 12 February 2008 | FinanceAsia.com

The post-mortem on the credit crunch is already underway at UBS as institutional shareholders attack risk management and foreign capital infusions.

From the sleepy cantons of Switzerland is unexpectedly emerging one of the most wide-ranging attacks on investment banking performance, risk procedures and excessive compensation.

Following expected losses of SFr12.5 billion (\$13.75 billion) in the fourth quarter and SFr4.4 billion for 2007 (the only bank so far, alongside Merrill Lynch, to plunge into the red for the full year), the UBS board in December invited the Government of Singapore Investment Corporation (GIC) and an undisclosed Middle Eastern investor to invest SFr13 billion for 10.4% of the group. Although this seemingly follows the Citi and Merrill model of being bailed out by rich individuals and sovereign wealth funds, the Swiss are kicking up a huge fuss.

In the vanguard is Profond, a Swiss fund with SFr44 million worth of shares in UBS, which is complaining that the infusion will dilute existing shareholders and that existing shareholders should have been given an equal chance to provide the capital instead, either through a rights offering or through a public offer of the mandatory convertible notes that the board wishes to sell to the new investors. Raising their ire is the fact that existing shareholders were excluded from applying for the capital-raising exercise, something Swiss companies may do if it's perceived to be in the interest of the company. Indeed, given that the share price is trading at multi-year lows, investors feel they are unfairly missing out on an attractive opportunity to increase their stakes.

UBS countered in a press release that the outside investors fulfilled the need for "firm and immediate commitment" to capital strengthening, that they are both reputable investors and that any delay could have had a disastrous effect on how the public view the bank. Given the importance to UBS of immensely wealthy individuals, the argument makes sense, as far as it goes.

Another Swiss institution, Ethos (an alliance of pension funds promoting sustainable investment), is asking questions on risk management and ultimate responsibility. For example, many investors see Chairman Marcel Ospel as the real power at the bank, not CEO Marcel Rohner (who replaced the sacked Peter Wuffli last year). Both issues, and a demand for a special audit, are to be discussed at the bank's extraordinary general meeting on February 27.

One Swiss investor, speaking off the record to FinanceAsia, says that there is concern that UBS exhibited a conflict of interest when it came to "managing" and "controlling" risk. The former means the day-to-day

management of risk on trades and ensuring the bank is protected against trading mishaps. The latter refers to a policing function, whereby a wholly independent body verifies that risk standards are not lowered through the desire to maximise income by taking on excess risk. The risk controllers thus supervise the risk managers.

Ethos is focusing on the chairman's Office. This is a unit which bridges the dual-board structure found at many continental companies. It's composed of members of the board of directors and holds regular meetings with the CEO, who runs the more junior group executive board (GEB). The GEB is composed of business unit leaders. According to the UBS handbook, the chairman's office is responsible for the group's risk profile and for audits, among other tasks.

Based on the questions it has tabled to be answered by February 18, Ethos is seeking to find the person ultimately responsible for risk control. It points out that one of the members of the office, Chairman Ospel himself, is described by UBS as "actively supporting major client transactions and initiatives". But the role of supporting clients would appear to contradict the office's role as risk controller, argues Ethos.

Ethos is also asking whether chairman office member Marco Suter, in his function last year as delegate to the GEB's subcommittee on risk, behaved as a genuine risk controller by, for example, exercising his veto on certain trades, and reporting regularly back to the chairman's office. Ethos is querying whether, as the subprime debacle emerged, the office demanded an internal audit, as it is entitled to, and if not, why not? Additionally, Ethos wants answers on risk management/control issues at the proprietary trading platform, Dillon Reed Capital Management (DRCM), which was closed down last year.

Finally, Ethos is zeroing in on the question of compensation, namely how the staff responsible for risk control/management were paid. Given that UBS's internal guidelines warn against payments which involve conflicts of interest, Ethos is asking by what performance measures the group chief risk control officer's and Marco Suter's functions were evaluated, and whether their compensation needs to be revisited in light of recent events. Further, Ethos is wondering whether past profits need to be restated.

The role of DRCM could be important. Like other "in-house hedge funds" DRCM was set up by UBS traders (with UBS approval) using UBS capital but as a separate company.

"A bunch of guys thought that the huge amounts of money they were being paid at UBS was not enough, so they decided to try to get even more money by setting up a hedge fund," says one banker, adding that the positions those bankers took may have been copied at the proprietary trading desk set up within UBS after they left.

UBS has not made clear what proportion of losses come from DRCM, but it may do so when fourth quarter and full year 2007 results come out on February 14.

DRCM was similar to the structured investment vehicles (SIVs) used by the commercial banks: a way of making big bets, off-balance sheet. But just like the SIVs, the losses at DRCM had to be brought back onto the UBS balance sheet, contributing to an as-yet unknown extent to the SF20 billion UBS has lost in the sub-prime debacle – although the original official figure was just SF150 million.

Observers point out that UBS has an apparent lack of financial expertise on its board of directors, despite the inclusion of high profile industrial names such as Helmut Panke, the former chairman of BMW, and Sergio Marchionne, the former CEO of Fiat.

“Considering the business it was involved in, the board seems to have lacked the experience to cope with the challenges its business model was forcing it to face,” says one investor.

According to the UBS website, the board has one finance expert, Lawrence Weinbach, managing partner of Arthur Anderson until 1997 and currently a partner at a private equity firm.

It’s believed in some Swiss investing circles that this apparent lack of financial expertise actually bolsters Ospel, since there is almost nobody with the requisite expertise on the board to challenge him about how he runs the bank.

One trader says that the fate of the investment banking arms at banks like UBS, which were originally commercial banks, contrasts with the success of Goldman Sachs.

“Goldman, although no longer a partnership, has a history of collaboration. People check on each other’s businesses, and it’s okay. There is also a strong top-down message coming from the leaders, who have been doing this very risky business for many decades, have many contacts and push the firm in the direction they want it to go. In contrast, at some of the other banks, if a profitable trading team is investigated they will scream and shout and threaten to leave if they are not left alone. So management often backs off,” he says.

The role played by GIC and the unnamed Middle Eastern investor is being viewed cynically in some quarters. One investor believes that these new shareholders were brought in by Ospel to form a partnership with him. Holding 10% of the company, these investors will be able to control the company. “Assuming that, on average, 30% of shareholders turn up to vote at the AGMs, somebody controlling one-third of that effectively controls the company,” he says.

The suspicion amongst opponents of Ospel is that he has cleverly changed a crisis into an opportunity for consolidating his power by obtaining the support of GIC and the Middle Eastern investor. (GIC and Suter from UBS did not respond to a request for comments for this story).

Some important dates lie ahead. UBS must respond to the questions raised by Ethos by February 18. Earnings are due out on February 14. And on February 27 it is time for the EGM at which these issues will be discussed and the capital raising prospects voted upon. An even more important event will take place in April. This is the ordinary general meeting, where Ospel may try to extend his three-year term as chairman. He appears to have the backing of the board, but it’s rumoured some shareholders are in favour of a change at the helm and would like to see Deutsche Bank’s Josef Ackermann or an official from the Swiss central bank take over. The Swiss are enraged that "local" rival Deutsche generated SF11 billion in profits last year.

Ethos explains its interest in the UBS case as being from the point of view of a pension fund – where long-term investments need to be stable. As such, one member of the foundation told FinanceAsia that it was concerned that companies such as UBS were allowing poor corporate governance and risk control to affect long-term performance.

The Swiss know all about long-term, given their strong private and commercial banking culture. But other countries will doubtless also be asking similar hard questions about an investment banking culture which permits bankers to trade risk, but usually without having to pay for it.

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