# The crisis at the heart of UBS

Swiss banks are supposed to be boring but the crisis at UBS shows how one of Europe's most sensible companies threw caution to the wind. **Lukas Hässig** in Zurich investigates

From as early as 2002, UBS management was warned that it had taken risky positions in mortgage-backed securities. But the Swiss bank continued ploughing money into the infamous CDOs – and was overwhelmed by an avalanche of bad debt in 2007

"Our senior management is unanimous in its aversion to risk-taking. We are known for this on the markets

**Marcel Ospel, former chairman, UBS**

On Tuesday Peter Kurer, the new UBS chairman, fulfilled his first promise. The 59-year-old former company lawyer drew a line under the era of Marcel Ospel, who resigned as head of the Swiss bank in April after seven years in office. Four veteran directors were forced to resign after the bank lost billions of dollars in the US mortgage market.

But restoring confidence in this once impregnable financial powerhouse will take more than management change. An investigation into the cause of the losses at UBS shows how repeated warnings were ignored throughout the company, its culture and reputation for prudence corroded by the short-term riches on offer during the good times.

And the pain goes on. On Friday UBS warned of more write-offs to come on top of the $37bn already put aside to cover losses in the US sub-prime debacle and subsequent credit crisis. Meanwhile, the bank is also involved in a dispute with the American tax authorities that threatens the future of Swiss banking secrecy. The damage to its reputation for prudence is such that even the fabled private banking arm is suffering, seeing a net outflow of deposits from the world's super-rich.

No wonder many investors are pulling out too. Last week the share price plunged to just 19.81 Swiss francs, breaking the previous low set when the bank lost 1bn francs following the collapse of Long Term Capital Management, the hedge fund. Discounting inflation, the UBS share price has fallen by more than 10 per cent since its defining merger with Swiss rival SBC in 1998.

The component parts read like a Who's Who of international banking: Union Bank of Switzerland, Swiss Bank Corporation, Paine Webber, Dillon Read, SG Warburg. From offices in midtown Manhattan and London's Broadgate Centre, its investment bankers had a swagger all of their own.

But no other major European bank has suffered from the credit crunch quite as much as UBS. Over the past 12 months, what was once the epitome of a serious, solid Swiss banking house has turned into a symbol of greed and excess and become a byword for hubris in the world of fast money.

The collapse of UBS has little to do with bad luck and the mistakes of traders. It is rather the result of a banking culture that managed to combine a predilection for risk-taking with an overestimation of its own ability. "Above a certain level, every loss points to a fundamental problem of banking culture and competence," wrote Markus Granziol, the former UBS investment bank director. He was right.

UBS senior management was warned early enough. From April 29 to May 7 2002, risk managers at its Zurich headquarters studied the bank's mounting trades in US mortgage securities. They went to New York and consulted the highly paid traders of the principal finance credit arbitrage (PFCA) and commercial real estate (CRE) arms. On their return to Switzerland, they compiled a report that was designed to wake up UBS senior management to reality.

"PFCA and CRE have built a large real-estate position and now probably hold one of the largest books on the Street," was the risk managers' verdict. Even at this early stage, they had put the bank's involvement in these still little-known mortgage securities at around $25bn. At the exchange rate of the time, this amounted to almost the bank's entire capital of 44bn Swiss francs.

The vast sums had been invested in complex securities, which five years later would go into free fall. Around $10bn was invested in a form of derivative known as a "reference linked notes". By the end of 2007 that figure had climbed to $13bn.

In their report, the risk managers cautioned about the illiquidity of the positions – in other words, that they would be difficult to offload when times got tough, a major factor in the global credit crisis last summer. "A realistic unwind time of their positions is estimated to be between six months and one year," they wrote at the end of May 2002.

The risk managers suggested that the US security positions be subjected to a rigorous stress test. But UBS senior management took its time, and because of internal differences the report was left in the files.

The report from May found its way to senior management nonetheless. It was addressed to the bank's top risk assessor, Walter Stuerzinger, 53, the head of market risk and one of the few hot shots at the old UBS to have successfully weathered the merger with SBC. Marco Suter, 50, whose loyalty to Osper is legendary, was the head of credit risk.

At UBS headquarters, just who should watch over the US mortgage department remained undecided for some time. Investments in ordinary securities were considered market risks. The nature of mortgage-backed securities, by contrast, was more like a credit risk.

In the end, Stuerzinger assumed responsibility. On the advice of Marcel Rohner, 43, now the chief executive, Stuerzinger gave Mark Wallace, the head of risk at the investment bank, the job of carrying out a stress test. His scenario was a 20 to 30 per cent drop in prices in the American property market.

The stress test forecast theoretical losses totalling $500m, which, with a total of $25bn invested in the US mortgage market, was surprisingly small. The correlation between market collapse and the level of losses remained a mystery for the specialists. "We should stop PFCA/CRE getting any bigger than it is now," was the advice of the risk experts. Stuerzinger replied by recommending that the risk analysts seek work elsewhere.

But by 2004 at the latest, the US property issue was on the desk at UBS top management. On October 13 2004, the bank went public. UBS declared that it had become one of the biggest players in asset-backed securities. "Over the past two years, growth in asset-backed securities has outpaced other sectors in the fixed-income markets. At the same time, our investment banks' market share in this sector has grown, leading to an increase in exposure," the bank said.

The UBS board of management apparently failed to question such a substantial involvement in asset-backed securities. Instead, the bank's senior advisers, who include Ernesto Bertarelli, the owner of the America's Cup winning yacht *Alinghi*, opted to alter the bank's method of risk calculation. "The enhanced model adds a number of historical data models, which more closely reflect the individual behaviour of products such as US agency debentures, residential and commercial mortgage-backed services and other asset-backed securities such as credit card and automobile loan receivables," wrote the bank.

As a result, "value at risk" (VaR), the formula that uses statistics to calculate maximum trading losses with 99 per cent accuracy, dropped to 25 per cent. The change, wrote UBS, "reflects in part the increase in our volume of these highly rated fixed-income asset classes over that period".

The document shows that those at the top of UBS were aware of the high levels of investment in the US mortgage market and other asset-backed securities as early as the autumn of 2004. This has been substantiated by statements from an unnamed financial manager who was later to leave UBS. "The collapse of the US property market was known as the single most dangerous risk inside UBS," he revealed recently.

UBS needs to draw a line under the past. Its inner circle still consists of Ospel's colleagues

The high levels of sub-prime investment did not deter UBS from further speculation. At the start of 2005, the father of the successful UBS investment bank, John Costas (now 50), and his key right-hand man and interest rate specialist, Mike Hutchins, 52, opened negotiations with UBS headquarters in Zurich. They wanted to use UBS capital to start a hedge fund, named Dillon Read Capital Management, that could take over all PFCA & CRE business.

In March 2005, Costas informed his superior, Peter Wuffli, 51, the chief executive, in his London office, that he wanted to resign from his directorship of the investment bank in order to take the helm at Dillon Read. Costas said he expected that a "series of dinners" would enable the two sides to find an ideal solution to the situation.

However, less than 48 hours later Wuffli sent an e-mail congratulating Costas on his move. The suspicion remains that Wuffli wanted to be rid of Costas because he considered him a possible rival.

The bank announced the personnel changes at the investment bank and the setting up of Dillon Read at the end of June 2005. A week later, on July 7, Ospel agreed to be interviewed by me. He made some notable comments. Asked whether UBS was running too large a balance sheet with too many risks, Ospel, the then chairman, replied: "We wouldn't be lauded for our caution by the supervisory authorities and the rating agencies if we had an overly risk-laden balance sheet. They study these things on a regular and detailed basis." Ospel praised the caution of his own people. "Our senior management team … is unanimous in its aversion to risk taking. We are known for this on the markets. Those who view matters differently are not looking at things in the proper light."

Ospel added that careful business practice belonged to the "company's DNA" and included Costas in his line-up. "I am known for my strong aversion to risk and John Costas is by nature much more risk-averse than I am," he added.

Today, after the bank has suffered losses totalling billions through US mortgage investments, some of which UBS already had on its books at the time of that conversation, Ospel's credibility has to be called into question. Was he fully convinced of what he said in that conversation? If he was, it shows that he had lost his grip on the business.

The UBS press department argues that in July 2005 the most disastrous investments in US debt securities had not yet been made. "The current loss-making investments do not stem from 2002," says Michael Willi, a press spokesman. He says the current crisis stemmed from "securities based on mortgages which were issued from 2006 to 2007, towards the end of the credit cycle when US mortgage lenders had lowered their standards too far and supplied credits to debtors with a poor credit rating".

But a few weeks after the Dillon Read episode in mid-2005, the new senior management team at the investment bank developed a strategy for growth that would also end in disaster two years later. Costas's successor was Hew Jenkins, 50, who had previously been in charge of the bank's equity business.

Jenkins called on McKinsey, the consulting firm, to investigate areas for growth. McKinsey was well known at UBS. Wuffli had worked for the company in the 1980s and McKinsey had represented UBS. Now their advisers were discovering gaps in emerging markets and raw materials.

A second consulting firm, Mercer Oliver Wyman, a subsidiary of Marsh & McLennan, was asked to produce an analysis on how UBS could close the gap against its competitors in fixed-income trading. When Costas was in charge, the investment bank became one of the top three in share trading and management consultancy, but UBS lagged behind on fixed income despite its huge investments in the US mortgage market.

Mercer's advisers suggested to the new fixed-income manager, Simon Bunce, the successor to Hutchins, that investments should be made in collateralised debt obligations (CDOs). These were collections of sub-prime and other debt securities.

In March 2006 Jenkins presented the growth strategy to the board. As soon as it was approved, David Martin and James Stehli, who were at the UBS New York HQ opposite Radio City Music hall, began piling up a mountain of CDOs. According to the *Shareholder Report on UBS Write Downs* – a UBS report on its sub-prime losses published this spring – the investments in Martin and Stehli's department climbed from nothing to $50bn between February 2006 and September 2007.

The two fixed-income experts appeared to be immune to warnings. John Paulson, the American hedge fund manager, forecast a collapse of the property bubble from 2006 onwards. On March 28 2007, as the sub-prime crisis started to take hold, Martin told investors: "These changes create opportunities for those who can adapt their business models."

Soon after, the Goldman Sachs and Credit Suisse. Even Costas and Hutchins, the former UBS stars, tried to minimise their sub-prime losses at Dillon Read. But it was too late. In May Wuffli pulled the plug, just before he too was forced to resign. Then the sub-prime market collapsed completely and on October 1 UBS wrote off losses totalling $4bn. Switzerland's reputation as a nation of cautious businessmen was exposed as a myth.

Since then UBS has been locked in a downward spiral. Apart from its sub-prime losses, the US tax authorities suspect the bank of systematically helping Americans to evade tax. Their attack is targeted at private banking and wealth management, the heart of UBS.

To recover its status, the bank needs to draw a credible line under its past. Kurer, the chairman, chief executive Rohner and Marco Suter, who has been finance director since October, have all been part of the failed strategy and have allowed a lack of control over the bank's affairs to develop. The inner circle at UBS consists exclusively of Ospel's colleagues. A true fresh start would look rather different.