The UBS Post Mortem: How Not to Organize and Implement Risk Management

UBS took more than $38 billion in write-offs over less than a year. It also fired its chairman, chief executive, chief financial officer and the head of investment banking. The Swiss Federal Banking Commission (SFBC), the bank’s primary supervisor, requested that UBS file a complete report on what went wrong. Shareholder activists threatened to turn to the courts to oblige UBS to release the report publicly. To avoid being compelled to disclose the much lengthier, more detailed report prepared for the SFBC, UBS provided shareholders with the attached 50 page report which describes the origins of its problems and losses to December 31, 2007. In order to preempt suits from its shareholders challenging the accuracy of the report, UBS hired KPMG to affirm that it was a full and fair summary of the official document.

UBS got caught in many of the same problems that brought down other prestigious names in banking, but it was the only bank obliged to explain to its shareholders how it happened.1 I would like to use this case as a springboard for a broader discussion about pitfalls in designing and implementing an effective risk management system. As you read the material please consider the following issues:

The governance of risk at UBS

- Consider the ability of UBS’s board to oversee one of the largest financial institutions in the world. What skill/experience is notably absent among the independent directors on the board? (See the excerpt from the UBS Annual Report for information about the board.)

- What was the board’s apparent appetite for risk? How does the board appear to have expressed its appetite for risk?

- UBS has had a dominant position in the global market for private banking and wealth management services. Why did news of these massive losses threaten its core profitability to a greater extent than similar problems damaged the core profitability at other major firms? How should this vulnerability be expressed in the board’s risk appetite?

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1 The Valukas Report, commissioned by the bankruptcy court, conveys an equally revealing account of what went wrong at Lehman Brothers, but it is 2,300 pages long.
• How were high-level decisions regarding risk transformed into limits for traders, if at all? Focus on the instruments that resulted in the most significant losses. What does this tell you about the goals and priorities of management, and their alignment with risk management?

• Assess the capital allocation system at UBS. What strikes you as a fatal flaw that contributed to excessive expansion in the subprime business?

• The Treasury Division was charged with investing the bank's short-term assets in safe, liquid instruments. Among those investments was a significant amount of super-senior tranches of CDOs. Why would the Treasury Division get involved in this market? Does this indicate to you that the Treasury Division was being run as a utility or as a profit center?

• In March 2007, UBS informed its primary regulator that it had a small net short exposure to subprime real estate in the United States. How could the executives have made such a major mistake regarding not only the size, but also the direction of their exposure?

• UBS appears to have inadvertently created a culture that valued growth over the sustainability of profits. The pay structure failed to differentiate between those using skill to make large returns and those simply executing carry trades. Does this criticism appear to have validity? If so, how would you attempt to correct this distortion?

• Why did the investment bank at UBS depart from its traditional role as intermediary and decide to hold super senior tranches of CDOs rather than repackaging them and selling them to other investors?

Breakdowns in the first and second lines of defense

• UBS appears to have been misled by reliance on VaR-like models and estimates of correlations among various asset classes. How might this have contributed to the mistake in hedging the Amplified Mortgage Portfolio of Super Senior Tranches?

• Critics charged that UBS ‘outsourced’ its risk analysis of CDO tranches to the ratings agencies. Does this seem consistent with the evidence? Leaving aside the key issue that evaluation of credit risk should have been a fundamental responsibility of the bank, what observations should have led them to question the wisdom of this approach?
• When the subprime markets collapsed, UBS tried to take short positions in markets that had been highly correlated with lower quality debt, such as emerging market debt. How was this expected to mitigate their losses? What, in fact, happened?

• What evidence indicates that the investment bank seemed to be attempting to maximize revenue without regard to the trade-off between risk and reward? What are some of the signs that should have been apparent to the third line of defense?

• Why were senior managers unaware that they were holding more than $20 billion of super-senior CDO tranches in various parts of the investment bank when the market collapsed in August 2007? How did traders game the risk management system to conceal their holdings of AAA tranches of securitized assets? What does this suggest about how the management information system at UBS should have been redesigned?

• Although asset securitization was not new product in the run-up to the financial crisis, the application of these techniques to sub-prime mortgages was new. How should risk managers, at all levels, get comfortable with new products and applications?