1. Introduction

CSRC Vice-Chairman Mr. Chao Li,

Distinguished guests, ladies and gentlemen, good morning,

I am delighted to have the opportunity to join you all here today in Harbin for this conference. Before I start, I would like to express by sincere thanks to the CSRC and SAC for inviting me.

It is especially meaningful that I have been offered this chance to share my views today here in China, a market of key strategic importance for us at UBS. We believe that even as China undergoes a necessary period of economic adjustment in the transition to a consumer-led growth model, the macro trends underlying China's opportunities and long-term growth remain as compelling as ever.

We believe the potential for further growth in China's financial sector remains enormous. In that sense, China is fortunate in being able to review the lessons on risk management learned elsewhere in the world and adapt them to this country's unique circumstances. In this context, it is my pleasure to share with you my perspective on the efforts that have been made internationally to better manage risks and improve financial stability since the end of the financial crisis.

A quick note before I start: While in China banking and securities businesses are separated and regulated by CBRC and CSRC respectively. In Switzerland, the Swiss Financial Market Supervisory Authority: FINMA is the sole supervisor responsible for overseeing UBS as an integrated bank across all its business divisions, Wealth Management, Investment Banking, Asset Management and in Switzerland Retail and Corporates. Its regulations typically apply at group level across all our divisions. It is this perspective of a large global, integrated bank, including a strong investment bank that I will take today.

2. Post financial crisis reform – introduction

The financial crisis exposed the fragility of the financial system, and revealed risks stemming from misaligned economic incentives and at times ineffective regulation. Insufficient internal controls also led to an inappropriate treatment of risk within many financial institutions.

As result, changes and improvements were clearly necessary:

- On the one hand, more effective and internationally coordinated regulation, as well as enhanced supervision of financial institutions were required;
- One the other hand, banks themselves had to strengthen risk management and control frameworks

Today, I will address the developments that have taken place to put into effect both of these changes. I shall start by looking at the area of regulatory reform.

3. Regulatory reform

One of the key lessons from the 2007-2008 crisis was that, in order to re-establish trust and stability in the financial system, better and more internationally coordinated regulation was needed to ensure banks hold more capital and liquidity, as well as to make sure that global banks are resolvable in case they face insolvency.

In other areas, such as remuneration or governance, regulation should rightly remain mainly principle-based, but banks have been challenged to show leadership in complying with the spirit of those principles and develop best practice standards. I will come back to this point later.

As a result, in the immediate aftermath of the crisis, there was a great deal of consensus on global regulatory coordination. The G20 agreed on a number of important initiatives, and international organizations such as the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), were tasked with developing global standards and monitoring their implementation.

A number of very important initiatives arose from these early decisions: Basel III, which imposed on banks stringent new capital and liquidity requirements, was complemented by enhanced supervision for global systemically important financial institutions (G-SIFIs), while the FSB also established standards for recovery and resolution planning and for improving cross-border resolution of large financial institutions. Regulation, however, did not only focus on prudential requirements. The G20, for example, also agreed on a comprehensive reform of the over-the-counter (OTC) derivatives markets, including:

- reporting of all OTC derivatives transactions to trade repositories
- clearing of all standardised OTC derivatives through central counterparties, and

- execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

Let me first turn to the **Basel III** framework, as it is in my perspective the cornerstone of the post-crisis regulatory reform agenda.

- On the capital side, Basel III imposes more stringent capital requirements and larger buffers to cushion against losses. Capital requirements have been specifically enhanced for specific exposures, including market risk, complex securitisation, and counterparty credit risk, all of which led to major losses in the crisis.
- Despite some flaws and complexities, Basel III represents a very strong improvement to the earlier accords. It reflects additional risk types, defines stricter criteria for eligible core capital and strongly increases RWAs ratio requirements.
- Basel III also for the first time includes a leverage ratio globally.
- More recently, the FSB agreed on additional TLAC (total loss absorbing capacity) requirements to complement the Basel III going concern capital requirements. Global systemically important banks (G-SIBs) will be required hold an additional amount of loss absorbing instruments such as bail-in-able bonds, on top of the Basel III capital requirements, in order to facilitate their resolution without impairing financial stability or exposing taxpayers to loss.
- Switzerland, our home jurisdiction, has developed even higher requirements. The Swiss Federal Council has recently adopted amendments to the so-called too-big-to-fail provisions. These new requirements, which must be met by the end of 2019, make the Swiss regime the most demanding in the world on a relative basis. For the large Swiss banks, including UBS, the target going concern requirements amount to a 5% leverage ratio and 14.3% risk-based requirements. The large banks in addition have to hold additional gone concern capital for use in the event of resolution. This is the Swiss implementation of the FSB TLAC concept. These "gone concern" requirements amount to an additional 5% leverage ratio und 14.3% risk-weighted assets.
- Overall, this will lead to total RWA-based capital requirements of 28.6% and 10% leverage ratio in Switzerland.
- But Basel III did not only address capital. On the liquidity side, it also introduced new Liquidity rules (Liquidity Coverage Ratio: LCR; and Net Stable Funding Ratio: NSFR) to strengthen banks’ liquidity risk profiles and promote funding stability.

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A few years after the global agreement on Basel III, a very positive outcome is that these reforms have generally been implemented in a timely manner. According to the latest assessment of the Basel Committee:

- Basel III risk-based capital rules have been rolled out in all 24 FSB jurisdictions.
- Final liquidity rules have been issued in all but two jurisdictions.
- And regulators have set up crisis management groups and developed recovery plans for all G-SIBs.

As a result of these initiatives, financial stability has been considerably enhanced through significantly increased levels of capital, increased liquidity and improved resolvability.

According to Mark Carney, the Chairman of the FSB, if you include all the effects of reduced eligible capital, increase of RWAs and increase in regulatory capital ratios, capital requirements for most banks are now at least seven times the pre-crisis standards. For globally systemic banks, the capital requirements are now as much as ten times what they were before the crisis. And this is without even taking TLAC into account.

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4. Risk management reform

Let me now come to the second part of my speech: risk management. While new regulation can, to some extent, be perceived as the, necessary, external response imposed on the industry, the strengthening of risk management and internal control frameworks is the primary responsibility of banks. In that area, too, strong progress has been made over the last years.

Initially, the aftermath of the financial crisis was characterized by a focus on risk management systems and processes to meet regulatory and market demands for tightened controls and prevent a future crisis from occurring.

But the most recent annual Ernst & Young surveys of risk management in major financial institutions, which are conducted in coordination with the Institute of International Finance, show an evolution of priorities in terms of risk management, highlighting that a consistent theme across the industry has most recently been the degree to which firms are rethinking their approach to managing non-financial risks and risk accountability.

- firms are now looking at non-financial risks in a more granular way — by sub-risk types such as conduct, compliance, reputation, money laundering and systems,
- a very large percentage of financial institutions are now holding the front office — desk heads and business-unit heads — fully accountable for managing a wider view of risk, including non-financial risks, such as conduct and reputational risks, in their areas, and

- 75% of banks participating to the survey responded that they are making changes to their culture, and 81% are saying that cultural change is still very much a work in progress.

In this second part of my speech, I would like to address three specific aspects where we have seen important progress over the last few years: i) stress-testing; ii) culture and conduct risk; as well as iii) compensation, and share with you a few specific UBS examples.

- **Stress testing:** On the prudential side, stress tests grew significantly in importance for regulators and also for use as internal risk management tools. Within the regulatory community, the US Fed is leading the way through its Comprehensive Capital Analysis and Review (CCAR).
- Going forward, stress tests are likely to be used even more as a supervisory tool, with an impact on dividend payments. The requirements on stress testing in terms of data quality and governance will be further enhanced.
- Many firms have developed advanced internal stress-testing frameworks. At UBS, we have a comprehensive stress testing framework and we use stress tests to quantify the loss that could result from extreme, yet plausible macroeconomic and geopolitical stress events.
- Our stress testing framework, along with statistical loss measures, plays a central role in our risk appetite and business planning processes. It relies on three pillars: (i) combined stress tests, (ii) a comprehensive range of portfolio and risk type-specific stress tests and (iii) reverse stress testing. Our combined stress test framework in particular is scenario-based and aims to quantify overall Group-wide losses which could result from a number of potential global systemic events.
- This enables us to identify, better understand and manage our potential vulnerabilities and risk concentrations. Stress testing plays a key role in our limits framework at Group-wide, business division, legal entity and portfolio levels. Results are regularly reported to the highest level of management. We also provide detailed stress-loss analyses to the Swiss Financial Market Supervisory Authority (FINMA) in accordance with its strict requirements.

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- Let me now turn to one of the timeliest topic: **Culture and conduct.** Recently uncovered conduct and compliance failures have resulted in huge financial and reputational costs to the financial industry. Nearly two-thirds of participants to the Ernst & Young survey I mentioned before agreed that lapses in internal oversight and controls are the main reasons for these losses.
- Good conduct and a strong and dynamic risk culture are therefore prerequisites for success in today’s highly complex operating environment.

- Regulators and the industry have taken many steps towards regulating and managing conduct risk and rebuilding culture. At UBS, we are focused on managing conduct risk and fostering and further strengthening our culture as a source of sustainable competitive advantage both from a risk and a performance point of view.
- Our overall compliance program has two core elements: one encouraging people to do the right thing and two monitoring that people do the right thing.
  - *In order to encourage people to do the right thing*, we have developed Principles and Behaviors, articulating what is expected, role modelling the behaviors and building them into day to day processes. We have established three core principles – Client Focus, Excellence, Sustainable Performance – and three behaviors – Integrity, Collaboration, and Challenge – as the guiding framework for our activities. These principles and behaviors have been embedded across key HR processes, from hiring to development and evaluation. This supports embedding culture at all levels of the organization, from top management to front-line staff.
  - *To monitor that people do the right thing*, we have a strong control environment built around a risk assessment that has conduct risk embedded, as well as enhanced monitoring and surveillance. In this context, we concluded in 2015 our program to combine our Compliance and Operational Risk Control functions in order to manage the Group's compliance, conduct and operational risks in a fully integrated manner. This transformation has resulted in a strengthened control environment, the introduction of globally consistent processes, substantial enhancements to our detective control capabilities, and a well-defined operating model which is aligned to the Group's strategy and evolving regulatory requirements.

  - These changes to culture and conduct have been implemented globally. In China as well, our governance structure now has the UBS conduct risk framework fully embedded into it:
    - Our senior management in China have been trained on the importance of conduct risk – how to identify it and what it means to our business, operations and people.
    - The senior governance committees of our key operating entities – (UBS China Limited, our wholly owned foreign bank; UBS Securities, our fully licensed securities joint venture; and UBS Corporate Management Shanghai, our business solutions center – all have conduct risk included in their mandates.
    - To further ensure that conduct risk is embedded in all levels of our organisation, our Country Head has appointed a number of "Conduct Risk Champions" in all of our businesses and functions in China. These Champions have been specially selected for their behaviour and demonstrated attitude towards risk awareness, and going forward will

be tasked with running workshops with all employees to make sure all our staff in China engage in this important topic of Conduct Risk and understand the importance that Conduct Risk plays in their jobs and to us as a firm.

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- The glue that binds these 2 pieces – encouraging people to do the right thing and monitoring that people do the right thing – is aligned incentives. Rewarding good behavior and ensuring poor behaviors has consequences. This leads me to my next point: compensation.

- **Compensation** sets the right incentives. Since the financial crisis, the industry has evolved its compensation practices to ensure tighter alignment to sustainable performance over the longer term.
- At UBS, we have reviewed our compensation framework to reflect our focus on pay for sustainable performance, sound governance and risk awareness. This includes a strong governance and oversight of the compensation process to ensure that we set appropriate incentives and that we support and reward sustainable value creation in the longer-term interest of our shareholders.
- As a concrete example, for each member of our Group Executive Board, at least 80% of the performance award is deferred.

5. Conclusion

Improving risk management in the industry is an ongoing journey. Tremendous progress has certainly been made since the financial crisis, both in terms of complying with new regulation and improving internal processes, but banks must continue to adapt.

- On the one hand, regulation will continue to shape the environment: regulators are already discussing a so-called Basel IV and have not even finished drafting the rules of the post-crisis G20 commitments on OTC derivatives reform.
- On the other hand, risks continue to evolve, with cyber risk for example as one of topics that will certainly continue to draw an increasing share of resources going forward…

In this context, I would like to conclude by encouraging the industry and regulators to collaborate and work together towards a safer financial system. Events such as this one today are in my view very positive and helpful in fostering this collaboration.

It was a pleasure to be given this chance to speak in front of such a distinguished audience. As I mentioned at the beginning of my speech, UBS remains fully committed to China and we very much appreciate these opportunities to share our perspectives with you.

Thank you