FMR Advisory Round Table: Conduct Risk

Introduction

Over the last few months the topic of conduct risk, behavioural risk and general management concern around how to demonstrate to the regulators that a given business is behaving correctly, has come up again and again.

FMR Advisory was established with the area of conduct risk as one of two core competencies and wanted to provide a forum where industry practitioners could meet and discuss this topic in a frank and open way. The FMR Advisory Round Table was held on Monday 28th July at the Capital Club with representation from the banking, legal and broker communities. A highly topical and interesting discussion highlighted a number of key themes.

> As a regulator put it somewhat bluntly in November 2012, when looking at how to control conduct risk …"The alternatives for regulators are difficult. Personally, I think the whole regulatory environment (Basel III included) is way too pre-occupied with numbers at the expense of the qualitative standards. The problem with qualitative standards is it requires greater skill levels at regulators (which they have to pay for) and is more politically difficult to enforce"

Themes that came up included:

- The new regulatory focus and how both politicians and regulators are drilling into this area; whether called conduct risk, behavioural risk or simply as part of operational risk
- Who within a firm should be driving and leading this change
- What the change programme might look like
- Managing the behaviour of trading, sales and support staff
- To what extent is this outcome-based regulation and what the outcomes might look like

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Background

Following on from the furore over 'bad behaviour' at the LIBOR and FX Fixings, regulators are focusing in on conduct. It is no longer acceptable to approach the business with an attitude of "what can I get away with?" - The new approach has to be "is this the correct way to behave?". Planning for and then implementing a change programme that ensures the business is not only compliant with the new defined regulations, but will also be appropriately managed to encompass new behavioural best practice and responsibility, is a major exercise. Reflecting on the impact of this new focus, one senior banker at the table described how: "…we just changed what was a 40 page compliance manual to what is now a 74 page compliance manual – a lot of it on the subject of conduct risk"

As far back as 2004, The Committee of European Banking Supervision (the forerunner of ESMA) wrote a paper on Basle II recognising that human resources are an integral and important part of operational risk, as part of Pillar II. "The challenge of the impact of human beings on the business was always understood as a factor", David Clark, Chairman of WMBA added.

With significant fines being imposed by Regulators throughout the G20 jurisdictions, as well as the threat of possible litigation against business management, it is clear that Regulatory Risk has become a major focus for many board level directors.

Coupled with the higher degrees of customer care that will come in with MiFID, a deep programme of change is necessary in most institutions if large fines are to be avoided – (e.g. INVESCO fined £18.6 in April 2014). Managing operational/conduct risk is now bang square in the middle of the business – and the cost of failure carries significant regulatory, financial and reputational consequences.

As far back as 2008 the concept of management leadership in the area of Conduct Risk was recognized - "If you get buy-in you can achieve extraordinary things. But if you do not get buy-in you won't even achieve the ordinary. It's alright to talk about the tone at the top, but I prefer to talk about the tune in the middle." (Sir Mervyn King, Governor of the Bank of England in RSA Sept 2008)

The discussion

Regulatory focus

It was apparent from the discussion that not only has the Press raised the focus on how financial institution staff behave, but also that the regulators are asking senior management direct questions as part of the Significant Influence Function (SIF) regime, that are designed to highlight this topic. Whilst much of the conversation revolved around UK details and the approach of the FCA and PRA, the principles and focus on behaviour is acknowledged as being replicated throughout the G20 nations.

Whilst a question such as 'Do you understand your risk appetite?' may appear more general, the expected response would include strong elements of conduct risk, and as David Clark commented: "conduct risk appetite falls squarely in the middle of operational risk and reputation risk". Furthermore, the question around understanding your risk appetite would extend to demonstrating an understanding of the firm's customers' risk appetite. This line of questioning revolves around the theme that the customer should be at the centre of the business. Demonstrating an understanding of how the customers pay the firm and what they are expecting for that payment, not only in terms of goods and services but also in terms of the wider service and trust levels that they might expect, is key and relative to the degree of customer risk appetite.

The Senior person regime was discussed at length in this regard and attendees were eagerly awaiting the publication of the promised Consultation Paper on the subject from the FCA/PRA. In the week following the Round Table, this document was published and can be found on the FCA site (http://www.fca.org.uk/static/documents/consultation-papers/cp14-13.pdf). This is a joint issue for both the FCA and the PRA and borrows on the experience within the retail sector, working together with the SIF regime.

Who drives the change?

As highlighted in the previous section, the regulatory discussions are with senior business management, with the aim of ensuring that the management understand the risks associated with their business. Putting in place a programme for change to mitigate behavioural risk, to understand how the customers are being treated, is a direct responsibility of business management. There is a tendency in the early thinking of how to establish a change programme that addresses conduct risk, that this should simply be another compliance-driven activity. However this needs to be far more than an activity in order to be successful and deliver the desired outcome of real change. The bank that is 18 months into a change programme was very clear that it was only after the programme had been taken in hand by the management directly that change started to be effective. The table agreed that whilst the concept of behaviour being managed is decades old, with codes of conduct and the management board having this as an explicit responsibility, the reality was previously less proactive. Mike Phillips made the point that: "…the only way to solve this is as a blend of conduct and operational risk. The information is already well known but the rhetoric is different". Furthermore all participants agreed that the change in rhetoric has been dramatic in recent years.

Subsequent to the Round Table taking place, the FCA has published a letter that Mr. Clive Adamson, Director of Supervision at the FCA wrote to the FCA Practitioner Panel summarising the FCA approach to the use of attestations, (http://www.fca.org.uk/static/documents/attestations-clive-adamson.pdf).
"Attestations have been introduced as a formal supervisory tool. When we use an attestation, we do so to gain personal commitment from an approved person at a regulated firm that specific action has been taken or will be taken. The aim of an attestation is to ensure that there is clear accountability and senior management focus on those specific issues where we would like to see change within firms, often without on-going regulatory involvement."

The idea of listening to not only 'the tone from the top but also the tune in the middle' with regards to how a firm is managing conduct risk has been around for some years now, and was mentioned several times as a measure of management focus in this area – although acknowledged as one of the harder indicators to measure. The point behind this concept is based on management throughout the firm adopting responsibility for correct behaviour, which ties in tightly with the outcomes based approach for the 'Treating Customer Fairly' regime. As Mike Phillips of Société Générale commented: "Since Barings the regulators have been trying to force responsibility more directly into management to find the mechanism to force the tone from the top. I think that direction will continue come what may, whether it is called conduct or something else. It's about behaviour, it's about culture"

Change programme

With the Board having established the drive for a programme, the compliance department can step in more actively and help design the programme, together with the business management. Two of the banks were adamant that this mix of business and compliance engagement is crucial to the success of this plan. As Mike Phillips explained: "we helped shape the framework – the management had to drive it - and compliance becomes the enabler". The compliance element will roll out the programme into the wider business and then monitor and measure success over the coming months, however without the management-led engagement the compliance element will not deliver the outcomes. This has to become an integral part of day to day management. When getting into the details of management engagement and how to ensure their active participation Mike Phillips highlighted a possible response as: "when implementing a programme for changing behaviour, if anyone asks why they should do this, the reply should be 'why would you not?' - why not ensure that your team's behaviour is correct?"

One element that was discussed in making the programme effective is extending any existing interview preparation into a programme for ALL management, with key questions around conduct risk and mitigating strategies. Challenging the management team to take personal responsibility for these questions on an ongoing basis is one of the outcomes designed within the programme.

An interesting experience that was shared by Mike Phillips was how his team had altered terminology and phrases to resonate internally to the organisation – deliberately not referring to 'conduct risk' itself, which has perhaps an emotive attachment. "Given it initially came from the regulators, it was a question of transforming the ask into something that could be understood by the firm"

A number of details were also discussed in terms of making the programme effective, scalable and measurable. Quantative and qualitative dashboards are a part of measuring this and are a major factor of success. Another element that garnered some attention was the idea of Codes of Conduct and the extent to which banks might write their own Code and/or adopt a Code in wider use. David Clark added: "Culture change has both top down and bottom up elements and Pillar 2 adjustments would help to improve behaviour. A code of conduct, internal and external, would help significantly in the supervisory effort." The ACI Code of Conduct was highlighted in this regard as being applicable across jurisdictions and even adopted by some national authorities; the RBA in Australia and ECB FX Contact Group in the EU being examples of official recognition. This appears to be an area that will attract increased attention in the coming months.

Managing the behaviour

Once the change programme is in place the management of behaviour going forward was also examined. The issues around the new regulatory focus on fixings inevitably came up, looking at both the possible controls as well as the impact on the market. As David Clark voiced: "A critical danger of making benchmark regulation too onerous is the potential impact on market liquidity of submitters or market makers withdrawing – this is especially true in the FX market but could also affect commodities and energy. As a starting point the participants looked at the idea of 'how bad behaviour in LIBOR might have been picked up without the 2008 crash bringing such attention to the fix', or as one participant put it: "had the crisis not happened, would we be talking about a LIBOR fixing problem? I don't think so - the mechanism would have carried on working as it did previously". Discussion revolved around what might have brought attention to the LIBOR fixing had the crash not happened – what surveillance techniques were in place or could have been in place and what behaviour might have been picked up. Whilst there was no firm conclusion to the question, this was an interesting discussion and highlights how challenging measurement and discovery can be. As Simon Orton, partner at Freshfields put it: "How you deal with your customers is a different issue to how you deal with a counterparty - which is more about market integrity."

Another interesting point was the interaction between compliance and management. Compliance might ask a manager the degree to which they are prepared to accept bad behaviour. Whilst the manager might say that they have zero risk tolerance for bad behaviour – and this is laudable – it is evident that zero risk is impossible to achieve in practice. And so the debate circled around how best to mitigate as far as possible and how to catch any exceptions. This was felt to be an ideal example of how having the correct culture within a firm would bring benefit – in picking up the outlying risks. Therefore once again, management is key.

Different motivators for bad behaviour were discussed and it was quickly agreed that non-compliance through error should be more easily identified, however a deliberate act of bad behaviour is far more complicated – not least as there will normally be some related deliberate attempts to circumvent any safeguards. Interestingly there was some in depth thinking around how the examination of unusual profits, as well as the more prevalent examination of unusual losses, should be the norm. If personal greed is a factor then the related increase in profits may highlight a background of behaviour that requires more examination. Profit and Loss analysis includes the profits as well as the losses, or as Mike Phillips put it: "understanding the profit spikes is as important as understanding the loss spikes"
A related point was examined around reward and sanction for behaviour. Historically this area has been approached from a largely sanction based angle – bad behaviour is sanctioned. The question was asked, how could good behaviour be positively rewarded? One business manager present reminded the room how softer targets have been a part of the bonus scheme reward structure for decades. However he also pointed out that the vast percentage of bonus has always focused on raw profit generated – "make as much as you can, in any way you can." Having a target as a part of the achievable bonus is certainly one element, however the reality has until now meant that the percentage that related to this target was negligible.

Examples of how to reward good behaviour were brought to the table across different industries. To look at two differing examples:

A trader in Bank A discovers an error in an executed trade where the rate was incorrectly entered into the bank system. The error has been discovered by chance and happily the loss is small. He corrects the error, breathes a sigh of relief that he can absorb the loss in his trading book and that nothing serious came of this - and life carries on, no-one is any the wiser.

A flight attendant on a flight from New York to London discovers that the incorrect temperature can be entered into their microwave, which delivers food that is dangerously hot. The food is not delivered and a report log is completed and submitted as soon as the flight lands.

The stories above are examples of how two different industries typically approach a discovered operational risk and could hardly deliver a more striking contrast. In Bank A the error is corrected and never mentioned again. No-one learns from the error and an identical mistake could be made by our trader's colleague a few days later, this time for a significant loss. In the airline industry there is an established and robust workflow around reporting any errors – indeed flight attendants are rewarded for discovering and reporting mistakes, including their own. What is the behavioural norm in the OTC trading financial institutions when it comes to spotting an error? How can management truly champion correct behaviour in an overtly positive way?

It was felt that a board-recognised programme to reward good behaviour should be implemented as standard. The board should sign off an explicit conduct risk appetite – along with the attached reputational risk. One attendee discussed how the daily P&L reports he receives are risk-adjusted for capital charges based on, amongst other things, Operational and Conduct Risk. This same bank also signs up to an International Code of Conduct as their benchmark – the ACI Code of Conduct and the associated exams that are available - to ensure staff training and knowledge. Another bank present explained how all staff have to have passed the ACI Certificate in order to trade – and this includes a module on the Code of Conduct. They also have a compulsory 20 hours a year on CPD. It is clear that elements of monitoring and training for improved behaviour already exist in the industry. The question is the extent to which these are driven through by management on a daily basis.

Outcomes of the new regime

The final topic for discussion looked at the outcomes of this new behaviour-focused regime. One senior manager highlighted how he is regularly experiencing senior traders and sales people asking whether they are permitted to act in a particular way, which has perhaps hitherto been the norm. He feels that there is a real need for a recognised Code of Conduct that can be referred to across the market in a consistent approach. Somewhere to which the participants can refer for real examples that demonstrate how they should behave in given situations. As he put it: “People want a code”. Again the ACI Code was held up as a solution that already exists, although a major requirement to make this usable is that the firms would need to adopt the code as a requirement.

One might be forgiven for thinking that following the FCA driver of putting the client at the centre of thinking would ensure a compliant approach, however this is not always the case. There are often occasions when a trader is conflicted between the best interests of the client and the shareholder. The conflict can normally be managed through a correct and open disclosure to the client that normal bank operations may work against a client’s position, should the client hedge their risk in a given manner, however this shows that relying purely on the interests of a client is not in itself enough. A wider perspective of internal compliance procedures and the regulatory imperatives towards best practice has to be taken into account at all times. As Simon Orton explained: “There is a tension between conduct and rules. I am fairly relaxed about this as there is a blend of both in reality - to have a rule-set and a guide to behaviour - to achieve the correct outcome”.

An example of how the regulatory focus has already altered behaviour to the detriment of the customer was presented and discussed. A bank pointed out that the new environment has added risk to the market place, with the connected cost increase implications to the clients. For example:

- A client trades a Non-Deliverable Forward (NDF) with Bank A
- A month later on maturity of that original trade, the client then wishes to roll the risk for another month at prevailing market rates
- The client trades with Bank B
- Previously the two banks would understand who they both are in the trade and agree to net off the purchase/sale risk with each other at a central rate to the market. This ensured the best outcome for the client and prevented any related disruption to the price action
- Without the ability to discuss this risk together, given the restrictions now being placed on communication between institutions as a measure to mitigate any possibility of accusation around collusion or manipulation, the banks are having to independently trade in the market – therefore paying away the spread, the cost of which is naturally passed on to the customer in the two resulting trades.

The clear risk is that through attempting to ensure good behaviour, the providers of liquidity end up in a position where wider liquidity and the smooth operation of the market is negatively impacted. As an attendee summed this up: "The PRA is looking at how the current market makers evaluate conduct risk associated with providing liquidity and then decide that this is no longer a sound business given the attached risk - and therefore liquidity could disappear."

The final word of this Round Table report is not from the discussion on the day, but rather from a recent speech by Mr. Clive Adamson of the FCA: "…I have seen a sea-change in the attention being paid to the conduct agenda. Two or three years ago, conduct was something that most firms thought of as a compliance issue and so delegated it to compliance functions. Now, I would say that conduct is very firmly on the agenda of executive management and boards and we welcome that.

Part of the reason for this is that firms have come to realise the cost of getting this wrong in terms of potential regulatory fines, redress costs and litigation costs but also reputational damage. However, aside from managing the downside, firms are also realising the benefit of good conduct performance in terms of building customer trust. This is more than the traditional focus on customer satisfaction but about building a positive reputation for fairness."

"…we are looking at how the interests of the customer and market integrity are at the heart of how their business is run – this means our focus is on the firm's business model, culture and front-line activities such as product governance and less on second-line controls. This focus on how the business is run, rather than how it is controlled, is a fundamental change and is directly linked to our outcome-focused philosophy."

Appendix: Related Questionnaire

In preparation for the Round Table report FMR Advisory asked both the invitees and a small number of wider practitioners for responses to a questionnaire, with a view to understanding how the area of Conduct Risk is now being approached in their firms. The aggregate results are interesting.

Responses to Questionnaire

1. To what extent is the awareness of Conduct Risk higher today compared to a year ago?

With a scale of 1-5 with 1 being a low response and 5 being a high response, the average return was 4

One comment added: "It is significantly higher than a year ago."

A contrary view was however put forward: "I don't consider it to be any higher – if anything it is more confusing. We have had TCF for Retail focused firms, all firms were required to assess their Conflicts of Interest Risk at the time of implementation of MiFID (all of which is now embedded into the appropriate sections of the rulebook and now constitute business as usual), the Remuneration Code has been in place for some time and the key rules of COBS are required to be applied on a daily basis. All the "Emperor's New Clothes" appear to do is require an identification of KPI/KRIs and their reporting to senior management which is in itself a minor tweak to SYSC. To have departments running around creating these takes Compliance's eyes off the ball. Quite why the FCA have not sent out supervision teams to similar firms to lead a think tank on which KRIs/KPIs to implement, and to identify the key areas of risk amongst grouped firms is beyond me. So for me a 1 as it is identical."

2. What are the key influences of new focus?

a) Case of bad behaviour
b) Fear of fines
c) Fear of custodial sentence
d) All of the above

Responses ranged across a selection of a-d and an interesting mix of additional points were raised:

One respondent commented: "Regulatory risk. We have to repackage our Compliance function to meet the MCR requirements. Having a functioning department is no longer enough, it needs the right shade of lipstick and mascara on otherwise it is plainly ineffective in the eyes of the regulator."

Another echoed the regulatory drive saying: "I think it's partly driven by a and b, but also by the intense supervisory pressure coming from the regulators and the desire to protect the franchise and rebuild trust going forward."

3. To what extent is your firm putting in place a programme for change? Does this feel like a tactical fix or a strategically thought out programme?

This was a more open question and there was a highly varied set of responses.
One respondent was not aware of any programme for change, whilst another has been leading a programme actively over the last 12-18 months,
One respondent said: “It forms part of a general Risk Reassessment. We are taking the opportunity to spring clean and commit to writing all policies and procedures… …Without designing a box for the FCA to tick as part of their monitoring we face the risk of penalty. The FCA should be recruiting genuine subject matter experts and allocating them to industry sectors of their expertise. These experts should be offered sufficiently attractive packages to be retained so there is ongoing continuity and understanding within Canary Wharf as to what firms do and where real (rather than imagined) risks lie. This is not a failure of the firms – we pay enough in levies to expect the above.”

4. Who and what role is leading the conduct risk assessment and remedial action / change programme?

Again responses varied here. Two attendees suggested that the head of compliance would lead this programme, while another was adamant that management HAS to lead this change. All respondents agreed that there was a mix of Compliance and Management engagement and that neither would succeed without the other.