OLIVER WYMAN

The straight and narrow:

Managing conduct risk in wholesale banks

MARSH & McLENNAN COMPANIES

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Executive summary

Wholesale banks are in the spotlight once again. LIBOR-fixing, derivative mis-selling and other scandals have reinforced supervisor attention on conduct standards. The conduct of wholesale banks towards clients and trading counterparties is under scrutiny and will be subject to increasing regulatory supervision. This is underpinned, in part, by retail protection; retail consumers and investors can be harmed by poor conduct between sophisticated market participants. As such, this current focus on wholesale conduct of business is not just a passing fad. Banks cannot revert to the "everyone knows the rules of the game" mentality.

Fines for poor conduct of business in wholesale banking total US$1.5 BN (~0.5% of pre-tax profits) a year and are ramping up as regulators take a tougher stance. These fines are in addition to the larger costs of litigation, compensation, reputational damage and management resources consumed in remediation.

Emerging regulatory frameworks depart from the legalistic, compliance-driven approach of the past. Banks will have to focus on economically useful activity and ensure that good conduct is led from the top, embedded in the frontline and driven by ethical judgement. Today, most banks try to influence behaviour with rules and controls – with limited success. To achieve sustainable change, firms will have to manage conduct by way of institutional values and culture.

A conduct framework must cover four aspects of the wholesale banking business: (1) strategy and risk appetite, (2) governance, culture and incentives, (3) processes and (4) infrastructure. Frontline involvement will be critical to make this work because changes in conduct disciplines can ultimately affect customers' experiences.

To get proper engagement from the frontline, conduct risk management needs to be described as good business practice rather than compliance with rules. The medium-term prize for this fundamental shift is competitive differentiation. Banks can increase their share of clients' wallets by demonstrating superiority in testing product suitability, offering transparency and advice in the sales process and providing robust post-sales servicing and issue resolution.

There are four immediate priorities for wholesale banks. The first is to establish the right governance structure with well-defined accountabilities. The Board and the Executive Committee must take the lead in defining values and principles and in providing oversight. They will also have to define the roles and responsibilities of different participants in the first, second and third lines of defence and impose a definitive separation between the three lines. Second, a diagnostic must be performed to identify major gaps between the requirements of the local regulator (and where appropriate, Group-level priorities) and the existing framework. The third priority is to embed good conduct into the bank's culture. Finally, banks must develop processes to address conduct risk. This will require reengineering existing processes as well as designing new ones.

Spotlight on wholesale conduct

Conduct in wholesale banking refers to the way wholesale banks behave towards other firms that are clients and counterparties in the financial markets. Recent scandals in this area, such as LIBOR manipulation, mis-selling of derivatives and anti-money laundering/know-your-customer (AML/KYC) failures, have propelled conduct risk to the top of the management agenda for the C-suite of many wholesale banks, as well as drawing the ire of regulators, shareholders and clients.

Financial repercussions for conduct infractions have been hefty. Many global wholesale banks (or wholesale banking divisions) have provisioned or paid out US$0.5-1.0 BN each in fines, lawsuits or settlements related to conduct issues over the last few years. These fines are merely the most obvious cost of misconduct. Greater cost can ultimately flow from the damage done to the bank's reputation and brand and from diverting management's attention away from commercial endeavours and onto dealing with regulatory investigations, litigation and remediation.

"An insurance company or pension fund may be itself a large institution, but sitting behind the company or pension fund are retail investors. Any poor practice which unreasonably shifts income to the industry is at the expense of some end retail customer. There are no free lunches, and shoddy wholesale practice is not a victimless act, even in those cases where it is not defined as a crime."

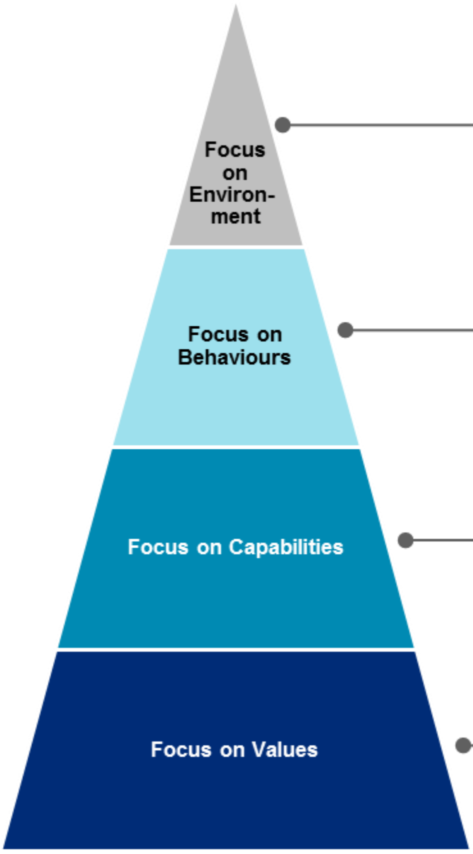
Adair Turner
Chairman, UK Financial Services Authority

Table 1
Examples of potential conduct risks across the wholesale bank

Corporate banking	• AML/KYC • Mis-selling (derivatives, structured products, etc.) • Inappropriate advice • Fraud • Anti-competitive behaviour
Investment banking/capital markets	• Mis-selling (derivatives, structured products, etc.) • Market abuse (e.g. LIBOR-fixing) • 'Front-running', 'late trading' • Insider trading • Rogue trading • Aggressive tax avoidance structures • Fraud
Transaction banking	• AML/KYC • Overcharging on captive FX • Transactions with sanctioned counterparties • Fraud

Conduct risk management at wholesale banks is at different stages of development. Some banks have done little more than AML/KYC. Others are setting up comprehensive Group-led programmes. Most banks have many fragmented and uncoordinated initiatives and are only now looking at how to bring these together. The Conduct Risk Pyramid in Figure 1 illustrates some of the different approaches we have observed.

Figure 1
Conduct Risk Pyramid



Examples of measures observed at banks	Industry progress
• Led by Op Risk • No access for public-side employees to private-side offices • Content filters to prevent access to unauthorised websites • Disabling of USB drives to make data transfer more difficult	All banks will have some measures at this level
• Led by Compliance • Code of conduct/rule-book • Checklists, processes and controls • Incentives and punishments linked to behaviours • Activity-based MI/metrics to monitor behaviour	Most banks focus on behaviours, where there is a high level of reliance on the 2nd and 3rd lines to enforce good conduct / prevent misconduct
• Led by frontline • Dedicated conduct training, while conduct considerations are built into sales and other job-related training • Training supplemented by performance measurement and coaching so that employees understand how to behave	Many banks have compliance training as box-ticking exercises – only a few banks integrate conduct into required job skills
• Led by Board / ExCom • Values incorporate and emphasise good conduct and fair treatment • Staff values aligned to firm values through recruitment, training and development, and performance management	Many banks have a statement of values but these are rarely enforced or embedded – no banks have achieved a truly values-driven approach

Institutions typically move down the pyramid as they evolve their approach to conduct risk management. In the pyramid, each level drives the levels above it. A change at a lower level will cause changes in the levels above, while making a change at a higher level may not affect the levels below.

For example, a bank could identify matching products to client needs as a desired behaviour. But if the banker does not know enough about the product or the client's needs, it cannot be achieved. Similarly, if the banker over-values short-term profit, he may ignore the needs of the client and instead sell a complex derivative that is unsuited to the client.

Most banks will have already covered the environmental aspects; today they are likely to be focused on behaviours. While they will have some initiatives at the capabilities and values levels, few have a systematic approach. They aim to influence conduct with processes and controls rather than by addressing the underlying capabilities and values that drive behaviour.

Alas, control processes are ill-suited to wholesale banking, with its bespoke products and constantly reconfiguring deal teams. Behaviour is ultimately what matters. But it does not follow that management can or should try to control it directly. Given the speed, complexity and consequent opacity of wholesale banking, values and culture will prove a more reliable foundation for good conduct than any set of rules can. A shortage of rules at wholesale banks is not the problem. The problem is a culture of "mere compliance", of following the letter of the law while having no genuine commitment to honourable behaviour.

The emerging global regulatory response

Globally, regulators are increasing their powers and expertise to impose stricter standards on market participants. The *caveat emptor* approach to wholesale transactions is on the wane, with broader systemic concerns coming to the fore. There is also a sense that the industry has lost its way and needs to focus more on economically useful activity rather than the relentless focus on maximising short-term profits and returns at the expense of clients. We do not expect wholesale conduct regulation to converge internationally in the way that it has for prudential regulation. However, there are common policy threads across most jurisdictions. These include the fair treatment of customers, product and service suitability, integrity of financial markets and the protection of client assets.

"We need to turn the page on an era of irresponsibility. We need to put transparency, responsibility and ethics at the heart of the financial system."

Michel Barnier
European Commissioner for Internal and Market Services

The emerging regulatory frameworks mark a departure from the legalistic, compliance-driven approach of the past to one that will require supervised firms to adopt an approach that is:

- Led from the top
- Embedded in the frontline
- Driven by judgement

Table 2
Examples of regulations and supervisory approaches relating to wholesale conduct in the UK, US and EU

UK	US	EU
Financial Conduct Authority (FCA) • Must be driven by senior management • Strong emphasis on culture of placing consumer "at heart of business" • Consider impact of poor conduct in wholesale markets on retail consumers • More assertive supervision of existing rules covering wholesale participants • More criminal prosecutions, tougher penalties	**Dodd-Frank Act (DFA)** • Internal business conduct requirements (robust compliance/risk policies) • External business conduct requirements (onboarding and pre-trade measures) • Documentation requirements **Financial Industry Regulatory Authority (FINRA)** • Standards of commercial honour and principles of trade • Assessment of suitability of products for customers **Securities and Exchange Commission (SEC)** • Developed formal agreements to secure cooperation of "insiders"	**Markets in Financial Instruments Regulation / Directive (MiFIR / MiFID)** • Role of board members in compliance, risk management and internal audit to be strengthened **Capital Requirements Regulation / Directive (CRR / CRD)** • Corporate governance initiatives which aim to increase the effectiveness of risk oversight by boards **Market Abuse Directive (MAD)** • Contains provisions on insider information and market manipulation

This new approach will create a material drag on wholesale market participants who currently generate US$300 BN a year in pre-tax profit. Conduct fines have grown substantially in the last two years and are currently running at US$1.5 BN per year (not including the as yet unknown level of LIBOR settlements) in the UK, US and Europe. On top of this, operational compliance costs will increase by US$10 BN per year.

Box 1
Case study: UK Financial Conduct Authority's approach

The FCA will commence operations in April 2013, with a focus on the conduct of financial institutions. According to the document *Journey to the FCA* published by the Financial Services Authority (FSA) on 16 October 2012, key features of the FCA's approach to conduct will include:

Objectives	• Secure appropriate degree of protection for consumers • Protect and enhance integrity of UK financial system • Promote effective competition in the interests of consumers
Differentiated supervision	Supervision will be differentiated, with four conduct supervision categories (C1-C4) based on their potential impact on the objectives of the FCA (broadly based on size and complexity) • C1 and C2 firms will have nominated supervisors • C3 and C4 firms will be supervised by teams of sector specialists
Culture and governance	• Conduct must be driven by senior management – "from the boardroom to the point of sale and beyond"
Supervisory framework	Current ARROW approach will be replaced by the Firm Systematic Framework (FSF), which will consist of: • Business model and strategy analysis (BMSA) • Assessment of how the firm embeds fair treatment of customers and ensures market integrity through four modules – Governance and culture – Product design – Sales or transaction process – Post-sales/services and transaction handling • Assessments will take place through interviews, with more detailed testing only if it is the only way
Wholesale vs. retail	• No hard divide between wholesale and retail markets • Ensure customers, whether retail or wholesale, enjoy protection from risks arising, either directly or indirectly, from wholesale activities • Sophistication of parties involved in transactions not a reasonable defence for poor conduct
Deterrence	• More criminal prosecutions, tougher penalties, senior management held accountable, compensation for consumers • "Shoot first and ask questions later" – e.g. 12-month product bans without consultation if suspected to be detrimental to consumers

Long term implications for wholesale banks

Wholesale banks must place good conduct at the heart of their business models and corporate culture. To achieve this, firms will need to change their approach to conduct risk so that it moves up the Conduct Risk Pyramid (see p3), focusing more on values and capabilities than controls. Only then can good conduct become embedded into the business in a way that minimises risk and satisfies regulatory expectations.

Table 3 illustrates some of the key elements that need to be addressed. While the specifics will vary with local regulations, the priorities will be similar for most banks.

"All these banking institutions have fine statements of their ethical practices on paper, but how much it's really enforced, how much is in the instincts of staff, and particularly the traders, up and down the ranks, is difficult to say."

Paul Volcker
Chairman of the Federal Reserve (1979-87)

The language surrounding conduct will be important. It should be couched in terms of good business practice rather than compliance with rules. Many previous conduct-related initiatives, such as AML/KYC have been overly rules-focused and insufficiently business-focused. The resulting disconnect with the business has meant that these processes have been less effective – and certainly less efficient – than they could have been. Frontline involvement is critical not only to get the buy-in but also to strike the right balance between ensuring proper checks and controls and maintaining a good customer experience. They are best-placed to identify problems and they are also likely to be among the supervisors' targets when assessing wholesale conduct.

For example, the UK FCA will make its assessment of the largest firms (supervisory categories C1 and C2) mainly by interviewing staff. Whom the FCA will interview remains uncertain, but they are likely to speak to the second line control staff before approaching the frontline to verify the information gathered. Everyone will need to work together and be in agreement. Achieving this will require shared values.

Table 3
Example Wholesale Conduct Risk Framework

Element	Description
Strategy and Risk Appetite	• Establish the relationship between conduct risk and business strategy via formulation of: – Values and mission – Business model sustainability with respect to conduct – Articulated values then drives risk appetite and behaviours within the firm • Conduct risk should be included as a component when setting risk appetite, developing metrics, limit setting and cascading
Governance, Culture and Incentives	• *Formal organisation*: Governance and committee frameworks support effective conduct risk management from a controls and business perspective • *Informal organisation*: The "unwritten guidelines" and relationships that constitute the informal organisation must be aligned to the formal organisation • *Informal organisation*: The "unwritten guidelines" and relationships that constitute the informal organisation must be aligned to the strategy and values of the firm • *Talent management*: Talent sourcing, training and accreditation provide the right skills and embed the right mind sets and behaviours to manage conduct risk • *Performance management:* Performance metrics and targets, compensation and reward design, and disciplinary frameworks and sanctions • *Communications*: Clear, consistent and regular communication around the stated conduct standards delivered regularly with senior sponsorship and cascaded down though management layers
Processes	• *Product design:* Conduct risk assessment embedded into the product value chain; products designed with a focus on meeting client needs; marketing and targeting appropriate to the client's level of sophistication • *Sales:* Controls implemented against each step of the sales process, including pricing, client identification (including AML/KYC), suitability assessment and deal closure • *Post-sales:* Active post-sales monitoring and remediation where appropriate, complaints handling and targeted risk-based monitoring
Infrastructure	• Management information (MI), metrics and conduct risk reporting architecture to inform senior management, enable them to exercise oversight and evidence good conduct risk management to external stakeholders • Systems, data and technology must provide consistent and reliable data

The visibility of conduct risk management, both internally and externally, will help. It should be apparent that conduct is being monitored. Exemplary conduct is the standard, and conduct failures result in disciplinary actions, including reductions to bonus or fines and, ultimately, dismissal. Line managers must be held accountable for the standards exhibited by their teams, with the onus on them to provide the necessary mentorship and performance management (and for the firm to equip them with the capabilities to do so). A communications programme targeting external stakeholders such as clients and shareholders will also be needed. This ranges from simple public relations exercises to building conduct into the brand promise.

Box 2
Focus on Values

"We must continue to measure every act against not only what is legal but also what we would be happy to have written about on the front page of a national newspaper" – Warren Buffett, Chairman and CEO of Berkshire Hathaway

The historical approach to conduct risk has focused on following rules, sometimes leading to behaviour that, although legal, has been questioned by the public and regulators on ethical grounds. Aggressive tax avoidance schemes and certain trading practices fall into this category. The challenge here is that the boundaries are ill-defined and rules are open to misinterpretation and gaming. Senior managers must be clear about their bank's values and how they translate into action and culture.

To ensure that bankers behave appropriately, banks need shared values that are embedded into their business models and cultures. The question "is it legal?" is but a minimum condition and must be supplemented by the questions "is it good?" and "is it right?" Each of these questions represents a different set of values, each with its own associated toolkit and potential pitfalls, as illustrated in the following table:

Approach to values	**Description**	**Toolkit**	**Pitfalls**
Is it legal?	Rules-based with a focus on whether behaviour is within the confines of the law	• Rules • Checklists • Carrots and sticks	• Letter not the spirit of the law • Some behaviours, while legal, may still be frowned upon • Smart bankers will find loopholes • Requires myriad of complex rules; hard to communicate and implement
Is it good?	Utilitarian approach that seeks to maximise benefit for the most people	• Team-based incentives • Customer satisfaction • Values statements	• Potential for 'group-think' • Lose focus on the profit objective • Different interpretations of "good"
Is it right?	Principles-based approach emphasising personal judgment	• Code of conduct • Training • Incentives • Communication and management exemplars	• Assumes that everyone has similar ethical priorities • Outcome receives less consideration

Immediate priorities for wholesale banks

There are four immediate priorities for wholesale banks:

1. Set up the governance and organisation for Wholesale Conduct Risk Management
2. Run an assessment based on local wholesale conduct requirements, including a review of ongoing change initiatives
3. Embed conduct risk into the culture and values of the organisation through incentives, recruitment, training, etc.
4. Develop "Business-As-Usual" (BAU) processes to address conduct risk, building the capabilities by reengineering existing processes (e.g. deal approval) and designing new ones (e.g. new reporting).

"The banking sector is clearly facing a deep crisis of confidence and trust…only an unswerving determination to "do the right thing"…will address and rebuild that trust."

Antonio Horta-Osorio
CEO, Lloyds Banking Group

1. Set up governance and organisation

The Board or the Executive Committee of the wholesale bank must take the lead on conduct by setting the strategy, defining the risk appetite and providing oversight. They will need to decide where to house the conduct risk function. There are many potential models: for example, it could sit in compliance, under the CRO, under the COO, or be a separate Conduct function reporting into the CEO ("twin peaks").

The best approach is likely to be one where the ownership of conduct risk is in the frontline, supplemented by strong oversight and control from the second line and assurance from the third. There will need to be a definitive separation of the lines of defence so that each can perform its role effectively. Many banks think that they have achieved this simply by having separate teams, each with its own reporting line. However, organisational separation is insufficient because the first line can still influence the second and third lines in subtle ways. For example, the compensation disparity between the first and second lines compromises the independence of the second line because the second line is incentivised to seek to join the first. "360° reviews" need to be managed carefully if they allow the first line to influence the performance management of the second and third lines may also make them less likely to be tough on the first line.

A clear articulation of accountabilities across the three lines of defence is therefore important. For the control functions, a balance also needs to be struck between their advisory and control roles and responsibilities. With the COO function at many banks increasingly taking on full front-to-back responsibilities, there is likely to be a large role for the COO to play in managing the full chain of controls and producing the necessary management information (MI). A potential model for such banks is for the second line to step back and provide oversight based on key performance indicators (KPIs) from the COO.

2. Run assessment

Based on the requirements of the local regulator, an initial assessment needs to be carried out to identify any major gaps. US banks, for example, must make sure they have picked up on the various aspects of Dodd-Frank related to conduct risk, such as suitability assessments and documentation processes. UK FCA-supervised banks will have to perform a Business Model and Strategy Analysis, and assess themselves across the four core assessment modules of Governance and Culture, Product Design, Sales and Post-Sales.

In addition to the "hard" assessment of the structures, policies and processes, there should also be a "soft" assessment of the firm's culture. This type of assessment comprises surveys, interviews and focus groups involving senior management, frontline, middle and back-office and clients. The objective of the cultural assessment is to understand the tacit rules and ecosystem that people rely on to do their jobs. These relationships, processes and team structures are undocumented and usually cut across the formal reporting lines in a bank.

Corporate bankers, for instance, are typically organised into sectorial or regional teams. Yet these teams rarely work together on a day-to-day basis. The corporate banking ecosystem is typically made up of the relationship director, the relationship assistant, the product partners, the credit analyst and the client service team. As many of them are not connected through direct or indirect reporting lines, understanding how they interact to produce the products and services required by clients gives an insight to the culture and values of the bank.

The assessments should identify the specific hot-spots to be addressed. For example, there could be unrealistic sales targets, remote locations or teams that have not internalised the culture and values of the bank, unhealthy (whether overly antagonistic or cosy) relationships between different parts of the bank.

On-going change initiatives should also be reviewed to ensure that conduct risk considerations have been embedded. This will determine which projects to continue, which to reconsider the scope for and which to stop. Projects with a client or frontline impact not led by the frontline or with close engagement with the frontline will need to be restructured to increase frontline involvement.

3. Embed good conduct into culture

A culture of good conduct has three components:

- *Head*: Knowledge and understanding of the bank's values and the roles and responsibilities of each colleague to support them
- *Heart*: Belief that good conduct is important and that "doing the right thing" will ultimately be recognised and rewarded

- *Guts*: Empowerment and bravery to question and make the right decisions, even where this conflicts with more immediate incentives, a perceived chain of command or the status quo.

The findings from the cultural assessment will determine the approach and the interventions to use, which will typically include recruitment, incentives, policies, processes, tools (such as segmentation models, customer relationship management system) and training. For example, training programmes will need to be developed for Executive Committee members, for new starters and for staff being prepared for promotion or re-assignment. Performance measurement and targets, and incentive schemes may need to be redesigned and disciplinary procedures and practices updated so that compensation is properly adjusted for conduct, with people rewarded for good conduct as well as being punished for bad conduct.

4. Develop processes

The assessments in (2) and (3) above should not be a one-off exercises. They need to be migrated eventually into business-as-usual (BAU) processes such as new product approval. Conduct risk controls should be integrated into the existing control frameworks in operational risk, compliance and front office control to ensure an integrated control environment that promotes efficiency and transparency. Reporting and early warning indicators need to be developed, while control breaches have to be linked to tangible actions (e.g. written warning, fines).

Identifying and reporting the right metrics for monitoring conduct risk is difficult. Many banks look at the data they have readily available and convert it into conduct risk metrics rather than figuring out what is needed for decision-making. This approach sometimes ends up relying on metrics focused on intended behaviour rather than actual outcomes (e.g. target customer profile as opposed to product uptake by segment).

Conclusion

Those firms that don’t adapt will continue to suffer fines, reputational damage, litigation costs and squander resources and management attention on remediation efforts. Firms that do adapt will acquire a larger share of the market as clients switch providers, become more efficient as the costs of compliance and remediation decrease and, ultimately, become more profitable. With wholesale banking looking less attractive today to young people because of its sullied reputation, creating a firm that can truly claim to be different will help win the war for talent. Good conduct is good business.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialised expertise in strategy, operations, risk management, operational transformation, and leadership development.

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