UBS CEO speaks at the Deutsche Bank Global Financial Services Conference

Q&A discussion
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Speakers: Sergio P. Ermotti, UBS Group AG CEO and Kinner Lakhani, Deutsche Bank head of European banks research

Kinner Lakhani:

Okay, good morning everyone!

Welcome again to Deutsche Bank's 8th Global Financial Services Conference. My name is Kinner Lakhani, I run the European banks research effort, and it is a great pleasure to have with us today UBS CEO Sergio Ermotti. So I thought maybe I will kick off with a few questions, and then hopefully the audience can come in and ask whatever questions they have.

So we have 45 minutes this morning, so thanks again Sergio, for joining us.

I guess thinking about strategic developments over the last 12 months, we have probably had the largest wealth management merger since UBS SBC, albeit an internal merger between your wealth management and wealth management Americas business.

So I wonder if you could maybe spend a few minutes to map out what you see in the short term, maybe more in the medium term, as the opportunities for the group, perhaps both from a strategic perspective, from a cost perspective, and from a revenue perspective.

Sergio P. Ermotti:

Yes, actually if you think about that, the decision was almost a natural evolution of what happened in the last few years with the U.S. businesses and the international businesses, reshaping themselves into the new paradigm, and in the last two years they have been starting to converge in terms of how they look at services, how they look at products. So for us the opportunity was really to tackle the next phase in making sure that we have the engine behind our goals to improve our pre-tax profit margins by double digits over the next few years, like we did in the last five-six years. And we really felt it was necessary to go to a next level in how we look at clients.

There is a high convergence of needs across the globe, particularly in our ultra space and in our GFO space. We do see more and more clients looking for the same kind of solution and so the synergies were quite natural.

We also see that post FATCA, post cross-border automatic exchange of information, it made it much easier for us and for everybody to operate and serve, for example, U.S. citizens, U.S. persons, internationally. That was for us a pretty difficult time, a really complex issue to handle, so we could not really exploit one of the biggest, largest wallets of assets in the world. Now we do believe that bringing together teams is going to improve the situation. We can serve better non-U.S. citizens that want to come into the U.S. and invest. Definitely we have a big opportunity to merge the two Latin American businesses that we had before.

And it is not just an issue of cost. I think it creates completely a different dynamic and offering.

In a nutshell, it is a combination of fostering growth and also addressing some opportunities in the way we look at costs. For example, we didn't really need to have two financial officers, two legal teams, two CRO organizations and we are freeing up resources for the future – we can look at expanding and using not only products but also technology applications, although it is not so easy to bring the international platform into the U.S., but there are modules that we can leverage more.

In a nutshell, I do think that this is really the natural evolution for us in looking forward and in serving better our clients and capturing growth.

Kinner Lakhani:

Alright, so would you say it is the ultra-high net worth clients that have the greatest commonality between the Americas business and the international business?

Sergio P. Ermotti:

Absolutely, yes, at the end of the day, we already see, when we talk about non-U.S. clients or the commonality on how they look at using our multi-booking center capabilities, how they look at products, that it is converging.

And here it is very important for us to bring the expertise of both sides together, such as best practices in the U.S. to the rest of the world. And I am very happy to see that there is momentum already building up in the interaction between the two teams' functions.

Because as you know, in large organizations there is a limit on how much you can foster collaboration if you have different business divisions and different businesses.

Once you bring them under one umbrella, there is a natural incentive to work together. And I see a lot of interaction between our colleagues from the U.S. and the rest of the world translating into better opportunities for us.

Kinner Lakhani:

Right, maybe switching to digital investments: You announced, I think, in your full-year results a 1 billion investment program, or an incremental 1 billion investment program over the next three years: Could you maybe elaborate on that in terms of where the money is being deployed and where you see the competitive advantages materializing from those investments?

Sergio P. Ermotti:

Well, let me start with saying that continuing to invest in technology is critical to be successful in the future, I am totally convinced of this. Of course, we look at how we invest money: technology is pretty much defined by enhancing client experience, and then in digital channels, in the way we interact with clients. Also I would say the second very important issue is product and execution capabilities, speed, quality. And the third one, which I think is the game-changer for the industry and for us, long term, is how you become more efficient and effective in the way you invest in technology.

That's the reason why I don't think it's sustainable to think that technology is an area where you cut costs.

Technology is a means to save costs. And in that sense we are starting to see how technology helps us to achieve our cost targets in the rest of the organization: Our goal is to take Corporate Center down by 2 or 3% a year, by using technology [corrected from original].

Because of what happened in the last few years, we made a lot of investments and we continue to do so. These are cash investments that are recognized through P&L, but also we are capitalizing part of these developments that are going to be used over the next 5 to 10 years potentially – because the truth of the matter in banking is that it is quite difficult to think that you develop something and then you throw it away after 5 years. The length of how long it stays with you is very important.

We are capitalizing part of it and on spending we are seeing already the trend changing away from spend into remediation and regulatory requirements. For example, we had to spend a lot of money in defining our group structure, from a parent company into a holding company with subsidiaries.

Over the next one or two years we expect this go down, and we will continue to invest in serving our clients, and doing our back-office and back-end more efficiently.

So across the board we invest money in all businesses: look at wealth management, we have now de facto one platform for all non-U.S. businesses, which gives us a competitive advantage where we compete. We are already a leader both in terms of size and cost-income ratio, and growth will come at a marginally lower cost than our competitors.

And by doing that we also create a better environment, to onboard clients, to be compliant, to share product capabilities. We are making investments here in the U.S., we are starting to see the developments of our cooperation with SigFig of our advice advantage program, where we give our non-FA channels the opportunity to leverage on technology.

In the IB, our technology developments are in Neo, the FX platform, and also in the research, in Switzerland we are developing by 2020 a fully digitalized offering.

And last but not least the back-end, we have been rolling out almost 400 robot applications at the end of 2017 – we are going to more than double that by the end of the year.

This is already translating into savings.

So technology is really a means to change our bank, front to back. So we have to expect this cost base of 10% of the top line to continue to be there for the foreseeable future.

Kinner Lakhani:

And in terms of leveraging the scale of the UBS wealth management business, I understand that you are rolling out the One Wealth Platform across the world. Could you maybe give us a bit more background on that? And where you are in that process?

Sergio P. Ermotti:

Well, for us, I think the result of those investments in the last 3-4 years allowed us today to have north of 85% of the non-U.S. assets booked onto one platform – which is, I would call it, a more brother-and-sister platform, not yet one, but it is quite close. It is allowing us, as I mentioned before, to onboard clients faster, have less manual intervention by our client advisors in the way they process any kind of execution capabilities, payments, anything which is of an administrative nature – it is allowing us to serve clients faster. So the client experience and also the product output is allowing us to capture the economy of scale that I mentioned before. So the main booking centers are Switzerland, Europe and Asia and they basically share the same platform.

And this is unique because there is no asset manager that has such a starting position, and in the next 18 months we are going to fine-tune this platform further, and make it even easier for us to work together and create economies of scale. And as I said before this is very important, it means that we can respond to product and client needs faster on a global basis, rather than having local champions.

Particularly in Asia, where we see superior growth in terms of long-term developments, we are going to have a chance to continue to be best-in-class.

Kinner Lakhani:

So I guess given that you mentioned Asia, maybe we could talk about China a bit – there are potentially some changes coming through in China, particularly in relation to foreign ownership.

And I know UBS has been clearly investing a material amount of resources into China – so, how do you see the Chinese growth opportunity across your businesses?

Sergio P. Ermotti:

Well, China and Asia for us is a fantastic story – I think, arguably we have one of the best, if not the best, franchise if you look in aggregate at our wealth management, our IB and our asset management capabilities we have an excellent base to start with to exploit the next phase of investments. I think it is clear that the new opportunities coming from bond connect, Shanghai London connect, the opening up of the domestic markets, the inclusion of the A shares into the MSCI, it's all an opportunity for us. Also to be able to go above 50% in controlling the local subsidiaries. These are all the ingredients that are going to fuel the next phase of growth, across all businesses.

If I look in the investment bank, for sure we are really very well-positioned and there the trends I mentioned before, of inflows into China but also outflows out of China in the future, we have a set-up that will help us to serve that.

In wealth management, we are waiting for the licenses to be able to operate locally in Renminbi and provide services. It’s an enormous opportunity, because that is really basically a market that has still a brokerage culture, not yet a wealth management culture – and we do believe that going forward, as wealth gets created because as you know, every three or four days there is a new billionaire in China, and so you can imagine how many multi-millionaires are created on a daily basis, is a huge opportunity for us.

And not only in terms of serving clients directly, but also helping other banks and financial institutions, to bring in expertise and best-in-class, and to become a bank for banks.

And also last but not least, in asset management, we already had some good success in developing onshore capabilities – our own products, but also in helping foreign investors to tap the local bond markets with dedicated products.

So I see opportunities coming for us for the next 10 years.

It is going to be gradual, but we have been investing in China since the 90s.

And in the last 10-15 years, on a faster pace, and very constantly – we were not pulling away or adding more depending on tactical market situations. We have been committed to Asia for 50 years or more, and in the last 20 years in China, and we will continue to do so.

So we have an excellent franchise there and my goal, and my colleagues' goal, is to leave to the next generation of colleagues at UBS, but also clients, as much opportunity as we have today in working with this fantastic franchise.

Question from the audience:

Hey, good morning: So one question. Some of your management team colleagues have been rather vocal recently on U.S.A. and corporate finance expansion, so why do you think now is a good time to break into the top-ten, why UBS is well-positioned to gain market-share in this market?

Sergio P. Ermotti:

If I look at our existing capabilities in the U.S. they are already pretty good and strong across the board, but of course there are areas where we can invest and solidify our position. One area is in the corporate M&A space, in the origination space, and it is all about tapping opportunities that are serving us in order to help the U.S. business and there is a big opportunity also for us coming from a closer cooperation, particularly with ultra and GFO clients with the IB in the U.S.

So we need to build up capabilities to be close to help those clients to monetize, to risk manage, to create structures where the IB and origination capabilities can be of advantage, but also helping our global franchise to be more diversified.

So, in a nutshell, I think it is a continuation of what have been doing in the last few years. We are not obsessed about closing certain gaps quickly. And at UBS we have today, for sure in the IB, a unique model that has been quite successful if I look back the last five years.

And so we are focused on creating strong capabilities in each region, and the sum of this makes it a valuable business.

Question from the audience:

Thank you, sir, one more question on wealth management, in particular ultra-high net worth individuals when it comes to margin pressure going forward. Could you elaborate a little bit more, where do you think the next 2 to 3 years, what will happen to margins?

Sergio P. Ermotti:

I think it's clear that margins will continue, not only in wealth management but also in asset management, gross margins will continue to be under pressure. There is no doubt in my mind.

And that is, if I look at the last 5 years, 6 years, we have been de facto going through a massive contraction of gross margins but we improved our net margins.

So the solution here is multi-facet, you have to work on different levers – first of all diversification of your revenue lines. For example in the last few years we improved dramatically our penetration of mandates, we focus on advisory fees, on lending, on other ways to enhance the profitability, and on the other hand, costs.

So of course what we aim to do is to create, over time, the efficiency in the back-end, the efficiency in our operation – that are then available to create three dynamics:

1) One is to pass those savings to clients;
2) The second is to re-invest in our future;
3) And the third is to give part of it to shareholders.

So, it is quite impossible to think that in the future you won't see pressure on the top line. Even when you look at the developments on the deposit side of the equation, even when rates are normalizing, I would say it is wishful thinking that the margins on the deposits will be the ones we saw before the financial crisis or before rates started to go down to almost 0 or negative. There is going to be for sure a different dynamic and different game in terms of how banks are funded and the transparency the investors are getting nowadays will also put pressure there.

But of course you need to think about how you are going to be more efficient across the board. And there is no excuse not to create value if you have top-line pressure.

Question from the audience:

Good morning, Martin Zeman, I work for wealth management, Deutsche Bank. I would like to ask you a question on the European banking industry in general, relative to the U.S. banking industry. I think we look over the past few years, judged by the share price performance, most of the European banks have struggled. And in your opinion, what is it going to take for the European banks to catch up in terms of interest rate environment, costs, regulations, for us to see the European banks perform again as well as the U.S. banks have performed over the last 5-6 years?

Sergio P. Ermotti:

Well, first of all, I don't think this question can be answered in a way that is applicable to every bank. So I think that first of all, I do think the refocusing and reshaping of each bank, particularly the larger ones, but not only on what you stand for. What kind of business you are specialized? What is your added value? What is the starting position? Then you could argue, compared to the U.S., of course you need to have for any kind of activities in banking, but particularly for the more traditional ones, the levers that are normally positive for banking. For example a rates environment that is positive and not negative – because this a huge headwind for every bank – particularly for more traditional banks.

So a normalization of rates, because even if in the U.S. the rates were low, they were never really negative.

And as a big source of headwinds for the industry, you need to have underlying economic growth across the region that sustains credit in a positive way. If you have no underlying economic growth that is meant to be sustainable, it is difficult to see how people, how banks can develop.

I think that you need to have regulatory changes that allow a reduction of the huge fragmentation that you have in the U.S. I mean if you look at the landscape of banking in Europe, it is extremely fragmented. Of course in the U.S. you can argue that you have 5,000 or more banks, but if you look at the top 5-10 banks, they have scale, they have unique opportunities. I do think that a true Europe needs to also have scale, but focused scale; scale just for the sake of being big doesn't really change anything. But if you try to have a combination where scale and strategy can be a win-win that would change Europe for the better.

I think it takes a lot of things. There has to be for sure a combination of regulatory and political willingness to do that. But also you need underlying positive growth and momentum, and positive stories, which is clearly as we speak not the case.

Question from the audience:

I'd be interested in your views on consolidation and wealth management in the U.S. precisely, and perhaps as part of that, the fiduciary rule, and what's left of it if you will – what the drivers may be for moving from the old broker-dealer model into a more of a fiduciary wealth management, and UBS' role in that.

Sergio P. Ermotti:

Well, actually if I look at one of the successes, the reason why today we are up there competing with the best in the wealth management business in this country, is because we successfully moved away from being a broker-dealer kind of operation, into embracing the DNA of the traditional wealth management of UBS – it took a lot of years but this is now playing in the right direction.

So I do think that this is a trend that will continue. I do see a lot of opportunities in this area. I do see opportunities but also in helping and serving the more traditional channels, RIA channels. You will need to see some consolidation also in the U.S.

What I mentioned before with banks is also going to play out for independent investment managers – but I believe that at that stage consolidation may come in a hybrid way. You don't necessarily need to consolidate the top of the organization, the revenue, the client-facing activities – but you will see the need of the industry converging into using the same platforms. Everything which is commoditized needs to be shared, it's not applicable only to the U.S. I think it is a theme that will develop more and more. I have been talking about that for the last few years, and I am encouraged to see that other banks are starting to also look at this dynamic as a way to create economy of scale without necessarily going through traditional consolidation.

And this is something we see in every industry. You look at the car industry and the huge amount of investment they need to put into e-cars – you see big players, fierce competitors, working together on developing 60%, 70% of a car, in common, and trying to really differentiate themselves at the top end.

Consolidation in our industry, particularly in wealth management, may have certain limitations because the client-facing part of the equation is likely to stay sticky. But where you can get some advantages is there.

So we would like to think about the many opportunities that are coming in that sense, sharing infrastructure, being part of an infrastructure, but also helping other institutions to serve their clients better.

Kinner Lakhani:

So, I think in some senses UBS' opportunities are way beyond Europe.

Could you maybe talk about some of the cyclical tailwinds that we have. Regularization is kind of behind us. From here, you are probably one of the best positioned European banks to higher U.S. Dollar rates, well positioned for growth and with fairly good appetite in Asia. I just wanted to get a sense of how confident you feel today in terms of the trends you see at the moment, of UBS benefitting from these kind of cyclical tailwinds?

Sergio P. Ermotti:

Well, the cyclicality depends always on the time horizon and time frame you are talking about. If you measure things by weeks or quarters, it is quite difficult to make a statement. But I do think that the trends that are said to foster growth in our industry are quite clear: the absolute trend is wealth creation, particularly coming from Asia; but also the need of people to save more, and so when you look at wealth management in the asset management businesses, we are well-positioned to capture those trends.

When you talk about higher rates in the U.S., yes, I think you could actually see how we are benefiting from that, because if I look back at our NII number – you know, between 2014 and 2017, we improved our [GWM] NII by 1 billion in 4 years during which you had a low-rates environment. Only lately the U.S. dollar is picking up, but remember that we have huge headwinds in our balance sheet from negative rates in Swiss francs to negative rates in Euros, which is a double whammy because not only do you not make any profits out of that but you also have capital and HQLA and resources linked to that.

And despite all that, we managed to improve our [GWM] NII almost at a double-digit compound growth rate in the last four years.

Now I think the opportunity for us is, if I go out of the macro-trends and look at penetration of lending, without compromising our attention to quality of lending, we can improve this. I mentioned before the opportunities between the IB and wealth management in all regions to offer more structured ways to help our clients to manage their exposures or to monetize, leverage their positions. I think we can do that.

and we can expand our capabilities in mortgages. So across the board, we see ways to be able to expand our NII, and last but not least, one day, Swiss franc rates and Euro rates will also normalize.

And of course it is not something that I predict in the foreseeable future, but over long term we have quite a significant upside during a normalization of rates. But despite what I mentioned before, even if rates normalize, the margins won't be the same in relative terms but to where we stand today there are still a lot of opportunities for us.

And remember that we still have hundreds of billions of cash on the accounts of clients. So if you look at cash balances with us, or declared by clients, they are low 20% still. So pretty big impact on profitability.

Question from the audience:

The comments on interest rates are very helpful – you certainly need rates to normalize but my question to you is: How do you view the appropriateness of negative rates for so long? Was this indeed the best course of action? What would you have advised otherwise?

Sergio P. Ermotti:

By the way, I forgot one point that is quite critical, but the headwinds we get on the NII on higher funding costs coming from regulatory requirements on the TLAC front, it's quite substantial – so if I think about the NII development, it is not only on the revenue part of the equations, we also have the drag of higher regulatory requirements for TLAC.

Now on the negative rates environment, for banking it is quite clear, it is not helpful – but one could argue that if it's only banking affected we could and we should live with it. But the truth of the matter is that this is now creating a side effect in the rest of the economy, for sure, not only at consumer level and savers that are not feeling comfortable about their wealth position and the ability to spend, because what they used to see as income coming in, allowing them to sustain a certain spending habit, is now eroded on a yearly basis by small inflation, and the fact that you have negative rates or almost no rates.

And in the entire savings system, the pension funds system, and the social system, the effect of low rates is starting to create gaps in funding – asset bubbles in certain parts, for sure across the board, in any asset classes you could argue that there is already a quite high valuation. But if you look at real estate, and in some cases also at equities, they are clearly exposing the system to a big threat.

So in a nutshell, as you can understand, it is not advisable to continue to pursue that strategy, particularly if U.S. rates goes up, hopefully European central banks in general will at least try to keep the gap at the same level as we had in the last few years.

Question from the audience:

Hi, just one question on the Brexit and how do you think that that's going to change the operational model of UBS?

Sergio P. Ermotti:

I think that we de facto made our decisions now to tackle this post-Brexit situation. We have a big advantage that we already have an existing operation, two operations in Europe, but particularly in Frankfurt we have SE, Societas Europaea, our goal is to convert the structure in the UK and this one into one umbrella, and then a few hundred people will be based in continental Europe and some of them will be in Frankfurt, but many will also go specifically in Paris, or Milan, or Madrid, in the locations where we have clients – it is not a big revolution.

Brexit is more costs, no advantages for clients, and de facto a lose-lose for both UK and Europe in aggregation – I think they are going to lose significance and efficiency, but we do believe that we will be able to serve clients, as soon as early 2019, or hopefully if there is a more generous transition phase, hopefully by latest 2020.

Question from the audience:

Thank you. I have a question regarding capital return, capital requirement. So I think you have announced 2 billion of share buyback, and that will come on top of mid to high single-digit growth of the dividends but at the same time you are already operating above your guidance of core CET1 ratio of 13% and leverage ratio of 3.7%, so is there scope that maybe you could over-deliver there? Or do we need to think about any potential litigation or regulatory risk that could potentially hit capital ratios? Thank you.

Sergio P. Ermotti:

Thanks, when we plan and we announce our capital return policies, we always take into consideration potential idiosyncratic events, so I would say our capital return policy will not be affected by resolution of matters, also because it is not likely that those things are going to develop in a way that the concentration of the resolutions are at one point in time – so we have plenty of opportunities to both fulfill our capital return commitments, initiating the share buyback this quarter, as we announced.

We are at the same time, building up between now and 2020 [corrected] 4 billion of extra capital – and we announced the share buyback as the first program, and once the program is completed we are going to tackle and see what we can do, but for this year the very minimum we want to achieve is 550 million share buyback.

And for sure also to deliver on our progressive cash dividend growth. Clearly, when I look at the current market and the current stock price, I think I would expect that our cash dividend component will increase at the low end of the single digits – because at these levels of stock price we want to look at share buybacks as a better way to return capital to shareholders.

Kinner Lakhani:

Makes sense, yes. On the investment bank, you know, you have successfully mapped out a kind of high-velocity model – maybe lower capital intensity model, and clearly meeting costs of equity. But at the same time, your model suffers from lower volatility, as it has in the last kind of 2-3 years.

Do you feel any need to maybe diversify your model into other areas which could maybe counter-balance the pressures from low volatility, or is the strategy just to stay 'as is'?

Sergio P. Ermotti:

I am not a masochist, but I like this suffering at 24% return on allocated equity. The truth of the matter is that our IB business model, if I look at the time series of the last five years, has been constantly delivering in every market condition, more volatile and less volatile – actually if you look at 2017, it was quite a nasty environment for volatility across all asset classes, and we still delivered a very good result.

Why? Because not only we gained market share in those areas, we gained efficiencies, but also at the end of the day if I look at our portfolio, it's already complemented today by pretty good and solid businesses in financing, in advisory, in capital markets, in corporate derivatives, where we have a pretty good competitive position. If we look in those areas where we choose to compete, it's quite clear that our strategy in the IB is not to be big – it is to be strong, good and profitable, and serve our institutional and corporate clients with the best of our capabilities, and by the way, this is then crucial: to be able to serve our ultra- and GFO clients, and our corporate clients in Switzerland.

But we have stand-alone best-in-class capabilities, we have, if you look at those areas where we want to compete, we have more top-five positions than we had 5 years ago.

So I don't feel that we need to do anything other than here and there do adjustments – we are very active with our business model, look at the last quarter, I think we had the second-best performance in the IB in the industry. So I frankly think that our business model is more of a problem for our competitors than it is for us.

Kinner Lakhani:

Well, I think we are out of time, so thank you very much for your time. Thanks, Sergio.