

'5 Conduct Questions'

Industry Feedback for 2017


Wholesale Banking Supervision

April 2018

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Conduct Risk Programmes

Introduction

We introduced the 5 Conduct Questions programme in 2015 as a key part of our strategy for supervising wholesale banks. The objective was to prompt as well as support internal programmes for improving conduct in a systematic manner that enabled firms to challenge themselves and to informally benchmark their efforts across the industry. In April 2017 we published an initial report with detailed feedback from the larger wholesale firms about their conduct programmes, along with specific examples of what they thought worked well or not.

In this second report, we give an update on industry progress by the same firms. While we seek to understand how firms were approaching their programmes as a whole, in the first year our attention focused on Question 1 and the identification of conduct risk. Over the past year we focused on Question 2 and staff engagement in conduct programmes. Some comments that appeared in our first report are repeated here because of their continuing relevance or dominance.

In this report we also discuss some conduct risk observations from other supervision activity with wholesale banks. Our intent is to provide some useful feedback in a timely manner. The topics covered are pricing transparency for complex derivatives and an assessment of technology and cyber risk including the governance thereof.

Finally, we report briefly on some of our outreach activity with the wholesale banking sector.

While this report covers supervisory activity and discussions with a sample of about 30 firms, the content is relevant for all firms in the wholesale banking sector. We encourage all wholesale banking firms to read the feedback and consider whether or how they might effectively incorporate any of the approaches described in their own organisations.

All this work connects to the broader and continuing FCA cross-sector priority on firms' culture and governance as set out in our 2017/19 Business Plan. www.fca.org.uk/publication/business-plans/business-plan-2018-19.pdf.



The 5 Conduct Questions:

1. What proactive steps do you take as a firm to identify the conduct risks inherent within your business?
2. How do you encourage the individuals who work in front, middle, back office, control and support functions to feel and be responsible for managing the conduct of their business?
3. What support (broadly defined) does the firm put in place to enable those who work for it to improve the conduct of their business or function?
4. How does the Board and ExCo (or appropriate senior management) gain oversight of the conduct of business within their organisation and, equally importantly, how does the Board or ExCo consider the conduct implications of the strategic decisions that they make?
5. Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?

1. Observations from the 5 Conduct Questions Programme

We are pleased that, despite significant market distractions, conduct risk has remained a key focus of attention for boards and senior management in wholesale banking. At an industry level, progress among the larger wholesale banking firms is encouraging. It is, however too early to know how effective these conduct programmes are, or will be, in the longer term.

A few firms are now beginning to reap some benefits from their effort exemplified by improved staff engagement and ultimately the potential competitive advantage of positive and visible management of conduct risk. On the other hand, completing initial infrastructure changes or rolling out training programmes can lead to a premature sense of achievement. Making organisational and process changes represents basic groundwork in the development of an environment that self-reinforces good conduct outcomes. While progress is welcome and duly acknowledged, our priority is to ensure that there is no reduction to the continuing effort needed to achieve a high standard of behaviour.

It is unsurprising that firms initially focused on meeting regulations and their own policies and procedures, such as Personal Account Dealing and completing training on time. Firms now need to shift more of their attention outwardly to consider whether their actions are causing or have the potential to cause harm to customers or markets.

While many of the larger firms have marshalled the resources for these important initiatives, many firms still remain in early planning stages. Conduct is important for the whole of the financial services industry. Larger firms who have prioritised other initiatives and smaller firms that may lack the immediate resources to launch comprehensive programmes still face the downside risks that arise from poor conduct. The health of the financial services industry as a whole is dependent on all

participants addressing conduct in a fulsome manner. This includes strengthening and acknowledging good conduct as well as addressing poor conduct. This effort might start with initial programmes but continuing vigilance and reinforcement will be needed thereafter.

We provide more details in the rest of this update but our key observations include:

- 1.** Nearly all front-line business areas have taken full ownership for conduct risk and related change and development programmes. Firms that were slower to make this shift continue to lag behind their peers
- 2.** Several firms have decided to elevate their effort to global, firm-wide programmes, adjusting them to take into account differing approaches by home and other regulators
- 3.** Some firms have created new First Line of Defence (front office) roles with titles such as 'Chief Conduct Officer' or 'Head of Culture and Conduct' with a mandate to develop a holistic approach to the firm's conduct programmes. They have also created or expanded 'Front Office Supervision' (FOS) tools to improve the ability of business heads to monitor and manage directly
- 4.** More firms have expanded their programmes to include full front-to-back or end-to-end risk reviews, rather than limit their focus on more immediate client-facing activity
- 5.** Firms increasingly base performance, promotion and remuneration on separate assessments of 'how' individuals perform in addition to 'what' they achieve. They then integrate the two assessments for a more complete individual profile

We strongly encourage firms and senior management to continue to focus on their conduct and culture and to ensure that good practice becomes embedded throughout their organisations. In addition we urge readers to note:

- 1.** If your firm has not yet focused intently on conduct and culture, you risk falling significantly behind your peers. You also risk running increasing and unmanaged levels of conduct risk
- 2.** Having focused initial efforts on adherence to internal rules, it is important for firms to begin looking outwardly at harm or potential harm to markets and to clients
- 3.** Board-level governance and engagement with the conduct and culture programmes is important but it requires training and support to be effective, particularly for Independent Non-Executive Directors
- 4.** While this report is addressed to firms as a whole, it is also important and useful for individuals to read and digest

II. Other Supervisory Activity in wholesale banking

Price Transparency

In late 2016 and 2017, we visited several firms to assess how effective front line



supervisory controls were and the potential conduct issues in selected derivative trading businesses. We looked at straightforward and complex interest rate options (non-linear rates trading) and complex products such as options trading (structured credit trading). We gave each firm we visited tailored feedback. This report gives some general observations about the importance of conduct risk management that other firms could find useful. We also suggest four questions that senior management might ask themselves about conduct risk in these businesses.

Technology

In 2017 we met with firms to explain our approach to proactive supervision of technology, in terms of conduct risk and the wider potential for harm to clients and markets. Firms now generally have a good level of understanding of the issue and appreciate the key challenges the industry faces across their technology infrastructure. But while firms fully recognise the importance of technology, they need to improve their governance and overall risk management of this important area.

III. Outreach in wholesale banking

In 2017 we launched the 'CEO Roundtable' programme. We invited CEOs from the twenty largest wholesale banks to meet informally to discuss conduct risk topics. Two or three sessions are planned per year with topics largely proposed by the group. This forum represents a rare opportunity for participants to discuss matters directly with their peers. FCA representation is also senior, but serves to support wide exploration of ideas. As well as this forum, our Wholesale Banking Supervision teams met with industry organisations and participated in conferences as part of our wider communication strategy with the sector.

Next steps for the FCA

We will continue with our annual conduct meetings with the larger firms as part of our yearly engagement. The amount of attention we give these firms will reflect the degree of progress they are making. Our discussions could range across one or more of:

- thorough identification of conduct risk
- behaviours being driven or incentivised by remuneration
- how well conduct risk programmes are being embedded throughout the organisation, and
- development of management information and early stage assessment of programme effectiveness

Some firms are shifting attention to look outwardly at potential harm to customers or markets and we will also look for more progress in this area.

To build on the high degree of firm engagement with the '5 Conduct Questions' we are extending the programme more widely across the wholesale sector. This will include,



for example, Asset Management, Trading Firms and Trading Venues. We will tailor the specific questions and the scope of the programme for each segment.

We will continue to reach out to the broader wholesale banking community in the UK. Our effort will continue as a mix of face-to-face meetings, group sessions, industry presentations and communication through the FCA website.

Section One

Detailed 5 Conduct Questions Feedback

Overall Programme Design and Effectiveness

Firms pulling ahead of their peers have an integrated conduct risk framework that covers all aspects of business activity, engages all employees (front, middle, back), clear risk appetite set at board level, monitoring of adherence within business units and clear accountability from business heads and staff.

Conduct risk programmes have generally been tailored by each firm to its own needs based on its size, business model and geographic reach. Experience over the past year has reinforced the positive difference which key design features can make as we highlighted in our last report:

1. highly visible board and CEO sponsorship, engagement and participation
2. senior executive leadership in programme design, engagement and delivery
3. visible business-led ownership of the whole initiative
4. front-to-back programmes that include business, control and support functions
5. integration within strategic or operational risk management frameworks
6. standardised conduct risk self-assessment processes across the firm
7. comparing conduct risk across businesses and functions (read-across), and
8. fully integrated training, promotion, performance management and remuneration with conduct and culture objectives

Similarly, we continue to observe that the following are less effective design features in achieving desired results or progressing at a pace similar to their peers:

1. programmes where the COO, Compliance or another Second Line of Defence unit is the primary driver, seeking to achieve buy-in from others
2. one-off or stand-alone projects with 1-3 year timeframes
3. top-down approaches to identifying risk which are not counter-balanced by energetic, bottom-up efforts by business units to identify where conduct risks can arise

4. continuing emphasis on 'controls' rather than more fundamental cultural drivers of behaviour
5. excluding significant business units, control or operational functions from the risk identification effort
6. a narrow focus on client-facing activity, given that conduct risk can arise anywhere

Some firms which initially used one or more of the less-effective design features above made changes after year one and enjoyed more rapid progress thereafter. Firms that continued to use one or more of the less-effective features have fallen further behind their peers.

Below we summarise a mix of feedback we received and some of our own observations against each of the 5 Conduct Questions.



Question 1: 'What proactive steps do you take as a firm to identify the conduct risks inherent within your business?'

Defining conduct risk

The FCA provides substantial information in its Mission Statement, Business Plans and through discussion of its statutory objectives all of which serve as a clear foundation for addressing conduct risk. However, the FCA does not provide an explicit definition of conduct risk as part of the 5 Conduct Questions programme. This is because it is essential for firms to work through this task themselves as a preparatory step for designing, prioritising and monitoring change management initiatives. By 2017 nearly all the firms we reviewed had working definitions, but a few still lacked an agreed definition. Some earlier definitions failed to address the importance of outcomes involving staff and other key stakeholders and this has been remedied. More advanced firms are on second or third iterations, having added risks to market integrity or effective competition. As well as refining their definitions, a few firms have taken the formal step of ensuring it is adopted globally.

Firms' definitions and activity have not yet paid enough attention to our emphasis on outcomes and the potential for 'harm', rather than a more inward focus on adhering to rules and generalised best practice. Some definitions are also carefully worded in a way that reflects the firm's legal considerations rather than the possibilities for harm to customers, markets or competition.

Identifying conduct risk

Conduct risk can arise anywhere and needs to be managed wherever it arises. Firms have made progress in identifying and managing conduct risk across all of their business units and well beyond point-of-sale activity.

Last year we identified three main approaches to identifying conduct risk:

1. A top-down model where centrally defined key risks were mapped to business activity, products and processes
2. A bottom-up model where individual business units analysed their own business and processes end-to-end and identified risks, often at the desk level. These risks were then aggregated
3. A reverse-engineered approach. Here, the firm reviews its processes to identify threats to desired firm-level principles or conduct outcomes and the design of controls that could mitigate the risks to these outcomes

Firms using the second approach or a combination of the first and second have continued to make the most progress. Firms predominately using the third approach significantly lag behind their peers.

Firms have made progress in identifying and managing conduct risk across all of their business units and well beyond point of sale activity. Firms making the most progress have used business-led exercises looking at whole end-to-end chains.¹ These exercises are supplemented by challenge from support and control functions and the results are shared for potential lessons across other business units.

We make wider points on training below, but we draw attention to the difference between risk 'awareness' and risk 'identification'. Firms have made significant effort to raise the level of general awareness of conduct risk but less effort on the skill involved in taking the next step of identifying conduct risk. Training that uses seemingly low-risk scenarios are now popular with firms. Their objective is to dig out the points where conduct risk can arise, assess how to proceed and identify whether the mitigants or controls to address the risk are adequate. Scenarios which do not have a clear outcome help ensure that 'judgement' and 'choice' are prioritised, making the value and importance of prompt issue escalation clear.

Risk assessments based on front-to-back process mapping in coordination with all the necessary support functions appear to be most effective. Again, we see an increasing number of firms considering how they can integrate their conduct risk frameworks into their Enterprise-Wide Risk Management Frameworks, for example, under a Chief Risk Officer or a Head of Operational Risk.

Here are some good examples we observed in Risk Identification:

1. elevating conduct to the same level as financial risk, thoroughly underpinned by risk management infrastructure
2. formally including a range of conduct risks in Risk and Control Self-Assessment (RCSA) processes
3. developing tools (eg Triangle of Risk) to ensure new staff are introduced to conduct risk, and thoroughly understand and remember it
4. some firms supplement the firm's Risk Assessment programmes with thematic assessments in particular areas as a method for identifying further risks.
5. one firm has set out ten specific qualitative tolerance statements on operational risk events and six of these include conduct as a root or underlying cause.
6. using the 'Conduct of the machine'² concept to prompt examination of technology (order routing, algorithms, robotics, etc.).
7. some firms have used Banking Standards Board feedback to consider their situation, both to assess their own best practice and versus their peers

1 For example: product development, quantification analyses, programme coding, sales, execution and delivery, service, internal and external reporting and periodic or end-of-life reviews

2 We note that 'Conduct of the Machine' is becoming used as a simple label to refer to unexpected or unintended results arising from programming errors or other malfunctions.



8. one firm put particular emphasis on its residual risk management exercise which focused attention on the areas that tailored controls could not effectively reach
9. one firm has created a specific feedback loop that immediately seeks to incorporate new risks into targeted training for staff

Some of the relatively weak examples we found include some firms which:

1. identified new conduct risks through new incidents occurring, rather than having forward-looking proactive efforts to identify risks before they happen
2. highlighted examples of conduct risks as 'new' that their peers would have described as standard risks already part of their risk framework and risk management processes for 5-10 years
3. generated significantly fewer STORs than other firms with comparably scaled businesses, raising a question about tolerance thresholds
4. have not extended their identification efforts beyond client-focused or initial front-of-house activity (eg conflicts of interest). This may reflect one or more of: initial design flaws, a late start, competition with other major projects for resources and/or just slower than desired progress in their individual programmes
5. In some firms, the effort to read-across, or explore how risks in one unit might apply elsewhere, appeared weak or non-existent

Question 2:

'How do you encourage the individuals who work in front, middle, back office, control and support functions to feel and be responsible for managing the conduct of their business?'

While firms typically discuss their entire conduct and change management programme, we did spend extra time on this important question in 2017. Firms have paid considerable attention to the need to calibrate carrots and sticks to ensure a reasonable balance and avoid unintended consequences, such as developing a culture of fear. Below we set out our observations and feedback, with some strong and weak examples.

Tone from the Top (Message Content/Frequency/Speaker)

Boards and senior management generally set out to craft and deliver appropriate top-down messages to staff. This initiative remains generally strong across firms with few exceptions. Some notable examples include:

1. messages use company history or unique company attributes to underpin corporate guiding principles
2. message content underlines that ownership of the Conduct Risk framework rests with Front Office management rather than a Support or Control function
3. a few firms have established significant conduct risk awareness programmes extending over several days or an entire week
4. some firms have framed messages around conduct and culture as a personal, aspirational goal or as a factor to improve their competitiveness
5. some firms significantly tailored their messages to reflect the seniority, function or responsibilities of the audience to heighten the relevance of these messages
6. some firms follow up Town Halls by distributing written materials to all staff to emphasise points made

However, some examples of where Tone from the Top was questionable include:

1. some CEO's were unable to explain the firm's agreed messaging
2. some board NED's had not been trained on Conduct & Culture



Behaviour at the Top

The impact of messaging is quickly undermined if leadership at any level visibly acts in a manner that falls short of stated expectations. Survey and anecdotal evidence suggests that behaviour at the top is not always consistent with the tone.

As a positive example, one firm sometimes led breach discussions by starting with an acknowledgment of partial responsibility in that they could have better spotted an individual's situation or designed a better control system. This indicated an open and supportive attitude and also displayed corporate humility. Conversely, some firms were seen to wield the stick so aggressively on escalated matters that it had undermined the concept of fairness in actual or expected staff treatment.

Accountability of Business/Unit Heads

Firms reported that the introduction of the SM&CR had a significant and positive impact on governance, conduct and culture. Specific responsibilities have been clarified in writing, backed up with managerial discussions on the meaning and impact of key changes and revised structures discussed and agreed with the regulator(s). These new structures have since been activated and supervised. Some examples of how the SM&CR supports conduct risk management include:

1. it is used to clarify responsibilities including conduct risk and sometimes evidenced by attestations
2. some firms ensure that business heads 'own' the decisions and outcomes of their staff compensation and promotions so it is not possible to ascribe responsibility or deflect blame to more senior management, HR or 'the process'
3. emphasising to staff the full picture of the impact of a poor judgement call including costs, reputational damage and other remedial work as an effective deterrent
4. one firm summarised its approach as 'What defines you is not the mistake you make but how you deal with it'
5. for conduct risk management some firms are recognising the importance of and the need for 'the hard work of leadership every day...'
6. one firm allocates a capital penalty to any business unit that fails to correctly record and report loss events related to conduct

However, as we noted above, staff in some firms have come to associate conduct risk only with breaches and punitive action against staff, which seriously undermines the intent and positive benefits of such programmes.

Responsibility of Team Members

Thinking of leadership as a disposition to lead, rather than something that attaches to a formal position or role, it is essential that accountability for conduct reaches all levels of a firm's management and staff. We found some positive examples:

1. 'I'm Accountable' booklet with scenario-based stories, distributed to staff
2. Business Heads actively engage with their direct reports on conduct topics
3. Front Office dashboards can also be seen by Support and Control staff, which enables informed engagement and discussions
4. One firm's programme was seen by staff as heavy on policy, process and mechanistic outputs. The firm then softened, personalised and supported the programme by stronger managerial engagement with good results.
5. Some firms take steps to publicly recognise instances of good conduct, on top or in place of any pay reward

On a negative note, some firms have over-emphasised the downside risks of breaches versus an appreciation of the upside benefits resulting in some staff viewing conduct as just another 'trip-hazard'.

Remuneration and MI

An increasing number of firms are removing perverse incentives and creating new approaches that reward not only what staff achieve but also how they achieve it. We note the wide gap between leading firms who began implementing advanced staff programmes that assess the 'how' as well as the 'what' 4 years ago, while others are still in discussion and planning stages.

Some firms clearly need to draw a stronger link between conduct and behaviour on the one hand and performance assessment and remuneration on the other. Awareness and wider-ranging change can be achieved gradually as firms publicise the impact on staff pay it becomes 'the norm'. However, some firms need to accelerate their efforts.

Some positive examples of progress include:

1. Many firms have made conduct and behaviour of equal weight to business goals for assessing performance, pay and promotion
2. Some firms formally capture breaches on personnel records (eg Red Flags, Yellow Flags, Conduct Flags). These are included in performance assessments and performance below standard due to a conduct issue would result in a financial penalty by reducing amounts of reward and affect promotion outcomes
3. Some firms ask for feedback from support services as part of the promotion process for front office staff. If objections are raised, this triggers further discussion with the individual. This gives the individual a chance to respond and ensures the process is fair, while also ensuring they understand and act on the observations



4. One firm made sure they communicated trends in under-performance that had resulted in remuneration penalties to staff in Town Hall or other meetings. This enables staff to focus more closely on those activities (eg AML processes, timely reporting and remedy of breaches)
5. Firms use staff survey data to gauge the acceptability and fairness to staff of the balance between remuneration and sanctions in the conduct programme

However,

1. Some firms are still more focused on penalising bad behaviour but are shifting emphasis to include positive reinforcement messaging
2. Inconsistently applying non-financial metrics or setting unclear goals can have a negative impact on these initiatives

Recruitment

Firms recruitment processes are increasingly taking into account conduct and culture attributes for staff at both junior and senior levels. These initiatives are developmental rather than fully embedded, but examples include some firms:

1. training their managers on how to assess potential recruits at the interview stage from a culture and conduct perspective
2. asking tailored questions in a standard interview or holding a more specific 'conduct interview'
3. asking situational judgement questions and scenario testing that helps inform conduct risk awareness

Market Integrity & Competition Objective

The FCA's statutory objectives include protection of market integrity and improving competition. We noted that one firm made a particular point of including anti-trust and competition law elements in its conduct training programme and definition of conduct risk. In future we will look for firms to pay increased attention to these points in the context of conduct risk management.

Question 3:

'What support (broadly defined) does the firm put in place to enable those who work for it to improve the conduct of their business or function?'

Conduct Risk Management

Including conduct topics in the RCSA infrastructure is a positive development, especially where firms fully integrate conduct risk into a strategic risk framework (eg Operational Risk). There has been a wide effort to design and implement online tools under the banner 'Front Office Supervision' or FOS. These tools include dashboards with a wide variety of content such as limits, process monitors or status reports. In the past, this content has been included only or primarily in second line of defence units such as Compliance, Financial Control or Risk Management and, for some information, in Human Resources.

While control units might continue to make use of these tools, their expanded use by front office business units has reinforced the point that they own and are responsible for the conduct in their respective businesses. Some good initiatives include:

1. Some firms have taken steps to ensure FOS tools are integrated fully into formal risk frameworks, rather than operating as standalone, ad hoc or supplementary tools
2. FOS tools are presented as an enabler and an empowerment device for use by staff to manage their activity
3. One firm has infrastructure in place for closely monitoring best execution pricing and automatically identifying trades outside of approved tolerance levels where redress might be appropriate. This resulted in the firm speaking to the client about redress before the client has even noticed the potential anomaly
4. Some firms have fully developed Risk Appetite statements across a range of selected risks, but most firms are still at an early stage in this area

Supportive Working Environment

Many firms have now developed 'content rich' intranet sites or web pages to support conduct risk awareness. These sites provide another messaging channel for 'Tone from the Top'. They also give updates on policies, process changes and relevant reading material, including links to academic articles, case studies, training tools and connected research. One firm uses a specific editorial style for all conduct-related



communications to differentiate these from other communications and give it a special status or identity. Other examples include:

1. firms wording communications carefully before they are sent out to the organisation so that they do not carry negative connotations or fear of reprisal
2. examples of actual industry events and own firm examples are re-presented to staff to highlight how business units can learn from events elsewhere

Whistle-blowing

The establishment of a safe (anonymous) and effective (responsive) whistle-blowing channel is an important component of conduct infrastructure. All firms are making substantial progress but some have room for improvement. We note that appointing an Independent Non-Executive Director to be responsible for whistleblowing is now more typical. We also saw that at least one firm uses a third party channel provider to support assurances of confidentiality and preserve anonymity.

Establishing a safe and open environment generally where staff feel safe in challenging each other and their senior managers in day-to-day activity also indicates a generally healthy cultural environment. We noted that speaking up is broadly encouraged but staff enthusiasm to challenge can still be mixed, reflecting continued caution on their part. This continues to be a focus of management attention.

Training

Many firms have introduced approaches to raise the level of interest and engagement in training programmes beyond what is possible in standard e-learning modules. This is often achieved by using real-life events from the firm's own experience, perhaps anonymised for sensitive subjects. Firms have also drawn on the academic community for thought-provoking presentations. Ambiguous training scenarios have been developed to tackle situations where the conduct risks are not immediately apparent or the decision choices are finely balanced. Some firms have employed professional actors to role play these scenarios. Some common initiatives include:

1. Incorporating 'read-across' lessons into their training programmes
2. Scenario-based training has become wide-spread. Topical situations included: gifts & entertainment, travel & expenses, mis-use of company credit card, complaint handling, front running in bonds or other products, transaction pricing, confidential information flows, transaction communications, mandatory referrals for corruption, confidentiality generally, conflicts of interest arising from interviewing prospective candidates from competitor firms and higher awareness of competition issues
3. Some firms use third party inspirational training to supplement internal training and awareness programmes for conduct and culture change

4. Tone from the Top is delivered in smaller group sessions with an EXCO member to enable an informal Q&A. This is also done by some firms as 'brown bag lunches' or 'skip-level meetings'³
5. Presentations on more specific or nuanced conduct risks that arise for products (eg re-hedging) where timing and inconsistency can create conflicts of interest or customer harm

However, we note again our concern that some firms may not be providing sufficient Conduct Risk training or adequate follow-on support for NED's.

Infrastructure

One firm explained that implementation efforts for the SM&CR had spurred process analysis and responsibilities at a more effective level than, for example, Sarbanes-Oxley.⁴ This had the added benefit of creating a more constructive dialogue between business units and staff in financial control units. Other examples include:

1. rotating junior staff and management on/off a Conduct Risk Committee and/or Task Forces bi-annually to give broader exposure to staff and raise the profile of the activity
2. Rationalising and reducing the number of active policies to a more manageable and streamlined level

3 A 'skip-level meeting' is where staff have an opportunity to meet and have an informal discussion with managers one or more levels senior to their immediate unit head.

4 The Sarbanes-Oxley Act of 2002 is a United States federal law that set new or expanded requirements for all U.S. public company boards, management and public accounting firms.



Question 4: 'How does the Board and ExCo (or appropriate senior management) gain oversight of the conduct of business within their organisation and equally importantly, how does the Board or ExCo consider the conduct implications of the strategic decisions that they make?'

Firms continue to experiment with management information for conduct risk. Management reports or Dashboards reflect a wide mix of risk limit breaches, training take-up, Personal Account dealing violations and a range of other potential risk indicators. Measures are most often inward-looking and related to controls. These far outweigh more outward-looking measures of potential harm.

Some firms reported good progress in reducing Personal Account Dealing violations, incorrect IT permissions and non-attendance at training. But they offered little on controls for new product development, complaint volumes or 'harm' related measures.

More advanced firms are now de-selecting and refining their choice of indicators or tailoring reports more specifically to the intended audience (eg detailed specifics for Trading Heads vs trend analysis on a consistent basis for Boards). Some firms have also made a concerted effort to build out their links to industry, consultants, academics and others in an effort to challenge their internal work.

We saw one specific example where a firm started a new form of conduct risk log. This covered situations that, as well as being included in an appropriate risk frame, ensured the risk and its causes were discussed at a conduct risk committee or a similar forum. The outcome of the committee discussion then fed immediately into tailored training plans for identified staff groupings and other measures.

Internal Audit

Internal Audits on the effectiveness of conduct frameworks and/or programmes are used by firms to inform Board and EXCO level management. Many firms have had one or more Internal Audit reports assessing the adequacy of risk identification, management processes, the status of controls or the status of overall change programmes around conduct. We found that very few of these audits provided significant challenge as a formal outcome. We would have expected to see more 'Needs Improvement' or 'Unsatisfactory' ratings on at least some programme components.

Question 5:

'Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?'

Horizon scanning initially focused solely on HR practices and remuneration. This has now clearly expanded across new sources of risk including: complex products, technology platforms, software and use of robotics (computer code responds as expected). Some key examples include:

1. one firm set up a formal working group to identify potential activities that could undermine existing strategies to improve conduct
2. another firm explored industry and academic links to seek wider read-across and horizon scanning information
3. some firms have used focused FCA Supervision work (eg Pricing Transparency in the following Section) as a prompt to think more widely about potential risks and reinforce read-across activity
4. conduct risk is now more fully explored in senior level discussions on business strategy

Section Two

Other supervisory activity

During late 2016 and 2017, as part of our usual firm engagement activity, we visited a number of firms to review one or more aspects of conduct risk management. This activity highlighted staff's alertness to conduct risk. Here we summarise some key points from two examples of this work.

1. Deep Dives in Derivative Price Transparency

We visited several firms to review their supervisory controls for selected desks trading straightforward and complex interest rate options (non-linear rates trading) and complex options trading (structured credit trading). Our reviews were to assess the effectiveness of front line supervisory controls and potential conduct related issues. We subsequently wrote to each firm outlining our specific findings. The 5 Questions programme sits behind such activity and we highlight here some wider observations about identifying and managing conduct risk in complex trading areas.

The nature and structure of the non-linear rates and structured credit markets can create conflicts of interest, particularly where:

- Firms act as both principals and agents
- There are information asymmetries between firm and client. Information asymmetries are highly significant - driven by the complexity of products and services, a lack of transparency in Over The Counter markets and different levels of knowledge among participants. These asymmetries heighten the risks of conflicts of interest, and could limit clients' ability to compare providers and make informed investment decisions, which may cause conduct-related harm

Another dimension of conduct risk is that traders can select or influence the choice of which complex valuation model is used for their trading activities. They can also make adjustments that reflect more subjective firm or client-specific factors.

During the past decade, changes in banking standards and regulation have encouraged banks to adjust their approach to the valuation of derivatives instruments. These adjustments are collectively labelled 'XVAs' and include specific adjustments such as Credit Valuation Adjustment (CVA), Debt Valuation Adjustment (DVA) and Funding Valuation Adjustment (FVA).

For example, CVA represents the difference in market value of a derivative contract traded between a risk-free counterparty, such as a clearing House or Central bank, and a counterparty with a higher risk credit profile. CVA can also be seen as the market price of the default risk for a derivative contract with a specific counterparty.

Our review focused on how desk supervisors treated CVA and other XVAs to identify whether and how they actually implemented the firm's conduct risk agenda in dealings with clients. We generally observed that some traders did not even consider conduct

risk as a factor in their activities in these markets. In some cases, we saw inconsistent client outcomes. This highlights the risk that firms which do not focus sufficiently on conduct risk and fair treatment of clients may disadvantage less sophisticated parties.

Some Key Findings:

Thorough identification of conduct risks in complex trading remains an area for improvement. Some First Line of Defence observations include:

1. the identification process fell short of examining the full range of conduct risks
2. conflicts of interest are not adequately understood and so remain largely unaddressed when pricing complex products
3. in discharging their supervisory duties, desk heads seemed over-reliant on the influence of sitting with the team rather than independent process oversight
4. the escalation process seemed ineffective as incidents we saw were substantially limited to actual, rather than potential, risk events
5. suspicious trades appeared to be under-reported or indicated a very wide tolerance across firms about what should be submitted

With regard to the Second Line of Defence Control functions:

1. some appeared to focus primarily on prudential risk without sufficient understanding or attention to conduct risk, which was often mis-labelled as or conflated with operational risk
2. while they individually displayed good bi-lateral relations with the First Line, they did not demonstrate strong discussion and understanding among themselves as a cohesive second line

Questions for Management to Raise:

Some questions that management at firms might ask about complex non-linear derivatives trading businesses include:

1. Have they adequately considered process oversight and managing conflicts of interest associated with including XVA within client pricing?
2. Can they demonstrate consistency of process and fair treatment of clients in applying XVAs on transactions and any subsequent unwinds?
3. For Bids Wanted in Competition⁵, are adequate formal procedures in place to mitigate conflicts of interest, ensure consistent practices (which may include applying best execution in some cases) and provide relevant controls and monitoring?

5 Bid Wanted In Competition – BWIC is an event where a Seller of tradable instruments requests that a firm (and potentially other parties) submit bids on one or more tradable instruments typically at a set date/time, and where the Seller is expecting the Firm (and potentially other parties) to submit a principal bid which may or may not be based on a bid solicited from a third party Bidder.



4. For Client Valuations, does governance infrastructure ensure that reports do not provide a misrepresentative view of a client's holdings by excluding portfolio level adjustments?⁶ Is there over-reliance on legal disclaimers as a way of managing risk?

When considering these questions, firms should ensure they have reflected the requirements and expectations set out under MiFID II, which has raised the bar in various areas including trading and cost transparency and conflicts of interest. These issues also relate to a firm's overriding duty to act in the best interest of its clients, or when dealing with eligible counterparties, to act honestly, fairly and professionally.⁷

2. Technology and Cyber Risks

We have highlighted technology and cyber as key priorities for supervisory activity in our Business Plan for the last five years. Technology continues to be an integral part of business strategies and the drive for competitive advantage among wholesale firms. Clearly, harm to markets and the users of markets can arise from poorly managed technology and cyber-attacks can exacerbate the impacts and the harm.

As a conduct regulator, we recognise how day-to-day behaviour can contribute to cyber security risk (eg safekeeping of passwords, clear desk policies, system access controls). Our Wholesale Banking Supervision function, together with in-house technical experts, has engaged with firms on their governance of technology platforms and services (the 'IT estate') in areas such as change management, incident response, business continuity, cyber resilience and management of risks and controls. This work has improved our understanding of the varying ability of firms to govern their IT estates in a way that supports and sustains their business models securely and resiliently. This basic engagement has also improved supervisory awareness of:

1. the relative sizes of Wholesale Banking IT estates
2. the scale of impactful technological evolution
3. the scope of other environmental pressures affecting IT estates
4. the overall breadth of the challenges senior management face, and
5. the ability to identify and efficiently assess potential causes of harm.

Some Observations

It remains firms' responsibility to navigate these challenges and the related conduct risks in line with regulatory obligations as set out in the FCA Handbook including Principles for Business and Systems and Controls. These risks arise and need to be addressed across the whole firm including all staff not just technical infrastructure, related support units or client-facing activity. Some key points to note from our work with firms include:

1. Most firms recognise the importance of good IT and cyber governance (in line with Principle 3, Management and Control)

⁶ In our view, unilaterally excluding material portfolio adjustments without consideration of the impact on client positions does not appear to be consistent with our expectation that information is presented in a way that is not misleading

⁷ COBS 2.1.1 R and COBS 2.1.1A R.

2. Some firms have not recognised the need for robust management of IT and cyber risk or their central risk management frameworks for IT needs significant improvement
3. Some firms are failing to communicate IT incidents and significant IT change programmes to the FCA in line with Principle 11 (Relations with Regulators)
4. Some firms are cataloguing IT-related conduct risks without adequately taking the further step of identifying where a single business or support unit may have a multitude of critical vulnerabilities
5. Some firms do not fully recognise the need for a continuous and evolving education and awareness programme for staff, who are commonly responsible for the success of cyber-attacks

Next steps

Our continued dialogue with firms, including sharing our observations of firm assessments, should help clarify and enable firms to resolve problems where needed. This in turn should help firms to effectively manage their IT functions in line with regulatory obligations and, in particular, our operational objectives.



Section Three

Outreach in wholesale banking

We engage with wholesale banks operating in the UK in a number of ways. We allocate significant attention to the largest firms, as they potentially have the most significant impact on the market as a whole. However, we seek to engage with the wholesale banking sector through direct supervisory contact as much as practically possible.

Industry Presentations

During 2017 members of the Wholesale Banking Supervision Management Teams attended a number of industry conferences, often as speakers and panel members covering topics such as FCA priorities, the Senior Managers Regime, MiFID II, the 5 Conduct Questions and the FCA Compliance Survey. We also presented to groups of firms organised by industry organisations and third parties such as consultants and law firms. Groups presented to include the Association of Financial Markets in Europe, UK Finance and the Association of Foreign Banks. We aim to continue this outreach effort as opportunities arise. We use our website to release relevant reports and firms also have many other contacts with the FCA (eg Authorisations, Policy, Enforcement, Client Assets, Financial Crime).

CEO Roundtables

As part of our supervision strategy, we have been hosting a series of roundtable discussions with the CEOs of the largest firms on topics that may be worthy of consideration in efforts to improve conduct and culture.

The roundtable sessions are designed to allow participants to examine a concept, hear from others who have practical experience or expertise and consider the practical aspects of applying these concepts. Participants can then draw their own conclusions on relevance of the topic and potential impact at their own firm. We do not endorse the views of various presenters, but seek only to use our knowledge and contacts across industry and academia to help prompt or support these discussions. This year, the roundtables focused on particular dimensions of two of the key drivers of behaviour that we focus on as a regulator when considering a firm's culture: leadership and purpose.

Leadership Character

Faculty members from the Ivey Business School in Canada presented to the CEO Roundtable in June 2017 on their work studying conduct in banking and root causes for the 2008 financial crisis. They suggest that framing the conduct issue as a moral behaviour problem, although not without merit, is ultimately incomplete. They propose

that it would be more productive to frame the misconduct and mis-behaviour as arising from a failure of 'judgment'. They then outlined the importance of character in making good judgement calls day-to-day and under moments of pressure. Dimensions of character were described as reservoirs which one could call upon to provide balance when forming a judgement. These dimensions all have behavioural elements, are measureable, can be better understood and can be strengthened. There is significant and growing interest in this approach from boards and senior management in financial services, regulators, the professions and industry in general.

Authentic Corporate Purpose

Representatives from a consulting and a retailing firm presented to the CEO Roundtable in November 2017 on formulating and ensuring the impact of corporate purpose initiatives. Wholesale Banking firms have generally invested significant resources to develop a range of Vision, Mission, Values and Principles statements. Statements of purpose often emphasise the firm's products, services and activities but do not always go to the heart of 'why' the firm chooses to do these things. Studies are now demonstrating that clarity of purpose leads to better staff engagement and sustained improvements in financial performance.

Diversity & Inclusion

The next scheduled CEO Roundtable is on the topic of Diversity & Inclusion. The session will focus on how diversity (changing the staff variety or mix) and inclusion (creating the supportive environment) are tightly bound together. From a regulatory standpoint it is important for the financial services industry to elevate the management of culture within firms as a leadership discipline, including diversity and inclusion, to the level of rigour and importance as risk management and strategic planning.

Further Roundtable meetings are planned in 2018 and beyond. They will cover topics which are selected in discussion with the participants.



Annex 1

Abbreviations used in this paper

5CQ	5 Conduct Questions
AML	Anti-Money Laundering (Financial Crime)
BWIC	Bid Wanted in Competition
CEO	Chief Executive Officer
CPBS	Conduct of Business (a section of the FCA Handbook)
COO	Chief Operating Officer
CVA	Credit Valuation Adjustment
DVA	Debt Valuation Adjustment
ExCo	Executive Committee (or senior management forum)
FCA	Financial Conduct Authority
FVA	Funding Valuation Adjustment
FOS	Front-office Supervision Tool
HR	Human Resources function
IT	Information Technology
MI	Management Information
MiFID	Markets in Financial Instruments Directive
NED	Non-Executive Director
Q&A	Question and Answer session
RCSA	Risk and Controls Self-Assessment
SM&CR	Senior Managers and Certification Regime

