The Rescue of UBS by the Swiss Confederation

THÉVENOZ, Luc

Abstract

This chapter examines the unique features of the rescue of UBS, Switzerland's largest bank, by the Swiss Confederation and the Swiss National Bank in the particular circumstances of the financial crisis culminating with the failure of Lehmann Brothers in September 2008. It analyses the particular mix of tools used for that purpose, including a capital injection of CHF 6 billion and the purchase of some USD 38.7 billion worth of troubled assets by the Swiss National Bank.

Reference


Available at: http://archive-ouverte.unige.ch/unige:10838

Disclaimer: layout of this document may differ from the published version.
18

THE RESCUE OF UBS

Luc Thévenoz*

A. Introduction

18.01 This financial crisis has required a great number of governments to take dramatic actions to avoid an economic meltdown by rescuing failing banks and other financial institutions. It has resulted in an unprecedented flow of public money into private institutions. In the words of the Governor of the Bank of England echoing an even darker moment of recent history, 'never in the field of financial endeavour has so much money been owed by so few to so many'. Even though all the plans set up to assist or rescue financial institutions use some combination of the same basic tools—capital injection, purchase of illiquid or impaired assets, guarantee of bank debts—they differ significantly from each other. Each one is unique, reflecting the particular circumstances of the recipient institutions and the way it was impacted by the crisis as much as the particular institutional, regulatory, supervisory, and even political setting in the relevant jurisdiction.

18.02 The rescue of UBS by the Swiss government and the Swiss National Bank was set up in a short month to match the particular position of UBS in the global financial sector as much as its unique position within the Swiss economy. It also bears the mark of a political system

---

* Professor at the University of Geneva and director of its Centre for Banking and Financial Law; chairman of the Swiss Takeover Board.


averse to state interventions in the economic market and the reluctance of the Swiss government to become, even momentarily, a shareholder of its largest bank. Considered in retrospect, such reluctance has been vindicated by the second crisis which UBS brought on itself, this one not the result of UBS’s excessive exposure to the subprime and other markets, but the retribution for its aggressive provision of offshore wealth management services to US customers in disregard of US tax and regulatory requirements.3

This chapter examines the unique features of UBS’s rescue by the Swiss Confederation in the light of the particular circumstances which prompted and informed that rescue.

B. Switzerland and its Two ‘Big Babies’

‘The Swiss economy is characterised by a comparatively large banking sector by international standards, and by the dominance of two banks, Credit Suisse and UBS.’4 In its 2009 Financial Stability Report, the Swiss National Bank notes that the banking sector’s total assets (measured by their balance sheets) amounts to some 8.2 times the GDP (down from more than 9 times at the end of 2007), well ahead of any other G-10 economy. Market concentration is high, although not the highest, but notable because UBS—the result of a 1998 merger between Union Bank of Switzerland and Swiss Bank Corporation—and Credit Suisse together account for 73 per cent of all banks’ total assets.

Table 18.1 Size and concentration of the banking sector in OECD countries*

<table>
<thead>
<tr>
<th>Country</th>
<th>Size of the banking sector (ratio of total assets to annual GDP)</th>
<th>Concentration (CR3: assets of the largest three banks as a percentage of total assets)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Switzerland</td>
<td>8.2</td>
<td>76</td>
</tr>
<tr>
<td>Belgium</td>
<td>6.3</td>
<td>89</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5.3</td>
<td>93</td>
</tr>
<tr>
<td>UK</td>
<td>4.3</td>
<td>72</td>
</tr>
<tr>
<td>Germany</td>
<td>3.4</td>
<td>41</td>
</tr>
<tr>
<td>France</td>
<td>3.3</td>
<td>75</td>
</tr>
<tr>
<td>Sweden</td>
<td>3.3</td>
<td>82</td>
</tr>
<tr>
<td>Japan</td>
<td>1.9</td>
<td>52</td>
</tr>
<tr>
<td>Canada</td>
<td>1.8</td>
<td>58</td>
</tr>
<tr>
<td>Italy</td>
<td>1.6</td>
<td>75</td>
</tr>
<tr>
<td>USA</td>
<td>0.9</td>
<td>46</td>
</tr>
</tbody>
</table>

* Ibid.

3 See particularly the Agreement between the United States of America and the Swiss Confederation on the request for information from the Internal Revenue Service of the United States of America regarding UBS AG, a corporation established under the laws of the Swiss Confederation, of 19 August 2009, as well as the Deferred Prosecution Agreement in United States of America v UBS AG, US District Court (Southern District of Florida), case no 09-60033-CR-COHN, filed on 18 February 2009.

These two ‘big babies’ are singular: they are the two largest banks active in the domestic market, inter alia with a joint share of 34 per cent of domestic credits, while being at the same time world leaders in wealth and asset management and bulge-bracket investment banks active in all major markets. The two banks combining a high degree of internationalization and predominant domestic market shares creates a systemic risk which came close to occurring during this crisis when the exposure of UBS to the US subprime market and leveraged financing threatened its existence.

C. UBS in Turmoil

In 2007, UBS was at the same time the global leader in wealth and asset management, a league table investment bank in the USA, and Switzerland’s largest retail and commercial bank. Though not engaged in the origination of mortgages in North America, UBS had developed a very significant asset securitization operation and was warehousing extensive mortgages and mortgage-based assets for securitization purposes. It also actively invested in the secondary market for asset-back securities (ABSs) and collateralized debt obligations (CDOs). Its exposure was compounded by two factors at least. UBS had transferred significant parts of its investment banking business, assets, and personnel into Dillon Read Capital Management, a subsidiary created to allow UBS top-notch clients to invest alongside UBS in some of its most significant proprietary trading books. This obviously reduced the size of UBS investment and activity in the capital markets which its investment banking business unit was keen and prompt to rebuild. This duplication of capacities and exposures occurred at the peak of the market and was fuelled by the overly advantageous financing that the investment bank division obtained internally from its sister asset and wealth management divisions.5

These factors combined with excessive reliance on agency ratings and risk-management and risk-control failures resulted in losses commensurate to UBS’s grandeur. While the second quarter of 2007 was UBS’s most profitable ever, write-downs and losses started accumulating from the third quarter onward. Loss of confidence soon resulted in net outflows of assets under management. UBS’s share price and market capitalization shrunk accordingly. On 10 December 2007, the board of directors announced that the Government of Singapore Investment Corporation Pte Ltd (GIC) and an undisclosed investor in the Middle East had agreed to subscribe to mandatory convertible notes for a total amount of CHF13 billion. An extraordinary general meeting of shareholders authorized the capital increase on 27 February 2008. Meeting two months later for the ordinary general assembly, UBS shareholders agreed to a further capital increase on 23 April 2008 which raised an additional CHF16 billion when sold to the public on 13 June 2008.

The Rescue of UBS

Table 18.2 UBS key figures*

<table>
<thead>
<tr>
<th>Date</th>
<th>Net profit or loss (CHF million)</th>
<th>Total assets (unweighted) (CHF million)</th>
<th>Shareholders’ equity (CHF million)</th>
<th>BIS Tier-1 ratio (%)</th>
<th>Net new money (CHF billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>31.03.2007</td>
<td>3,031</td>
<td>2,516,482</td>
<td>52,967</td>
<td>12.0</td>
<td>52.8</td>
</tr>
<tr>
<td>30.06.2007</td>
<td>5,547</td>
<td>2,542,180</td>
<td>52,802</td>
<td>12.7</td>
<td>34.0</td>
</tr>
<tr>
<td>30.09.2007</td>
<td>-858</td>
<td>2,486,728</td>
<td>49,724</td>
<td>11.0</td>
<td>38.3</td>
</tr>
<tr>
<td>31.12.2007</td>
<td>-12,967</td>
<td>2,274,891</td>
<td>36,875</td>
<td>9.1</td>
<td>15.5</td>
</tr>
<tr>
<td>31.03.2008</td>
<td>-11,617</td>
<td>2,233,142</td>
<td>18,059</td>
<td>7.4</td>
<td>-12.8</td>
</tr>
<tr>
<td>30.06.2008</td>
<td>-395</td>
<td>2,079,753</td>
<td>45,950</td>
<td>12.2</td>
<td>-43.8</td>
</tr>
<tr>
<td>30.09.2008</td>
<td>283</td>
<td>1,996,702</td>
<td>46,419</td>
<td>11.0</td>
<td>-83.6</td>
</tr>
<tr>
<td>31.12.2008</td>
<td>-9,563</td>
<td>2,014,815</td>
<td>32,531</td>
<td>11.0</td>
<td>-85.8</td>
</tr>
<tr>
<td>31.03.2009</td>
<td>-1,975</td>
<td>1,861,326</td>
<td>31,283</td>
<td>10.5</td>
<td>-14.9</td>
</tr>
<tr>
<td>30.06.2009</td>
<td>-1,402</td>
<td>1,599,873</td>
<td>33,545</td>
<td>13.2</td>
<td>-39.5</td>
</tr>
<tr>
<td>30.09.2009</td>
<td>-564</td>
<td>1,476,053</td>
<td>39,536</td>
<td>15.0</td>
<td>-36.7</td>
</tr>
<tr>
<td>31.12.2009</td>
<td>1,205</td>
<td>1,340,538</td>
<td>41,013</td>
<td>15.4</td>
<td>-56.2</td>
</tr>
</tbody>
</table>

* Data compiled from UBS quarterly reports.

On 20 May 2008, UBS raised an additional US$15 billion by selling US$22 billion-worth of residential mortgage-backed securities to a third-party fund managed by BlackRock Inc, the private equity firm. However, it kept exposure to the fund by providing an eight-year amortizing US$11.25 billion senior secured loan.6

When the unthinkable happened and Lehman Brothers filed for bankruptcy on 15 September 2008, the Federal Banking Commission in close consultation with the Swiss National Bank required both UBS and Credit Suisse to take immediate action and increase their capital base so as to reassure the markets and maintain their financing capacity. Credit Suisse, which had started reducing its exposure to the US subprime market earlier, was able to raise CHF10.4 billion capital from private investors and maintain its BIS Tier-1 ratio at around 10 per cent. UBS was not able to do the same. On 16 October 2008 in a dramatic press conference,7 two of the seven members of the Federal Council (the Swiss government), the chairman of the governing board of the Swiss National Bank, and the chairman of the Federal Banking Commission announced a rescue package comprised of two main components.8 The government would put CHF6 billion of Tier-1 capital into UBS while the central bank would purchase up to US$60 billion worth of illiquid assets from UBS.

---

6 See Note 38 in the Financial Information to UBS’s 2008 Annual Report.
8 Switzerland is not a member of the European Union and the choice of words in this chapter does not attempt to be in line with the EU distinction between ‘rescue’ and ‘recovery’ developed for the purpose of the state aids regime under European treaties: see Christos V Gortsos, Assessment of the Banking ‘Rescue’ and ‘Recovery’ plans of the Member States in the European Union, Banking Rescue Measures in EU Member States: Compilation of Briefing Papers, report from the Policy Department Economic and Scientific Policy to the European Parliament, IP/A/ECON/RT/2008-29 (January 2009).
D. The Rescue

18.10 The thinking and discussions that went on between the Swiss authorities and the two big banks between the bankruptcy of Lehman Brothers on 15 September 2008 and the official announcement of UBS’s rescue on 15 October 2008 are not public and were only partially reported upon independently. The fact that there was not even a rumour of UBS and Credit Suisse discussing some form of help with the government is remarkable.

18.11 The problem faced by the regulator, the central bank, and the government was not the solvency of either bank. Despite the write-downs both remained adequately capitalized, though thinly by Swiss standards which have always required more capital than the Basel and later Basel II standards. The real risk was the almost total evaporation of liquidity in most markets and the increasing difficulty of financing their operation. The drying-out of the interbank money market and the worries of depositors and short-term lenders to banks generally raised the risk of shutting down a solvent bank to an unacceptable level. Liquidity cushions were drained at high speed. Credit Suisse and UBS were not in the same situation. Credit Suisse was better able to weather the storm. On the other hand, UBS had written down US$48.2 billion of assets as of 30 September 2008 and was perceived as definitely more fragile, while its strategy and leadership was openly questioned. In short, unlike Credit Suisse, UBS was faring worse than its peers.

18.12 Increasing or uncapping depositor protection was not an adequate response. Though they enjoy a broad base of deposits, the liquidity of both banks fundamentally relies on wholesale funding in the interbank market. Depositor protection may possibly avoid a retail run on the bank but it would not help rolling-over short-term debt in the wholesale market. Indeed neither the original CHF30,000 per depositor protection scheme, nor its increase to CHF100,000 voted by the parliament on 19 December 2009, would cover all UBS depositors because of its global cap of CHF6 billion.

18.13 Even though wholesale short-term financing was the critical point, a public guarantee of notes and bonds issued by UBS and Credit Suisse was not really considered at this stage. One of the reasons was that a significant level of guarantee—as implemented for example

---

9 See, however, M. Zaki, UBS Les dessous d’un scandale: comment l’empire aux trois clés a perdu son pari (Lausanne: Fivre, 2008).
10 As of 10 October 2009, Credit Suisse had made US$15.8 billion write-downs to UBS’s 55.9. (Source: Bloomberg, November 2009.)
11 The relevant amendments to the 1934 Banking Act were adopted on 19 December 2009 and entered into force on the next day: 2009 Recueil officiel du droit fédéral 55. It is an interim measure pending the adoption of a more substantive reform of deposit protection which is currently being considered.
12 The current depositor-protection scheme is not based on the accumulation of premiums into a fund but on ex post contributions by all banks when a depositor-protection event occurs. The total outstanding net contribution is capped at CHF6 billion at any given time. According to the report submitted by the government to the parliament on 5 November 2008, 2008 Feuille fédérale 7951, at 7956, each of eight banks held deposits of more than CHF6 billion. UBS held approximately CHF36 billion of deposits, i.e. six times the system cap. Depositor protection is presently undergoing a major reform, which the parliament must adopt before 31 December 2010 when the temporary amendments voted on 19 December 2008 will expire.
The Rescue of UBS

in the UK and Germany later on—would involve amounts that could not possibly be committed by the government without prior, formal approval by the parliament.

The prevailing analysis was that any relief would require a significant de-leveraging of both banks combining the raising of new core capital with, if necessary, the divestment of those assets that were illiquid and gave rise to damaging write-downs.

For reasons of competitive neutrality, the same relief package was offered to UBS and Credit Suisse. Both were keen to avoid state support and approached private investors. Credit Suisse was successful and raised CHF 10.4 billion from a number of investors. UBS was unable to find additional capital and wound up accepting the rescue package which is analysed below. The private solution of Credit Suisse and the public solution of UBS were publicly announced on 16 October 2008, sealing the failure of what many considered as the world's largest and most successful asset and wealth manager to save itself from the predicament which its investment arm had brought upon it.

(1) Divestiture of Troubled Assets: The SNB Stabilization Fund

Even after US$42.8 billion of write-downs, UBS's main problem remained its inventory of illiquid assets. Not only were they impossible to realize in the short term but their valuation mostly relied on quantitative models based on flawed assumptions. Selling those assets would create liquidity and free up regulatory capital; it would also de-leverage the total balance sheet and contribute to restoring investor and market confidence. The only problem was that there was virtually no market for such assets.13

The most original element of UBS's rescue is the central bank's innovative intervention as the lender of last resort by creating and funding a US$60 billion 'stabilization fund'. The term sheet of the transaction was agreed on 15 October 2008, the day before the whole package was publicly announced. It allows for the purchase of up to US$60 billion of UBS's illiquid assets, consisting of residential and commercial mortgage-backed securities, securities backed by student loans and other asset-backed instruments, US auction rate securities, and monoline wrapped assets.

Assets would be purchased at their value as of 30 September 2008, being the lower of their value in UBS books after write-downs and the value determined on the basis of independent expert opinions. Each transfer to the stabilization fund would be financed by a 10 per cent equity contribution from UBS, which would serve as haircut, and by a 90 per cent loan from the Swiss National Bank (SNB) secured on the assets transferred. The loan would be made for a period of 8 to 12 years and in the same currencies as the assets transferred. It would carry interest at one month-LIBOR in the relevant currencies plus 250 basis points.14

The term sheet contemplated the use of a limited partnership under the law of Cayman Islands, a special purpose vehicle which has been successfully tested time and again,

13 Acknowledging the BlackRock transaction.
14 To finance the loan, the SNB initially used a currency swap facility with the Federal Reserve Bank of New York. In February 2009, it started issuing its own short-term 'SNB USD Bills', which are notes denominated in US dollars with terms of less than one year.
especially for hedge funds. That choice however was not well perceived by the general public in Switzerland. The SNB finally opted for a limited partnership for collective investment (LPCI) governed by Swiss law, a still essentially untested vehicle under the 2006 Federal Act on Collective Investment Schemes. The SNB StabFund Limited Partnership for Collective Investment was licensed by the Swiss Federal Banking Commission on 25 November 2008 and registered on 27 November 2008. Its board consists of three directors appointed by the SNB and two directors appointed by UBS. It is fully consolidated in the financial accounts of the SNB.

18.20 As a limited partnership, the stabilization fund has no shareholder capital. Its general partner and its only limited partner are both Swiss companies limited by shares subscribed and paid for by the SNB. The 10 per cent equity contribution made by UBS for each asset transfer to the fund takes the form of a premium payment for a call option. After the loan from the SNB is repaid in full, the call option will entitle UBS to repurchase the fund for a price of US$1 billion plus 50 per cent of the fund's equity. In other terms, UBS carries the first 10 per cent of the losses incurred on the fund assets. If the fund ultimately turns in a profit, UBS is entitled to half of the profit in excess of US$1 billion.

18.21 Beside this 10 per cent primary loss protection, the SNB holds a warrant on 100 million UBS shares. It can exercise this long-term call option on approximately 2.8 per cent of the current share capital of UBS at the shares' nominal value if it incurs a loss on its loan when liquidating the assets of the fund.

18.22 The stabilization fund has actually acquired a total of US$38.7 billion of assets in three tranches from December 2008 to April 2009. This is significantly less than the maximum of US$60 billion originally contemplated. The target reduction was announced on 10 February 2009 and was essentially motivated by a change in the International Financial Reporting Standards allowing UBS to classify certain assets as loans and receivables which are subject to impairment charges instead of mark-to-market valuation.

18.23 The creation of the stabilization fund is remarkable not so much as a general approach to rescuing troubled banks—indeed, the creation of 'bad banks' is one of the best tested resolution tools—but for its use of a central bank's powers as the lender of last resort. Because of their fiscal implications, 'bad banks' are typically created or authorized by an act of the legislature. A typical instance is the US$700 billion Troubled Asset Relief Program created by the USA in the autumn of 2008. In this case, however, the SNB stabilization fund was created by the board of governors of the central bank based on the bank's mandate to act as the lender of last resort.


Table 18.3  SNB StabFund's portfolio at purchase value (30 September 2008)*

<table>
<thead>
<tr>
<th>Asset class</th>
<th>US$ billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Subprime</td>
<td>5.6</td>
</tr>
<tr>
<td>US Alt-A</td>
<td>2.4</td>
</tr>
<tr>
<td>US Prime</td>
<td>1.9</td>
</tr>
<tr>
<td>US Reference-Linked Notes</td>
<td>5.8</td>
</tr>
<tr>
<td>Commercial Real Estate</td>
<td>5.7</td>
</tr>
<tr>
<td>Student loans (ABS)</td>
<td>0.5</td>
</tr>
<tr>
<td>Other positions</td>
<td>17.5</td>
</tr>
<tr>
<td>Valuation correction</td>
<td>-0.7</td>
</tr>
<tr>
<td><strong>Total portfolio</strong></td>
<td><strong>38.7</strong></td>
</tr>
</tbody>
</table>

* Source: SNB. The purchase value in this table is the aggregate value of each class of assets on the books of UBS as at 30 September 2008. The value correction of minus US$0.7 billion results from their valuation by independent experts as at 30 September 2008.

The Swiss National Bank was founded in 1907. Its current legal mandate is set out in the 2003 National Bank Act. It mandates the bank to 'pursue a monetary policy serving the interests of the country as whole'. It further directs the bank to 'provide the Swiss franc money market with liquidity' and to 'contribute to the stability of the financial system'. 'In performing its monetary tasks . . . , [the bank] may . . . enter into credit transactions with banks and other financial market participants on condition that sufficient collateral is provided for the loans.' Even though the present Act does not refer to the function of lender of last resort, its broad language includes the mandate and the powers for the Swiss National Bank to act as such, as was intended by the legislature.

As early as 2004, the SNB clarified publicly its approach to emergency liquidity assistance (ELA), a departure from its previous constructive ambiguity approach. The SNB Guidelines on Monetary Policy Instruments set out three conditions for such assistance. They first restrict ELA to a 'bank or group of banks . . . of systemic importance for the stability of the financial system'. UBS undoubtedly qualifies under this criterion. The requirement that the beneficiary 'must be solvent' is much more arduous to verify, because it distinguishes liquidity from solvency issues. Liquidity assistance is part of the mandate of the SNB and


18 Arts 5(1) and 5(2)(a) and (e) of the Act.

19 Art 9(1)(e) of the Act.


clearly covered by the language of the 2003 Act quoted above. Conversely, solvency aids were deliberately excluded from the responsibilities of the central bank. Under the Swiss Constitution, such aids fall within the competence of the government and of the parliament because of their fiscal implications. UBS recapitalization is a case in point, as we shall see below. In a financial crisis, liquidity and solvency situations are very hard to distinguish as a matter of fact. Indeed, it may be that liquidity assistance and capital injection must occur at the same time. The Governing Board of the SNB made the purchase of UBS’s illiquid assets conditional upon a recapitalization of at least CHF6 billion by private investors or by the public hand and, second, by requiring the Swiss Federal Banking Commission as UBS’s supervisor to formally certify UBS’s solvency.

18.26 The third requirement for ELA is that ‘sufficient collateral must be provided at all time to cover the liquidity assistance’. The availability and provision of collateral helps only to address liquidity shortfalls. However that a bank must resort to emergency liquidity assistance generally suggests that its most liquid assets have already been used as collateral in other transactions. ELA will therefore typically involve assets which are much less liquid such as mortgages. In the case of UBS, the SNB went two steps further than had been previously contemplated. On one hand, the assets transferred to the stabilization fund are extraordinarily heterogeneous and illiquid, ranging from asset-backed securities to derivatives of all kinds. On the other hand, the assistance was not extended by way of a secured loan, but rather by an asset purchase on a non-recourse basis. In the short term, these assets were not expected fully to cover the loan granted by the SNB to its stabilization fund, even taking into account the 10 per cent haircut which UBS puts up with every asset transfer to the fund. As a matter of fact, the haircut has been wiped out by further write-downs during the first quarter of 2009; on 15 November 2009, the SNB loan to the stabilization fund remained fully covered by the warrant the SNB holds on 100 million UBS shares.

(2) Maintaining Capital Ratios: The Capital Injection by the Swiss Government

18.27 In the opinion of Swiss authorities, taking up to US$60 billion of troubled assets out of the UBS balance sheet would not be enough to restore market and investor confidence in UBS. Some recapitalization was indispensable, not least because transferring assets to the stabilization fund would use UBS capital for 10 per cent of their value. While UBS had successfully raised CHF13 billion of capital from two very substantial institutional investors in December 2007, it was not able to repeat the feat and was left with accepting the public hand.

18.28 The recapitalization for a total amount of CHF6 billion—a figure close to the US$6 billion which would be needed by UBS upon transferring assets to the stabilization fund

---

22 See the government report cited in n 12.
23 Interim results of the SNB as at 30 September 2009, media communication of 15 November 2009. Part of the assets are not fully funded-derivatives so that SNB’s exposure is larger than the current amounts of its loan to the stabilization fund.
The Rescue of UBS

—had to be executed on very short notice, without any time for formal endorsement either by the parliament, whose fiscal powers were required, or by an extraordinary meeting of UBS shareholders. Notably, the UBS board could not use previously authorized capital in any amount near to what was needed. Based on the successful experience gained earlier with the GIC recapitalization, the parties opted for the use of mandatory convertible notes.

Mandatory convertible notes (MCNs) are equity-linked and equity-based financial instruments which may never be redeemed in cash. They thus count from the date of issue as Tier-1 capital for regulatory purposes. Upon their 30-month maturity or upon early redemption at the option of either their holder, the Swiss Confederation, or their issuer, UBS AG, the notes automatically convert into UBS shares. The number of shares will depend on the conversion price determined by the market price of UBS shares during the 15 days preceding conversion within the boundaries of a minimum and a maximum conversion price which are set out before the issuance of the notes. MCNs are debt instruments which carry 12.5 per cent interest per annum until their maturity, even upon early redemption. Because MCNs are Tier-1 capital, coupon payment may be waived by the issuer in certain critical circumstances, unpaid coupons being then converted into additional shares.

MCNs are essentially similar to preferred shares used in other jurisdictions for recapitalizing banks. They are considered as Tier-1 capital. They carry no voting rights until conversion, but provide instead a significant interest payment reflecting the risk incurred by the note holder. Moreover, after an initial lock-up period, they may be converted or resold in the market, permitting an early exit and, if the rescue has turned out to be successful, capturing upside price movements compensating for the downside risk of the recapitalization.

An interesting feature of the recapitalization of UBS by the Swiss Confederation is the decision-making process. Neither the federal constitution nor federal legislation give the government explicit power to directly or indirectly participate in the capital of a bank. This would normally require an Act of Parliament. Both houses of the Federal Assembly regularly sit four times during the year, in March, June, September, and December, for three weeks each time. In any event, the rescue package of which the MCNs are part could not possibly be arranged and debated openly. Swiftness and finality were essential to its success, even though full finality was not entirely possible. On 15 October 2008, the government adopted an ordinance on the basis of emergency powers granted by the Constitution itself. The ordinance is based on Article 184 ‘Foreign relations’, which authorizes the government to act where ‘safeguarding the interest of the country so require . . .’ It also refers to Article 185 ‘External and internal security’ empowering the government to

25 Or any other for-profit corporations, except airline companies. Based on a provision of the 1948 Aviation Act, the Swiss Confederation subscribed to a rights issue of Crossair (now Swiss International Airlines) in 2001/2 in the wake of the grounding of Swissair.

26 Issuance of the MCNs was subject to the decision of the UBS shareholder meeting to authorize the issue of shares into which MCNs would convert.

issue ordinances ‘counter existing or imminent threats of serious disruption to public order or internal or external security’.

18.32 Underwriting the MCNs required an expenditure of public money which must be authorized by both Houses of the parliament. On that front also, the government used an emergency budgetary procedure and at very short notice obtained clearance from a parliamentary committee before adopting the 15 October 2008 ordinance. It sought and obtained the approval of the parliament at its next session, which was given in the terms proposed by the government but not without prior heated debates. Specifically, while the parliament refrained from forbidding the payment of any variable compensation to UBS staff and from setting a cap on individual remuneration packages, it explicitly required UBS to comply with government injunctions in respect of corporate governance.

(3) Capital Requirements, Leverage Ratio, and Compensation Policy

18.33 The 15 October 2008 memorandum of understanding between UBS and the SNB specifically requires UBS to comply with international best practices for compensation schemes and policies to be laid down in consultation with the Swiss Federal Banking Commission. Based on the parliament’s mandate, the government tasked the Federal Banking Commission, UBS’s supervisor, to review and approve the 2008 variable compensation to be paid by UBS. In the wake of government assistance to the financial sector, there is hardly any topic more emotional in the public opinion than performance compensation paid to bank employees during a crisis. What ought probably to have been a decision made by the government’s treasury department was actually delegated to the regulatory agency, a doubtful arrangement. FINMA, the successor to the Federal Banking Commission as of 1 January 2009, finally approved a complex mix of cash payments, deferred conditional cash payments, and share and option programmes in respect of 2008, the total discounted value of which amounted to CHF5.4 billion. The general public showed very little understanding of this approval. The regulator then prepared guidelines for the whole industry. On 21 October 2009, FINMA issued minimal standards which are mandatory for any financial institutions required to hold CHF2 billion or more of regulatory capital; the standards are considered as best practice guidelines and have recommendation value for all other regulated entities.

18.34 The recapitalization of UBS and the defeasance of illiquid assets urgently called for additional regulatory and supervisory measures. And such measures had to address both systematically relevant banks. On 20 November 2008, the SFBC and each bank agreed

---


The Rescue of UBS

on a consent order substantially increasing capital requirements and setting a maximal leverage ratio. At the latest by 2013, UBS and Credit Suisse are required to hold between 150 per cent and 200 per cent of the Basel II Pillar I required capital on a risk-weighted basis. The definition of a capital band rather than a threshold should minimize procyclical effects. In good times, the banks are required to hold 200 per cent of the standard Basel II requirements. This cushion may be lowered to a minimum of 150 per cent in adverse economic circumstances. Below that level, immediate additional measures must be introduced such as raising new capital on the market or limiting dividend payments. For the first time in Switzerland, both consent orders set a minimal leverage ratio of 4 per cent for each regulated entity and a minimum of 3 per cent at group level. These leverage ratios define the proportion of core capital to total (not risk-weighted) assets.\(^{32}\)

(4) The Rescue, 14 Months Later

The help provided to UBS from the public purse and by the central bank has turned out to be reasonably successful so far, though it would be preposterous to write that history before quite some time has elapsed. At the time of writing this chapter, UBS has recently returned to profitability, but the negative set new money is a preoccupation.\(^{33}\) Its shareholders, who held no less than four general meetings in 2008, have only met once in 2009 and approved a further capital increase which raised an additional CHF3.8 billion on 25 June 2009 in a private placement.

After purchasing a total of US$38.7 billion of illiquid assets, the stabilization fund was able to liquidate a significant portion of its assets. Write-downs have wiped out the haircut of 10 per cent but the current loan by the Swiss National Bank to the fund remains covered by the warrant it holds on 100,000,000 UBS shares. Whether the central bank ultimately ends up with a loss can only be ascertained once all assets are sold and the fund is wound up, a process that may take up to 12 years.

The government itself was keen to resell its UBS participation in the market. The initial lock-up period expired on 9 June 2009. Because UBS was in the process of placing new shares, the government agreed to a further lock-up and did not wait much longer. On 19 August 2009, it converted its mandatory convertible notes into UBS shares. The shares were sold for CHF5.4 billion to institutional investors by way of an accelerated bookbuilding private placement while UBS redeemed the outstanding coupons for CHF1.8 billion, resulting in a profit of CHF1.2 billion for the public treasury.

E. An Institutional Viewpoint

Any financial sector rescue plan, be it tailor-made for one bank such as in the case of UBS or designed for a broad class of financial institutions such as TARP, reflects the circumstances of a particular financial crisis, and the particular stage of the crisis when the plan is developed. No less significant are differences in the political and institutional


\(^{33}\) See Table 18.2 above.
framework in each jurisdiction. This includes the regulatory and supervisory arrange­ments, such as whether the bank regulator and the central bank are or are not the same and, if not, the extent and quality of their cooperation. It also includes the powers that the Constitution and the legislature have delegated to the executive branch, including the central bank and regulatory agencies. Political attitudes towards the role of the state in the economy are no less significant.

18.39 In Switzerland, the central bank never was in charge of micro-prudential supervision of banks and financial institutions. From 1934 to 2008, it was part of the core task of the Federal Banking Commission. The creation of FINMA has not changed the existing distinc­tion between the mandate of the central bank, which includes financial stability, and the micro-prudential regulation and supervision entrusted to FINMA. This distinction requires an extensive degree of cooperation between FINMA and the SNB. One pragmatic approach has been for decades that all data provided by the banks for statistical purposes are collected and treated by the SNB on behalf of FINMA as well as on its own behalf. This arrangement requires both institutions to look together at the same set of individual and aggregated data. The collaboration must obviously go much further and deeper. From 2003 onward, it has included preparation of contingency plans for difficulties affecting systematically relevant banks. The ability of the central bank to design and implement at short notice a highly complex liquidity assistance package could only be made possible by increased dialogue between the regulator and the central bank, as well as between them and their two ‘big babies’.

18.40 One possible view of the rescue of UBS announced on 16 October 2008 is of a traditional distribution of roles among the government, the central bank, and the regulator. Only the government had the power and legitimacy to support the solvency of UBS by providing CHF6 billion of capital. By lending up to CHF54 billion to UBS against assets valued at CHF60 billion, the central bank acted in its capacity as lender of last resort. Since liquidity assistance may only be extended to solvent institutions, the solvency of recapitalized UBS was certified by FINMA which in close step raised risk-weighted capital requirements and introduced new leverage ratios and compensation standards.

18.41 Another view would be more critical. In many respects, this rescue package is unorthodox. ‘Bad banks’ are typically created by governments with parliamentary approval because of their fiscal consequences. The rescue of UBS takes another road. Using its emergency powers granted by the Constitution, the Swiss government made a CHF6 billion capital injection which was later ratified by both Houses of the parliament. As would be expected, Members of Parliament were not all overly pleased because they had no real choice. But the issue disappeared ten months later when the government was able to resell its mandatory convertible notes at a hefty profit.

18.42 The most significant part of the rescue package, however, was the purchase of UBS’s illiquid assets by the SNB for up to US$60 billion, 90 per cent of which are funded by the SNB

---

34 Shortly before the crisis, the cooperation framework was set out in a Memorandum of Understanding between the Swiss Federal Banking Commission and the Swiss National Bank in the field of financial stability dated 23 May 2007. A new and extended MoU is expected to be agreed by SNB and FINMA in the near future.
The Rescue of UBS

with a limited recourse to UBS by way of a call option on 2.8 per cent of UBS share capital. The SNB StabFund is a bad bank for UBS’s illiquid assets 10 per cent of which has been funded for by the government subject to parliamentary ratification and 90 per cent by the central bank on the sole authority of its board of governors. The stabilization fund is fully consolidated into the central bank accounts so that the taxpayer bears the risk of loss on these assets until full liquidation. Framed as emergency liquidity assistance, this asset purchase is a very innovative instance of the central bank’s acting as lender of last resort.

One cannot understand the set-up of UBS’s rescue without considering the institutional and political equilibria in Switzerland. The undisputed view that only the government may provide solvency assistance was weakened by a deep political aversion to the federal state’s holding financial and voting rights in economic ventures, however systemically relevant they may be. The grounding of Swissair planes and the ensuing CHF2 billion capital injection was still hovering in the minds of politicians and the public. The Federal Council is made up of seven ministers appointed by the parliament to reflect the respective weights of the five major parties represented in the parliament. The lack of permanent leadership—with a rotation every year when one of the seven members assumes the mostly honorary role of president—within the government contrasts sharply with the strongly centralized and durable leadership provided by the central bank’s three governors with six-year tenure. In addition, the SNB has long enjoyed strong and undisputed independence from the government. This allowed the SNB board of governors to be the leading force in shaping up and taking the financial and fiscal risk of the rescue package.

Even though it is too early to draw lessons from the rescue of UBS, one of those might be that a strongly independent central bank in a politically and institutionally stable country may partially substitute for the government in providing leadership in times of financial crisis. That capacity is not hampered by the fact that the central bank is not the micro-prudential regulator and supervisor. Provided there is intensive cooperation with the latter, this distribution of roles may actually support the monetary mandate by freeing the central bank from conflicts of interest and by buttressing independence in a manner that it could not achieve if it were to assume regulatory powers.
CONTENTS—SUMMARY

Table of Cases  xxv
Table of Legislation  xxxi
Table of International Conventions/Agreements/Regulations etc  xxxix
List of Contributors  xliii

I THE REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

1. The International Financial Architecture and its Reform after the Global Crisis  3
   Mario Giovanoli
2. Reforming the IMF  40
   Sean Hagan
   Jonathan T Fried and James A Haley
4. Standards and the Rule of Law after the Global Financial Crisis  96
   William Blair
5. The G-20 Emphasis on Promoting Integrity in Financial Markets  104
   James H Freis, Jr

II FINANCIAL REGULATION AND SUPERVISION: THE CRISIS TEST

   Christos Gortsos
   Jean-Victor Louis
8. The Basel Committee and EU Banking Regulation in the Aftermath of the Credit Crisis  177
   Klaus Peter Follak
9. Striking Changes in US Banking Supervision and Regulation  204
   Ernest T Patrikis
10. Lessons for 21st-Century Central Bankers: Differences between Investment and Depositary Banking  
*Cynthia Crawford Lichtenstein*

11. The Reform of Financial Regulation in the United Kingdom after the Crisis  
*Sandeep Dhama, John Taylor, and Charles Proctor*

12. Regulation of Rating Agencies: Current and Future  
*Takashi Kubota*

13. Sovereign Wealth Funds and their Regulation  
*John Taylor*

### III FINANCIAL CRISIS RESOLUTION AND LITIGATION ISSUES

14. The Federal Reserve's Response to the Crisis: Doing Whatever it Takes Within its Legal Authority  
*Thomas C Baxter, Jr and David Gross*

15. European Supervisors in the Credit Crisis: Issues of Competence and Competition  
*René Smits*

*Bernd Krauskopf*

17. Cross-border Bank Resolution: A Reform Agenda  
*Eva Hüpkes and Diego Devos*

18. The Rescue of UBS  
*Luc Thévenoz*

19. How Crisis-Resistant is Islamic Finance?  
*Gopala Krishnan K Sundaram*

20. The Donegal Case and the African Legal Support Facility  
*Adesegun Akinjuwon Akin-Olugbade*

21. The Enforcement of Sovereign Debt  
*Engela C Schlemmer*

### IV MONEY, CENTRAL BANKS, AND PAYMENT OBLIGATIONS

22. The Objectives of Central Banks  
*François Gianviti*
23. Neutrality of Money and Central Bank Independence  
   Manuel Monteagudo  
   484
24. In Search of Order in the World Monetary System: State Intervention  
   After the Decline of the Lex Monetae  
   Kazuaki Sono and Hideki Kanda  
   506
25. An Institutional Theory of Money  
   Antonio Sánchez de Vicuña  
   517
26. Transfer of Funds: Investment Rules and their Relationship to Other International Agreements  
   Rudolf Dolzer  
   533
27. Global and Cross-border Credit Transfers: The Role of Legislation in Addressing Legal Risk for Participants  
   Benjamin Geva  
   545
28. Indexation and Value Clauses  
   Charles Proctor  
   575

Index  
   593