PMQ Course in Corporate Governance
Open Book Examination
Model Test Paper

Maximum Marks: 100 Time Allowed: 3 hours

Note: Attempt ALL Questions

1. Read the following case and answer the questions given at the end.

As the largest Swiss bank and a leading financial service provider, UBS has a global presence in more than 50 countries with approximately 60,000 employees providing investment banking, asset management and wealth management services.

Since 1998, UBS has been the world's largest manager of private wealth assets. Following its formation, the bank quickly proceeded to pursue its ambition of becoming a global power in investment banking by expanding rapidly into the U.S. market. By 2003, UBS Investment Bank had become the fourth largest investment bank in the world, and was among the top fee-generating investment banks globally.

By the end of 2007, UBS was purportedly the most-leveraged major bank worldwide, with its assets far exceeding its total equity. Later on in mid-March 2007, the bank's channeling of more than US$100 billion into asset-backed securities led to massive losses during the subprime mortgage crisis. UBS then received a substantial financial bailout from the Swiss government and one of the bank's largest shareholders, Government of Singapore Investment Corporation (GIC), further injected US$9.7 billion into the bank. On 6 March 2009, the share price of UBS hit a record-low of US$7.72.

On 26 February 2009, Oswald Grubel was named Group CEO and was tasked with leading UBS out of its crisis. The move was well received by traders on the Zurich exchange as UBS' share price rose 14.85% to open at 11.60 Swiss francs (US$9.99) for the day.

Grubel's performance, to a large extent, met expectations. In his first year at UBS, he managed to stave off huge losses and in 2010; Grubel led UBS to even greater recovery as he returned UBS into profitability. The organizational culture of UBS also changed under the leadership of Grubel, who said in a statement, "I'd actually like to see us put more risk on the table".

UBS suffered an enormous dip in investors' confidence in 2008 after the subprime mortgage crisis and the multi-million-dollar tax evasion controversy in the U.S. However, the worst had yet to come.

On 15 September 2011, UBS became aware of a massive loss, estimated at US$2.3 billion, arising from unauthorized trading allegedly conducted by Kweku Adoboli, an employee in UBS' GSE Division. Adoboli was a director on UBS' GSE Trading team in London on the Exchange-Traded Funds (ETF) Desk and had been responsible for a portfolio of companies with assets totaling US$50 billion. To maintain his 'star' status in the bank, he started increasing his risk exposure for greater profit, which resulted in greater losses when his bets failed. Using the knowledge and skills he had obtained from this time as an analyst in the "back office", Adoboli began to engage in unauthorized trading, entering false information into the computer systems to conceal the risks he took. The increasingly risky trading resulted in volatile earnings and losses that he concealed using a range of prohibited mechanisms. These included one-sided internal futures positions, the delayed booking of transactions, fictitious deals with deferred settlement dates, and a concealment mechanism he termed the "umbrella". Eventually, losses snowballed to hit US$2.3 billion before anyone was any wiser.

When the scandal became public, UBS' stock price fell from US$12.68 to US$11.41, a 10% fall in value in one day. The scale of UBS' losses led to renewed calls for the global separation of commercial banking from investment banking while media commentators suggested that UBS should consider downsizing its investment bank.

The Swiss banking law requires UBS to operate under a strict dual board structure comprising the BOD and the Group Executive Board (GEB), with clear separation of duties and responsibilities. The BOD is responsible for overseeing the Group's direction and monitoring and supervising the business. The GEB is responsible for the executive management and is accountable to the BOD for the overall financial results of UBS.

As at 31 December 2011, the BOD comprised a total of 11 directors with diversified backgrounds, ten of whom were independent. The exception, Chairman Kaspar Villiger, was the former Swiss Minister of Military and Finance. He had come out of retirement to guide UBS back on track despite public concerns of whether his capabilities could be extended to places outside of the ministries, particularly in a bank like UBS.

Under the UBS BOD, there were 5 board committees covering audit, corporate responsibility, governance and nominating, human resource and compensation, and risk. The Risk Committee ("RC") was responsible for reviewing the bank's risk management and control framework. The Group chief officers and CEOs of the different banking divisions were to be present at meetings with the committee to ensure they were kept updated on the execution of risk management and controls. The RC had the duty to make reasonable enquiries into the possible deficiencies detected in the bank's control and monitoring mechanisms, and to raise these concerns during these meetings.

Under Grubel's charge, the bank undertook riskier business activities in order to increase profits, including proprietary trading which seeks opportunities with higher

leverage using the bank's own resources. In the Investment Banking Division, risk limits were increased, and punishment for excessive risk taking was overlooked in favour of generating profit. In particular, UBS was accused of rewarding traders who had breached compliance rules relating to personal account dealing and spread betting with increased remuneration and bonuses, as well as enrolment into higher-level management programmes. This sent out the signal that excessive risk taking and non-compliance of rules were acceptable for profit, thus incentivizing such risk-seeking behavior.

There were also signs that senior management neglected the importance of controlling and monitoring functions in the bank organization as evidenced by the lack of control infrastructure realignment during the transfer of ETF desk from the Cash Equities (CE) Division to the GSE Division. Responsibilities over Product Control continued to be held by the CE team despite the transfer. On many occasions, senior management sacrificed the effectiveness of controls for efficiency of processes.

The ETF trading desk was controlled and monitored by three separate back office functions – Operations, Product Control (PC) and Market Risk (MR), and the line managers who supervised traders. The key responsibility of the Operations unit was to ensure that trades at the Desk were accurately recorded and properly processed. The PC unit was tasked with performing checks and ensuring correct reporting of profit and loss (P&L) of each trader. The MR department was responsible for daily market risk reporting and analysis. The line managers ensured that the risk limits were adhered to and reported any breach to the management.

However, over time, breaches of compliance instructions remained unchallenged and warnings went uninvestigated. The Operations unit did not raise any doubts even though there were unresolved reconciliation errors followed by suspicious and unsatisfactory explanations. PC personnel simply accepted the traders' explanations for anomalies without sufficient analysis. It went completely unnoticed that the PC unit had not generated an important control report for a few months.

Furthermore, UBS did not impose an approval threshold or require evidence for adjustments of P&L, thus providing traders with the opportunity to conceal their losses. The market risk system for ETF Desk also did not automatically monitor trading positions in relation to pre-set risk limits. Line managers were uncertain of what their functions and responsibilities were in monitoring the ETF desk. Following a re-organization, no specific arrangements were made for transferring responsibility for monitoring. System alerts failed to reach the new direct line manager in New York, and ended up instead with the previous manager who acknowledged them, despite it no longer being his responsibility.

The relationships between traders and supervisors were characterized by a high degree of trust. Supervisors often did not question traders sufficiently regarding unusual increases in proprietary trading revenue as per guidelines. On numerous occasions where risk limits were breached and brought to the attention of the Desk's

line manager, no further investigation was made. Explanations were usually accepted without further verification.

UBS' operational risk department also placed a high degree of trust on the front office and their self-assessment of risks. Based on their internal framework of risk assessment, the operational risk department did not impose requirements for evidence or substantive testing to be done in order to validate self-assessment results. In addition, self-assessment was only done on an annual basis, hence presenting the possibility of control deficiencies going undetected for a long period of time.

Personnel in the control functions were allegedly incompetent and had a poor understanding of ETF-related trading activities. They saw their role as a support function rather than as a control mechanism. Moreover, the poor definition of certain roles and responsibilities and a lack of proper training essential to navigating the complexities of the ETF trading desks exacerbated the supervisors' confusion, and compromised the supervisors' ability to effectively carry out their duties.

By European bank conventions, no confirmation of positions from the bank's finance, risk-control and audit functions is required before proceeding with the trade. Investigators found that Adoboli had exploited this loophole in the regulations of ETFs to distort the true magnitude of risk exposure arising from the trade. This then allowed him to conceal his violation of stipulated risk limits and thus advance his fictitious trades.

This incident has prompted global banking and securities regulators to increase scrutiny on ETF regulations. Regulators are contemplating strict new rules dictating the amount and quality of collateral ETF providers' need, and could impose requirements for fund managers to disclose a greater degree of detail in relation to their counterparties.

In the aftermath, CEO Oswald Grubel and the co-heads of Global Equities at UBS, Francois Gouws and yassine Bouhara, resigned to assume responsibilities for the trading scandal. Sergio Ermotti was appointed as the Group CEO on an interim basis.

Investigations took place over an eight-month period to pinpoint the causes of the incident. Significant changes were made to UBS's infrastructure and controls, including changes to processes and monitoring capabilities. Changes to their internal control system, such as the escalation process for daily adjustments over defined thresholds and a supervisory signoff process, were implemented. Monitoring became more robust in UBS' Equities business, and there was better information flow to supervisors and risk managers.

UBS also aimed to reinforce accountability by the clarification of supervisory roles, reiteration of trading mandates and how employees' performance reviews were done. A new supervision structure was implemented to ensure that supervisors are

suitably experienced, while management information was improved with clearer prioritization of information.

On 20 October 2012, UBS announced its intention to transform the firm by restructuring business activities. In particular, UBS wanted to sharpen its focus in Investment Banking, and to exit fixed income business lines, proprietary trading and other lines and products that were overly complex and which did not deliver stable and attractive risk-adjusted returns under new regulatory rules.

In late 2012, however, UBS was involved in yet another trading scandal. UBS traders Tom Hayes and Roger Drain were charged for taking part in a multi-year scheme to manipulate LIBOR and other benchmark interest rates. UBS was fined US$1.5 billion – the second largest fine ever imposed on a bank by regulators in United States, UK and Switzerland. Along with UBS, many other banks, such as Barclays and RBS, were also fined for their involvement.

The persistent occurrence of banking scandals in financial institutions reflects a significant failure to address the core issues facing the whole financial sector. Despite the repeated revamp of internal control systems and changes in company leadership in individual banks, banks continue to grace headlines in shocking reports concerning new schemes involving fraud and manipulation. These points towards one overarching question: Can such issues in financial sectors ever be truly resolved?

Based on the above, answer the following questions-

a) What were the controls and monitoring mechanisms in UBS before the scandal took place? Comment on the effectiveness of these mechanisms and how such inadequacies provided opportunity for the trading scandal to happen.

b) Discuss how the risk-taking culture in UBS could have given incentive to the traders to circumvent the controls.

c) Should the board of directors have been held responsible along with UBS's CEO? What should the Risk Committee have done before the scandal fully developed? What are some possible challenges faced by the committee in pre-empting such scandals?

d) Were the measures implemented by UBS to remedy the faults sufficient? How else could USB improve corporate governance and internal control?

e) What were the regulatory loopholes that contributed to the unauthorized trading? Could regulators play a bigger role in the governing of financial institutions with heavy trading activities?

(10 marks each)

2. (a) “There should be a clear demarcation between the Chairman and the Chief Executive’s Role within the company to ensure a balance of Power and authority, with no individual having unfettered Powers of decision-making” Explain with reference to the recommendations of various codes.

(10 marks)

(b) Long term success of all business depends on managements’ leadership, ability and efforts. Elucidate this statement with reference to the professionals in committees giving your suggestion.

(10 marks)

(c) It is observed that “Good Governance emanates from value based management. The contemporary practices highlight the value creations which have now become the core objectives and strategies of business. In fact, value based management has strong influence upon corporate Governance Practices” Do you agree with the statement? What are the theories influencing corporate Governance? Are the theories relevant for India? Explain.

(10 marks)

3. “For better self-governance at Corporate Level, various initiatives have to be taken by the corporations” Discuss.

(5 marks)

4. “Corporate Social Responsibilities (CSR) underlines the care and concerns for all” Examine the statement analyzing the evolution of CSR with reference to the concept of trusteeship of Mahatma Gandhi.

(5 marks)

5. Corporate Governance has two dimensions (i) the external, country-level and (ii) the internal firm level” Discuss.

(5 marks)

6. “Are independent directors really independent?” Give your views.

(5 marks)