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Mr. David Sidwell
Senior Independent Director
UBS Group AG and UBS AG
Bahnhofstrasse 45
8001 Zürich

27 March, 2015

Dear Mr. Sidwell,

I am writing to you to express concerns we have that UBS may be in breach of undertakings it has given in 2008-10 to its shareholders, the Federal Banking Commission, Swiss Parliament and the Swiss Federal Council with respect to the way in which it funds its various business activities, and more specifically the way it funds the Investment Bank[1]. It may also be the case that the financial information published by UBS – and in particular its segmental accounts – give a misleading picture of the true profits or losses of the Investment Bank and that the Board of Directors has for years been endorsing the Group's strategy based on these numbers.

I do not make these statements lightly, and given the gravity of the issue it may be appropriate for the Board of Directors rather than the Group Executive Board to appoint independent accountants to look into the issues and report on their findings. Given that in the past all correspondence sent to the Chairman has systematically been re-directed to members of the Group Executive Board, I am sending this letter to you in your capacity as Senior Independent Director.

Hidden Subsidies/ Broken Promises

It is a matter of public record that the Investment Bank (IB) suffered catastrophic losses during the recent financial crisis – losses that in total amounted to more than 10% of Switzerland's GDP. The magnitude of these losses was such that UBS was required by the Federal Banking Commission to publish a special report (the "Shareholder Report on the Causes of UBS's Write-Downs") setting out the principal causes. In this report UBS identifies the causes of its losses that are specific to its sub-prime business but also the causes "that UBS believes are structural and thus relevant to more than

[1] When we refer to the Investment Bank this includes both Core and Non-Core/ Legacy businesses. Similarly, when we refer to Wealth Management (WM) this also includes Wealth Management Americas, which we treat as being part of the same business.

one business or the UBS Group overall" (also referred to as the "overarching causes" of these losses).[2]

One of these "overarching causes" was UBS' failure to charge an appropriate risk-adjusted cost of capital to the IB's activities, thereby resulting in the IB's true profits or losses being misreported and excessive risk being taken:

- "Given the internal funding rates in the UBS Funds Pricing Policy as it existed at the relevant times, UBS's businesses generally were able to fund themselves internally at prices that were better than those available in the market … Effectively the full benefit of UBS's ability to obtain funding at a relatively low cost in the market was passed through to the business, without any adjustment to reflect the nature of the relevant business activity … The Funds Pricing Policy made trades more profitable than they would otherwise have been, as even investments in instruments generating small yields still were profitable." (2008 Shareholder Report, p. 36)

According to the 2008 Annual Report and 2008 Prospectus, *inter alia*, the problem was rectified as follows:

- "A new liquidity and funding framework was introduced that requires each business division to be charged market-based rates for funding from other UBS divisions." (2008 Annual Report, p. 2)

- "In order to encourage a more disciplined use of UBS' balance sheet, the internal pricing applied for the Investment Bank reflects UBS's funding costs, plus an add-on to align the price more closely to the prices of defined peer firms … As a result of this change, the cost of funding in the Investment Bank now better reflects the liquidity of the underlying assets being funded and is comparable with the costs applicable to its peer group". (2008 Prospectus, p. 3)

Furthermore, UBS repeatedly commits to minimizing cross-divisional subsidies:

- "Our internal funds transfer pricing system is designed to provide the proper liability structure to support the assets and planned activities of each business division while minimizing cross-divisional subsidies… Funding is internally transferred or allocated among businesses at rates and tenors that reflect each business's asset composition, liquidity and reliable external funding." (2014 Annual Report, pp. 240-241)

It is clear from these paragraphs that the spirit of the reforms that management and the Board were required to introduce is intended to ensure that each of UBS' businesses receives funding and capital on the basis of its stand-alone risk profile, i.e., without internal cross-subsidies.

Our understanding, until quite recently, was that these principles formed the basis on which funding and capital were indeed being allocated internally and this, in turn, formed the basis of the various proposals we have made to restructure UBS.

[2] See Shareholder Report on UBS's Write Downs (18 April, 2008), page 32.

In reality, however, it appears that the IB's reported results and attributed equity do not reflect what management believes to be its true stand-alone funding costs or its true stand-alone capital requirements. This is clear from a letter that we received from Tom Naratil, Group CFO, on 2 September, 2014 which we then discussed with him during a meeting in Zürich on 9 December, 2014.[3]

During the meeting, Mr. Naratil emphasized to us that UBS' management believes that as a stand-alone entity the IB would not be able to fund itself in the market at rates that are as favourable as those that the IB receives from UBS and that the stand-alone IB might even not be regarded as investment grade. We were also given to understand that the capital required by the IB to operate on a stand-alone basis would be higher – not lower – than the capital that it requires as part of the UBS Group today.

If this is the case, this would suggest that the rest of the Group is bearing a huge burden to support a business whose economic profits are less than its reported profits and may be fundamentally unviable without substantially more capital than it has today. The IB may, in fact, be worthless once its true capital requirements are taken into account.

The amounts are not trivial. Based on public disclosures, it appears that the IB has received funding from the rest of the Group ranging from CHF 750 billion to CHF 140 billion today.[4] If we assume that the subsidy is equal to the difference between UBS' average cost of funds and the average cost of funds for a range of investment banking firms with weaker credit ratings such as Morgan Stanley or Jefferies, the total amounts to approximately CHF 6-22 billion for the period from 2009-14 and CHF 0.6–2.1 billion for 2014 alone. The weaker the IB's assumed credit rating, the greater the subsidies.

The risk for the Board is that the market may have been misled and that UBS may have operated for years in direct violation of the spirit of the undertakings given to its shareholders and to the Federal Banking Commission – as well as Switzerland's Parliament and even the Swiss Federal Council[5] – thereby exposing the Group to the risk of further penalties and reputational damage.

It is hard to understand how the Board of Directors could have allowed this to happen and in practice there are only three possible explanations: (i) the Board knew about it but chose not to intervene, which we believe is unlikely; (ii) the Board was completely unaware and was therefore ineffective; or (iii) the Board knew about it but relied too readily on management's views and was not prepared to challenge these. None of these is an acceptable explanation.

Clearly, however, UBS' most senior managers were well aware of the situation.

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[3] Mr. Naratil's letter dated 2 September 2014 invites us to apply "more realistic assumptions … regarding the **funding costs**, credit ratings **and capital requirements** of a standalone Investment Bank" [emphasis added].

[4] We have assumed IB internal funding to be equal to Funded Assets less Trading Liabilities less Attributed Equity.

[5] See the Transparency Report, published in October 2010 in response to the Parliamentary Control Committees' recommendations that were seconded by the Swiss Federal Council.

Corporate Culture

The 2010 Transparency Report attributes much of the blame for the losses incurred in 2007-09 to UBS' corporate culture, highlighting the need for a major change. The issues discussed in this letter suggest that the corporate culture at UBS may in fact have changed very little since then. Notwithstanding the official company line that places wealth management at the centre of the Group's strategy and thinking, the reality appears to be that the Group Executive Board is still dominated by current and former investment bankers and that the balance of power between the Board of Directors and Group Executive Board is resolutely tilted in favour of the latter.

Ultimately, however, the real problem may be that UBS as an organization is too large and too complex to manage and effectively govern – the fruit of a strategy built on takeovers that in many cases have yet to be properly integrated. The fact that Operational Risk – that is to say risk associated with human error or misconduct – is so high at UBS in relation to Credit and Market Risk [6] (the ratio is the highest among all of UBS' largest peers) is a telling indicator of how much of an issue this is. The fact that the Board may have failed to detect that the IB continues to receive a huge funding subsidy merely highlights these risks.

This leads us to the conclusion that UBS needs to be radically streamlined, just as many of its global universal banking peers are doing – with a new strategy and possibly under new management – or absorbed into an organization that is better able to take on this task. What we find difficult to accept is the notion – embedded in UBS' poor stock market performance of late – that UBS must inevitably carry the burden of an unviable IB. This is fundamentally an issue of governance that can be resolved.

Strategic Options

During the course of our past discussions, UBS' Chairman, Group CEO and Group CFO have all repeatedly defended the Group's universal banking strategy on the grounds of supposed synergies between WM and IB but have been unable (or unwilling) to quantify these.

The main reason, we believe, is that the IB continues to be funded at below market rates by the rest of the Group and that a transparent and informed debate on the value of synergies might result in the IB losing what is probably the single most valuable advantage that it derives from belonging to the UBS Group.

Our own view on the question of synergies is that there may well be some advantage in being able to offer M&A, corporate finance and other IB services that require little or no capital to entrepreneurial WM clients who own their own businesses, particularly in Asia, but this does not extend to trading on a large scale.

[6] As measured by Operational RWA to Total RWA.

The destruction in shareholder value that is associated with subsidising the IB is vast in relation to these synergies. Assuming that IB is valued at, say, a P/E of 6x and that WM is valued at 18x, every CHF 1 billion of earnings that is transferred from WM to IB results in a loss in value of CHF 12 billion for shareholders. **This can only be described as a negative synergy.**

There are several alternatives that come to mind, each of which would materially de-risk UBS and result in significant incremental value for shareholders.

1. The IB's trading books could be liquidated just as the Non-Core portfolio is being liquidated (i.e. leaving only corporate finance, M&A and other IB services that require little or no capital); or

2. The IB could be spun off, re-incorporated outside of Switzerland and simultaneously merged with another mid-sized investment bank so as to allow the combined entity to achieve economies of scale that are sufficient to cover the fixed costs associated with running large trading platforms; or

3. UBS itself could combine with one of its universal banking peers and their combined investment banks could be spun off.

Under alternatives 2 or 3 UBS could, of course, structure an arrangement with the spun off investment bank such that it is able to provide corporate finance, M&A and other IB services to its WM clients; this arrangement could even contemplate UBS retaining a small minority stake in a spun off IB.

Recommendations

Attached to this letter is an Appendix with a list of 10 questions that I would respectfully ask you to submit to your fellow members of the Board of Directors relating to the subject matter of this letter. I hope that you will find it to be useful in thinking about the issues.

As mentioned in the introduction, the gravity of these issues is such that the Board of Directors (and not the Group Executive Board) should appoint independent accountants to conduct an audit and should spontaneously publish their findings as soon as possible so as to minimize the risk of penalties or further reputational damage.

Given the complexity of UBS as an organization and the high level of Operational Risk that it carries, I would also recommend that the independent members of the Board of Directors appoint an independent financial advisor to assist them in considering whether there is any way that UBS could pursue a value creating strategy focused essentially on wealth and asset management – without the risks and organizational complexity associated with running global trading platforms. The Board cannot rely solely, or even principally, on advice from UBS's Investment Bank as this creates fundamental conflicts of interest.

Finally, notwithstanding the fact that the Nomination Committee has already made its selection of candidates for election to the Board of Directors this year, I thought I should let you know that I would be prepared in principle to serve as a member of the Board, if invited to do so. As discussed in this letter, I feel that the Board of Directors may be too dependent on the views of current or former investment banking professionals who play a leading role within the Group Executive Board.

A copy of this letter is being sent to FINMA, the Swiss National Bank and the Federal Department of Finance in view of the importance of these matters.

I look forward to receiving your response as soon as possible.

Yours sincerely

Eric Knight

cc: FINMA – Mr. Mark Branson, Chief Executive Officer
SNB – Dr. Thomas J. Jordan, Chairman of the Governing Board
Federal Dept. of Finance – Federal Councillor Eveline Widmer-Schlumpf, Head of the FDF

10 Questions for the Members of the Board of Directors of UBS

1. IFRS 8 requires that segmental reporting be consistent with management reporting and yet intra-Group funding has not been disclosed in UBS' annual reports since 2009. Is the Board properly informed about the Group's internal funding arrangements and are the terms of such funding being independently verified and benchmarked against those that the market provides to independent peers?

2. Is the Board aware that, according to the Group CFO, a stand-alone IB would pay significantly more for funding than it does today?

3. How does this square with commitments made by UBS to its shareholders, regulators and Swiss Parliament in 2008-10 to ensure that internal funding is only provided to IB at arms' length market rates?

4. Does this not imply that IB is effectively being subsidized and, if so, how does this square with statements made by UBS in its 2014 annual report implying that business units are <u>not</u> subsidized?

5. How much capital does the Board think a stand-alone IB would require?

6. Is the IB not likely to require this higher level of capitalization even if it remains part of the UBS Group – given the regulators' desire to segregate the risky IB business from the systemically more significant payments and deposit taking businesses in Switzerland?

7. How would this scenario be compatible with UBS' "generous" capital distribution strategy which aims to return surplus capital to shareholders? Is it sensible for UBS to be challenging its regulators in this way?

8. If IB receives a subsidy from Wealth Management and Swiss Banking, this would imply that its economic profit is not as great as the reported profit and that IB executive compensation is being inflated to the detriment of that of employees in Wealth Management and Swiss Banking. How does the Board respond to this?

9. If IB has almost no economic profits at all, does it have any value? Would the subsidy that it receives from Wealth Management and Swiss Banking not be more valuable to shareholders were it to be re-integrated into the profits of the latter? Is this not, in effect, leading to a massive destruction of value (i.e. a negative synergy)?

10. If the cost of capital used by IB to make investment decisions is artificially low, does this not re-create some of the risks that led to UBS' near collapse in 2008?