

CONDUCT RISK: MEETING REGULATORY EXPECTATIONS

June 2019

“Culture and governance is one of our cross-sector priorities where we have a permanent and continuing focus. We introduced the 5 Conduct Questions programme ... in 2015 ... to help firms improve their conduct risk management and ultimately drive cultural change.” FCA¹

As indicated by the introductory quote, the Financial Conduct Authority (FCA) remains sharply focused on **conduct risk** – in all of its possible manifestations. For many financial institutions, conduct risk will likely represent the single greatest specie of day-to-day operational risk. However, with relatively little regulatory guidance to date, many firms have struggled with the question of **what an appropriate conduct risk framework might look like, in practice**.

Since the introduction of its 5 Conduct Questions programme², the FCA has followed up with three annual feedback reports, outlining how firms have been progressing and setting out examples of good and poor practices.

The latest report, covering feedback from 2018/19, emphasises how firms should be taking a more strategic approach to change, putting in place a full range of long-term, connected initiatives. In particular, the FCA encourages a shift of mind-set towards firms working to develop and safeguard positive behaviours, rather than simply being focused upon the prevention of wrongdoing. The FCA suggests that strategies such as integrating conduct with long-term corporate goals, connecting conduct to an active concept of purpose, and focusing on the personal development of employees can help to reinvigorate efforts – especially if firms are finding that they are losing momentum.

This report also includes the FCA’s assessment of **“speak-up”** and **whistle-blowing initiatives**. Although the FCA found that there has been significant progress in this area, it has serious concerns about “widespread” non-financial misconduct. The importance of **‘psychological safety’, leadership character, behavioural development skills, diversity and inclusion** also feature prominently. Instructively, the FCA references a *“willingness to invest the time to understand and relate to your staff, peer group and others.”*

Significantly, the FCA also signals that it *“will increasingly include some degree of testing and challenge to management and staff below board and top management levels.”*

All firms are encouraged to note and consider the report’s feedback.

This note summarises – on a consolidated basis – key aspects of the FCA’s feedback to date, and overlays some pointed questions and [commentary](#). **It is intended as a practical guide by reference to which firms can gauge their conduct risk standing.** The detachable table in the Appendix lists all of the questions posed.

Summary of FCA’s Key Observations (Consolidated from all three Feedback Reports)

In summary, the FCA found that:

- Significant and encouraging progress has been made in identifying and managing conduct risk, however, overall progress or embedding has been patchy or is in danger of stalling
- Despite significant market distractions, conduct risk has remained a key focus of attention for boards and senior management
- Some initially UK-centric conduct and culture programmes are now being applied internationally
- Nearly all front-line businesses have taken full ownership for conduct risk and related change and development programmes
- Some firms have created new First Line of Defence (front office) roles with titles such as ‘Chief Conduct Officer’ or ‘head of Conduct and Culture’, with a mandate to develop a holistic approach to the firm’s conduct programmes
- Firms have also created or enhanced front office supervision tools to improve the ability of business heads to monitor and manage directly
- Firms should be aware that conduct risk may arise across the whole organisation and not just in the front-line business areas
- While (unsurprisingly) firms initially focused on meeting regulations and their own policies and procedures, some have now begun to position their attention outwardly to consider whether their actions are causing or have the potential to cause harm to customers or markets
- 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

¹ ‘Progress and challenges: 5 Conduct Questions – Industry feedback for 2018/19’.

² Originally targeted at wholesale banks, but now extended to apply to all FCA-regulated firms.

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- There is a growing awareness of the positive impact of an approach that joins up conduct initiatives with business strategy and developing human skills (a “*strategic approach to long-term staff development*”)
- 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
- 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
- Firms need to work on healthy, sustainable culture change by shifting their mind-set away from simply preventing harm to positively striving towards sound management and good outcomes
- Although firms have made significant progress in terms of developing a “speak up” culture and implementing whistle-blowing policies and procedures, non-financial misconduct remains widespread and firms need to ensure this is given sufficient managerial attention
- Some firms are now focusing on how counterparties and third parties with whom they deal (for instance, via outsourcing arrangements) are prioritising and managing conduct risk

Questions for Boards and Executive Management

Questions that the FCA would expect boards and executive management teams to investigate include:

1. Are conduct and related programmes suitably framed against your firm’s purpose and longer-term competitiveness and sustainability?
2. Do your conduct and related programmes include sufficient efforts to strengthen and support good behaviour rather than just reduce or eliminate bad behaviour?
3. Is there an adequate bottom-up exercise to identify and help prioritise conduct risks throughout your whole firm?
4. Do you have strategic HR programmes that focus adequately on developing the individual human skills that underpin conduct and culture change in line with the ambitions of the firm for itself and its staff?
5. In the shorter term, do your business managers and each of your lines of defence sufficiently recognise the variability and changing mix of conduct risks across your firm, and act on this?
6. In the longer term, does your firm adequately capture insights from bottom-up exercises, training programmes and crystallised events at an organisational level, such as in your overall corporate strategy, policy and updated training?
7. Looking at the evolving use of technology and digitisation, are you giving enough consideration to conduct risks that can arise as a result?
8. Finally, are you and management doing enough to address non-financial misconduct and personal misbehaviour?

Conduct Risk Supervision

As part of its conduct risk supervision strategy, the FCA will pose the following five 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 do the Board and ExCo (or appropriate senior management) gain oversight of the conduct of business within their organisation, and equally importantly, how do they 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?

More generally, the FCA will wish to understand what measures firms are taking to improve conduct.

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

Definition

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As a key first step, most firms will seek to **define 'conduct risk'**. Firms should put in the effort to create a definition tailored to their own history and circumstances, rather than adopting a standard definition. Definitions will typically refer to **client outcomes**, as well as factors such as their own staff, sustainability of their business, market integrity, and competition. Other elements will include the danger of actions or behaviours that may harm clients, cause the firm reputational damage, and risk undermining financial market integrity. However, firms should try to avoid only referencing problematic behaviour and should aim to focus on conduct across the whole curve of behaviours.

- Has the firm defined 'conduct risk'? If so, where?
- Do customer / client outcomes feature prominently in any such definition?
- Is the definition framed broadly enough so that it does not focus solely on negative behaviours?

Comment: Firms should ensure that all of these questions can be answered in the affirmative. In practice, it is difficult to conceive of a credible framework in which conduct risk is not defined in such a manner. Amongst other things (and importantly), an appropriate definition should guide the focus and direction of the firm's conduct risk programme.

- Is the definition of conduct risk referenced and utilised in practice?

Comment: It is clearly important that relevant elements of a firm's conduct risk framework are directly referenced back to the definition adopted.

Identification

While many firms use a top-down approach to start with, they commonly also supplement this with a bottom-up approach. Including a bottom-up approach introduces new risks or competitive business responses that top-down approaches are unlikely to identify.

- Does the firm employ both top-down and bottom-up approaches to the identification of 'conduct risk'? If not, is this readily explicable?

Comment: In our experience, it may well be difficult to justify any approach that does not involve both top-down and bottom-up methodologies – so as to ensure an appropriately comprehensive assessment.

Firms adopted different approaches to **collaboration and challenge** in the risk identification process. In some instances, the business alone would identify a set of risks before the 2nd line challenged the result. In other cases, the business and the wider 2nd line would work together to identify the risks. Firms making the most progress have utilised a business-led exercise.

Within some firms, risk identification work was driven primarily by control functions such as Compliance (as opposed to a business-led approach). These were found to have made less progress and/or needed to be repeated in order to be more effective.

- Is the 'conduct risk' identification process business-led; or at least is there meaningful business input from the outset?

Comment: In our experience, any other approach (in which the business does not have a substantive role) would be susceptible to challenge. At a more general level, the FCA has repeatedly affirmed its expectation that the first line of defence plays a more substantive role in the risk management context. Indeed, it would be decidedly unhelpful for the FCA to form an impression of a lack of engagement / interest by the front office in conduct risk management.

Firms also used **different levels of detail in their risk identification process**. Some firms used a desk-by-desk level, involving the individual desk heads and front office; others combined groups of desks, businesses or products.

- Has the firm made a conscious and cogent determination as to the appropriate level of detail in the conduct risk identification process?
- How comfortably could this be explained to the FCA?

Comment: Where conduct risks vary materially across desks, identification should ideally be at individual desk level. In this way (and in theory at least), there should be no material identification gaps across the firm.

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Some firms held sessions led by senior business line staff where conduct risks and 'grey' areas or 'dilemmas' were discussed. Firms used these sessions to discuss difficult issues and reinforce expectations, uncover additional conduct risks and produce FAQs for the rest of their staff.

Firms found these sessions were useful for both raising awareness of risks and identifying them, and so the risk identification process itself also became a training session, including regarding the importance of prompt issue escalation. However, training scenarios that do not have a clear outcome or model answer are preferred, as these require individuals to use their judgement.

- Would the firm benefit from sessions focussed on conduct risk, led by senior business personnel?

Comment: While this should not be regarded as compulsory, the potential merits should at least be considered. Run well, sessions of this kind can prove to be powerful and very effective.

Most firms initially focused their identification effort on **front office activity**. Firms have generally made **less progress identifying conduct risks outside of specific business lines**, but conduct risks can also occur across both operational and control functions. There is **increasing awareness that risk assessments based on front-to-back process mapping require coordination with all the necessary support functions to be effective**.

- Is the firm's approach to conduct risk overly-focused on the front office?
- Does the firm need to rebalance its focus - so as to capture conduct risk across operational and control functions?

Comment: It is clear that there is (in certain quarters at least) a perceived over-focus on conduct risk arising within the front office, to the exclusion of potentially significant conduct risks related to operational and control functions. Conduct risks do not arise exclusively in the context of the front office and this should be properly acknowledged and reflected (if not already).

Additionally, the FCA observed an increasing number of firms considering how they can map their conduct risk frameworks into their Enterprise Wide Risk Management Frameworks under their Chief Risk Officers.

- Have the potential benefits of mapping the conduct risk framework into the Enterprise Wide Risk Management Framework been properly considered?

Comment: This finding certainly accords with our own observations – whereby firms are seeking, where possible, to incorporate (or 'dove-tail') conduct risk into enterprise-wide risk frameworks. Amongst other things, such an approach ought to bring the benefits of synergy, familiarity and consistency.

Approach and the cross-comparison of risks

Risks identified in one business may manifest, perhaps in a slightly different form, in other businesses. Some firms have highlighted the benefit of performing 'read-across' exercises around conduct risk incidents and comparing the conduct risks identified.

- Does the firm routinely consider the potential applicability of risks and issues from one area to other business areas?

Comment: All firms should ideally consider potential 'read-across' during risk assessments. This is an important discipline, which can often (and easily) be overlooked; and will require input from those with the requisite knowledge and awareness to make such determinations.

Most firms have now defined conduct risk as a separate category that sits sensibly alongside other major risk types such as Credit, Counterparty, Market and Operational risk.

- Does the firm categorise conduct risk separately from other key applicable risk types?

Significantly, the FCA found that **non-financial misconduct** (such as bullying, personal misbehaviour or sexual misconduct) was "*widespread*". Further, firms' identification efforts in relation to non-financial misconduct are underdeveloped.

"A culture where non-financial misconduct is tolerated is not one which encourages people to speak up and be heard, or to challenge decisions. Tolerance of this sort of misconduct would be a clear example of a driver of an unhealthy culture. A firm which effectively addresses non-financial misconduct, encourages people to speak up and be heard or challenges behaviour and responses is demonstrating an aspect of a healthy culture."

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- Is the firm appropriately factoring non-financial misconduct into its conduct risk management framework?
- Is the firm paying sufficient attention to the behavioural / developmental skills required in order to foster a healthy and functional working environment?

Comment: The FCA has recently identified non-financial misconduct as a key area of focus – not least, because of its capacity to result in a toxic culture / working environment. Firms should assume that the FCA's focus on this important area will sharpen yet further.

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?

Cultural Influence

This question is inextricably linked to **compliance culture** and, unsurprisingly, culture is explicitly referenced in various of the FCA's observations.

For many firms, 'tone from the top' remains key. It may now be more appropriate to reframe this as 'tone from above', to acknowledge the fact that most staff are most influenced by their immediate managers. In practice, this might for example translate into senior management cascades, webcasts and 'town hall' meetings to highlight the firm's values and expectations around treatment of customers, fellow colleagues and market conduct. Smaller meetings or those aimed only at staff with a certain level of seniority may be more effective.

It is, however, also critical that senior management themselves visibly act in a manner that is consistent with stated expectations.

- Is 'tone from the top' demonstrated effectively within the firm on a relatively frequent basis?
- Do senior management actually practise what they preach?

Comment: This is a fundamental expectation of all firms, and has become all the more important in light of the heightened focus on senior individual accountability. All firms should therefore ensure that they are able to point to concrete evidence of 'tone from the top' – and on a continuing (rather than one-off) basis.

Many firms have globally-applicable **Codes of Conduct**, coupled with a requirement for all relevant personnel to sign an annual declaration / attestation confirming due compliance. Some firms employ tailored Codes of Conduct for supervisors, reflecting their specific responsibilities.

- Is there a good reason why the firm has not implemented a Code of Conduct – assuming that one (or something equivalent) does not already exist?
- Has the firm expressly considered the potential merits of a tailored supervisors' Code of Conduct?
- Does the firm require annual individual declarations / attestations from all relevant staff?

Comment: In our experience, the vast majority of firms will at least have generic Codes of Conduct. We suspect that an increasing number of firms will also see fit to adopt supervisor-specific Codes. Such Codes, together with annual compliance declarations / attestations, constitute an important control and protection for firms, and serve to help focus minds and re-enforce and clarify expected conduct standards.

In many firms, personal ownership of conduct risk is both reinforced by management and directly connected to individual objectives, remuneration, recruitment and promotion processes. However, some firms still needed to draw a stronger link between conduct on the one hand and performance assessment and remuneration on the other. The FCA found that progress on this front tends to be patchy. In particular, the proportionality of awards or penalties are inconsistent, and are seen as being so by staff. Even where firms have increased the weighting of the conduct element of an appraisal to 50%, this still has rather a modest financial impact because of the scale of bonuses. The FCA also found the gender pay gap to be quite marked in some firms, and urges firms to consider the fairness of their remuneration policies,

- Does the firm explicitly link ownership of conduct to individual objectives, remuneration, recruitment and promotion processes?
- If not, is there a good (and persuasive) reason for this?

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Comment: The absence of any such linkage is becoming increasingly difficult for firms to justify. Arguably, a firm cannot (credibly at least) claim to take conduct risk and culture seriously if it does not at the same time directly link ownership of conduct risk with these appraisal processes.

Some firms use actual (typically anonymised) instances of inappropriate staff behaviour and email traffic to encourage all staff to set the right example.

Comment: This can be a powerful and effective method of conveying important messages and is being employed ever more commonly. For many, reality-based training and awareness is the optimal way in which to engage relevant personnel, by 'bringing to life' otherwise abstract topics.

Firms' recruitment processes are increasingly taking into account conduct and culture attributes for staff at both junior and senior levels. This might include, for example, asking tailored questions in a standard interview, or asking situational judgment questions and scenario testing that helps inform conduct risk awareness and ethical / values mindset.

- Does the firm routinely and specifically incorporate conduct and culture considerations / assessments into its recruitment process?

Comment: This practice is certainly becoming more prevalent, and we expect this trend to continue over time – as this eventually becomes 'the norm'.

While no process is 'watertight', it is in our view important that firms at least try to gauge the ethical / conduct mindset of potential new recruits. Tailored situational dilemma scenarios can be particularly effective.

One firm had made a particular point of including anti-trust and competition law elements in its conduct risk 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."

- Does competition law feature sufficiently (or at all) within training modules and conduct risk assessments?

Comment: It would be fair to say that competition law risks have been historically overlooked by many firms. We are now, however, observing a more concerted focus on this important area of risk – not least, on account of the FCA's competition law remit, its significantly enhanced competition-focused resource, and the recently-announced first FCA-led competition enforcement case. Competition law risk is no less important than any other (more traditional) form of risk, against which firms typically implement mitigating controls.

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?

Supervision, Procedures and Management Information

Most firms had developed **conduct risk management information at desk-head level**, produced centrally, with a set of metrics relating to individuals' conduct and policy breaches. The **'dashboards'** picked up items such as:

- missed or late training;
- PA dealing rule breaches;
- excessive hours worked;
- late for work;
- limit breaches;
- expense policy breaches;
- suspicious transaction reports;
- word and voice surveillance reports;
- customer complaint analysis;
- high client entertainment;
- compliance exceptions; and
- selected HR reports in the search for conduct risk indicators.

The intention being to collate disparate pieces of relevant information to provide supervisors with a clearer picture of the risk and compliance culture within their area – so that it can be managed more effectively.

Some firms have progressed further by instituting **risk tolerances** for such breaches, and the creation of limits with the dashboards indicating if the tolerances are breached.

- What conduct-related management information is generated, and at what level of granularity?

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- Does the firm utilise a conduct risk dashboard, with similar indicators as above? If so, does the dashboard incorporate risk tolerances? If not, wouldn't this be useful?

Comment: The FCA has emphasised the importance of management information in this context (amongst others). In practice, such information will be essential to the proper oversight of conduct risk. As a result, conduct risk dashboards have become an increasingly prevalent feature of late. The incorporation of tolerances supports a more meaningful and effective conduct risk framework.

While some firms may utilise separate culture and conduct risk dashboards, others have sought to consolidate – given the obvious inter-connection.

Any such dashboards will be expected to evolve over time and should therefore be kept under periodic review.

Several firms will **reconsider metrics after a conduct incident has occurred** to check whether changes need to be made to ensure that such an event would be picked up if there was a recurrence.

- Does the firm routinely reconsider conduct risk metrics after a conduct incident has occurred?

Comment: This can be an effective way of ensuring that conduct risk metrics are kept relevant and up-to-date, thereby enhancing the overall effectiveness of the firm's conduct risk framework.

Some firms have gone so far as to introduce a specific communication programme around disciplinary outcomes to provide transparency on how the firm decided and applied them. This helped to foster a perception of fairness.

Other firms have introduced reverse mentoring initiatives.

Governance

Some firms have introduced a new or **stronger conduct risk challenge** in their existing new product / business approval processes.

Several firms made considerable efforts to create **governance and oversight structures for conduct** in ways that might only have been applied to other risks in the past. For example, some firms have created specific committees to focus on conduct risk. However, for some firms governance structures have proved somewhat of a hindrance, with complex infrastructure and centrally-led committees causing slower or stifled progress.

A number of firms use conduct and culture questions in staff surveys to determine how integrity and reputation are valued.

- Is there sufficient demonstrable focus within the firm's governance framework on conduct risk? How readily (and comfortably) could this be explained to the FCA?
- How does the firm assess staff attitudes towards conduct? Is there room for improvement?

Comment: Conduct risk oversight is expected to feature prominently (and explicitly) within governance frameworks. For many firms, conduct risk represents arguably the single greatest area of operational risk, and focus / attention should be commensurate.

Several firms have recently undertaken detailed governance framework reviews with a view to ensuring that conduct risk is appropriately (and explicitly) embedded.

Prudent firms will consider how confidently they could articulate their conduct risk framework to FCA supervisors. Any doubts or known weaknesses should be addressed, as this will undoubtedly remain a key area of regulatory focus (and potential vulnerability).

Risk Appetite

Some firms have looked to set risk appetites for conduct risk, and put tolerances and usages against their risk appetites. The FCA acknowledged that setting risk appetite for conduct risk may be harder than for prudential risk and, in the same vein, queried whether it is possible to move risk appetites to zero (as some firms have done) given the range of business firms undertake and the nature of conduct risk.

Some firms have framed their risk appetite statements as a series of expectations of its staff, and developed metrics around those desired outcomes. This serves to complement typical metrics around tolerance for the incidence of actual events expressed as 'events no more frequently than x and no more serious than y'.

- Does the firm set risk appetites for conduct risk? By whom is this undertaken and overseen?
- If conduct risk appetite is set at zero, is this realistic?

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Comment: Any firms with zero conduct risk appetites should re-consider whether this is realistic and justifiable, especially in light of the FCA's observations.

Training

Firms are increasingly recognising that conduct risk identification is a skill in itself.

Some firms have developed **ethical decision-making training** to help staff identify the right thing to do and to facilitate decision-making in grey areas. Numerous firms have launched more leadership / manager-specific training focused on the firm's business, conduct and culture. However, the FCA is concerned that some firms are not providing sufficient training or support for non-executive directors.

The transition from e-learning to broader use of face-to-face sessions continues, as does the trend towards incorporating conduct training into the recruitment process.

A number of firms have gone so far as to test staff on knowledge of procedures and discuss conduct scenarios. Indeed, face-to-face scenario-based training has now become widespread.

- Do conduct and conduct risk feature sufficiently prominently in the firm's recruitment process and on-going training and awareness programme?
- Does such training include tailored 'real-life' scenarios?
- Are supervisors sufficiently well-equipped / knowledgeable to identify conduct-related issues?

Comment: Training is particularly important in this context – it is vital that relevant staff are aware of, and alert to, the different types of conduct risk and their related responsibilities. Such training should be appropriately tailored and 'true-to-life'. More generally, we have observed a discernible trend towards interactive real-time training sessions, with attendees afforded the opportunity to pose questions and seek clarification of any areas of uncertainty.

Escalation / speaking-up

Escalation will be a fundamental component of any credible conduct risk agenda.

- Is escalation emphasised in conduct-related training and internal protocols?
- Are escalation processes well-known internally?
- Are senior staff trained on how to receive and deal with challenge?
- Have there been any recent instances of non-escalation? If so, what was the root cause, and have any issues identified now been resolved?

Comment: Escalation expectations and processes should feature prominently within relevant training and internal codes and policies. Any actual or perceived lack of clarity around escalation channels should be resolved at the earliest opportunity.

As and when issues arise, firms should specifically consider whether the particular matter was escalated in the correct way and, if not (and importantly), address the underlying reasons. Any identified shortcomings concerning escalation processes and/or awareness should be remedied.

Whistle-blowing

The establishment of a safe (anonymous) and effective (responsive) whistle-blowing channel is an important component of conduct infrastructure. Appointing an independent non-executive director to be responsible for whistle-blowing is now more typical.

- Does the firm routinely monitor the integrity and effectiveness of its whistle-blowing procedures and make enhancements where necessary?

Comment: The importance of a safe and effective whistle-blowing channel cannot be overstated – both from a conduct risk and culture perspective – as it will represent a pivotal feature of any sound conduct risk framework.

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?

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Many firms have a Conduct and Culture Report as a standing agenda item for their Board or ExCo meetings. This may include reports of conduct incidents, strategic decisions that may cause increased conduct risk, an assessment of new and emerging conduct risks and conduct risk metrics for all businesses and functions. Firms' investment in information-gathering is paying off, but the majority of management information focuses on misbehaviour and rule breaches, rather than positive conduct and behaviours.

- Do conduct and culture feature regularly on Board or ExCo agendas? If not, how do the Board and ExCo maintain appropriate visibility over these areas?
- Does management information focus on the full range of behaviours, rather than just poor behaviours?

Comment: It has become increasingly common for conduct and culture to be regularly and explicitly considered at Board and/or ExCo meetings. Indeed, this is now effectively a regulatory expectation.

Board and ExCo members may also sit on (Conduct) Risk Committees, which may meet more frequently than the Board, to ensure that conduct and culture programmes are rolled out effectively.

- Would creating a (Conduct) Risk Committee represent a potentially effective enhancement for the firm?

Comment: It would appear that this is becoming a more common phenomenon as the FCA continues to emphasise the importance of conduct risk and expectations continue to rise. While not an expectation per se, such an approach should at least be considered.

Many firms conduct internal surveys, some of which now ask conduct-related questions.

- Does the firm utilise internal surveys and, if so, do they include conduct-related questions?
- If not, why not?

Comment: Periodic internal staff surveys can be an effective way in which to gauge the ethical / cultural mind-set and attitude of employees. An increasing number of firms are now utilising such surveys, which are typically anonymous to encourage full and frank responses. A fear of negative survey responses does not, of itself, constitute a good reason not to roll-out a survey.

In a similar vein, exit interviews can serve as helpful barometers of values and culture, and represent a good opportunity to capture relevant (and often frank) insight.

Some Boards and ExCos require the internal audit function to routinely consider conduct and culture in business area audits. Internal audit sometimes undertake a stand-alone audit of the firm's conduct and culture programme. It is (self-evidently) essential that such audits are meaningful and sufficiently probative.

- Are conduct and culture routinely considered by internal audit – whether on a standalone or other basis?

Comment: Internal audit can play a valuable role in the independent assessment of conduct and culture, as more firms now appear to be appreciating. Active consideration should therefore be given to the incorporation of conduct and culture into internal audit programmes.

Strategic considerations

Some firms **think broadly about conduct risks** when considering a business exit. For example, one firm recognised that exiting a business in line with the contractual notice period could generate negative customer outcomes. The firm gave customers what they believed was reasonable notice (much longer than the contractual terms) and made provision for a different supplier to take on the business if the customer wanted. The firm then worked proactively with the customers to move them to a new provider.

One firm, when making significant strategic change to the business, deliberately decided to downsize the front office before the control functions to ensure appropriate oversight during the process.

- Does the firm proactively address potential conduct risks when considering strategic initiatives (exits, acquisitions, new business lines, products etc)?

Comment: While a firm will invariably have a host of different considerations at times of prospective strategic change, conduct risk should certainly feature as an important factor. Further, conduct risk-related discussions should be appropriately captured in minutes and notes to ensure that there is a good contemporaneous record, if ever challenged.

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

Many firms have focused this question solely on appraisals, remuneration and promotion. However, the FCA views it as being considerably wider, including horizon scanning internally and externally with consideration given to root causes of live or potential conduct events. The FCA was impressed to see one firm set up a working group specifically to address Question 5, but disappointed to find that many firms have not done much on this front. The FCA considers this area to be under-developed, and hopes to see firms develop a healthier approach to considering potential new sources of risk, and the changing profile of existing risks.

The vast majority of firms considered **both financial and non-financial factors** for setting variable remuneration. Several firms linked their own values and standards to the objective setting, appraisal and promotion process.

In many firms, promotion decisions now include a much **more overt assessment of the individual's conduct and cultural characteristics**, and firms are making a real effort to explain this to staff.

Firms are increasingly **splitting their grading system into 'what' and 'how'**, and being explicit and transparent to staff that their performance grade and reward reflects not only the financial and non-financial performance achieved, but also their conduct.

Additionally, firms are generally gathering **feedback from control functions as well as 360° feedback on people's conduct and behaviour**, which is used in the remuneration and promotion process, particularly for more senior and risk-taking staff.

A number of firms have developed 'scorecards' of conduct-linked metrics such as those linked to promoting the firm's desired culture, strategy, values, reputation, quality of client relationships, stakeholder engagement and people. These firms believed that this approach facilitates the measurement of performance against conduct objectives, and rewards and incentivises incremental improvements in behaviours and conduct.

- Does the firm include a horizon-scanning element in strategic business planning?
- To what extent (and how explicitly) does the firm take account of conduct characteristics within appraisal, remuneration and promotion processes? Is this well-known across the firm?
- Does the firm currently capture all relevant conduct-related feedback during such processes (including from control functions)? Is there scope for improvement?
- Can the firm point to specific instances where an individual was 'marked down' on account of conduct-related issues or concerns? Has this ever happened? If not, might that suggest that the focus on conduct and culture is more form over substance? How would the firm respond to any such challenge?

Comment: All firms should – as a matter of course – be factoring a demonstrable focus on conduct and culture into appraisal, promotion and remuneration processes. Needless to say, this must be substantive and followed in practice. Any firm perceived not to be taking conduct and culture sufficiently seriously during these processes runs a real risk of regulatory challenge and intervention.

Conduct Risk Programmes

Conduct risk programmes should be tailored to the needs of each firm, based on its: (a) size; (b) business model; and (c) geographic reach.

While there is no 'correct' approach, the following features are generally recognised by firms as effective:

- Highly visible CEO sponsorship, together with engagement and challenge by the Board
- Visible business-led ownership of good conduct
- Senior executives taking leading roles in, and accountability for, programme design and delivery
- Programmes that cover front office, control and operational functions
- Programmes integrated within strategic or operational risk management frameworks
- Use of a standardised conduct risk self-assessment process across the firm
- A firm-wide taxonomy for conduct risks across business lines and functions
- Regular discussion at Board level of conduct, culture and programme implementation
- Active engagement in the programme by internal audit
- Comparing conduct risk across business and functions
- Training, promotion, performance management and remuneration all linked to conduct and culture objectives
- Long-term conduct risk initiatives becoming fully embedded in business-as-usual

Conversely, programmes with the following features did not always generate the desired results:

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- One-off or stand-alone projects with a short timeframe
- Compliance or COOs being the primary driver of the programme
- Top-down mapping of desired conduct outcomes that are not balanced by bottom-up efforts by business units to identify where conduct risks could arise
- Disjointed or uncoordinated efforts by different business units
- Significant business units, control or operational functions being excluded
- Not examining if conduct risk arising in one area could arise in another
- Overemphasis on defensive efforts focused on 'controls' rather than more positive, fundamental drivers of behaviour
- Programme focus being limited to front office senior personnel, with limited or no involvement from middle and back office, risk, control and support functions
- A narrow focus on client-facing activity

Conclusion

For most (if not all) firms, conduct risk will represent one of the single greatest day-to-day operational risks. Regulatory expectations are clear: firms must maintain a concerted focus on the identification and management of conduct risk – including through on-going and evolving conduct risk and culture programmes.

This paper has drawn upon recent observations and insight to highlight a variety of practical measures that can be employed by firms to positive effect and, in turn, go a long way to satisfying regulatory expectations.

The table contained in the Appendix consolidates the questions posed into a self-standing checklist, which can be used as a means of self-assessment by firms wishing to gauge their relative conduct risk standing.



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APPENDIX

QUESTION	RESPONSE	ACTION POINTS & ACCOUNTABILITY
1) What proactive steps do you take as a firm to identify the conduct risks inherent within your business?		
Definition		
Has the firm defined 'conduct risk'? If so, where?		
Do customer / client outcomes feature prominently in any such definition?		
Is the definition framed broadly enough so that it does not focus solely on negative behaviours?		
Is the definition of conduct risk referenced and utilised in practice?		
Identification		
Does the firm employ both top-down and bottom-up approaches to the identification of 'conduct risk'? If not, is this readily explicable?		
Is the 'conduct risk' identification process business-led; or at least is there meaningful business input from the outset?		
Has the firm made a conscious and cogent determination as to the appropriate level of detail in the conduct risk identification process?		
How comfortably could this be explained to the FCA?		
Would the firm benefit from sessions to discuss conduct risk, led by senior business personnel?		

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QUESTION	RESPONSE	ACTION POINTS & ACCOUNTABILITY
Is the firm's approach to conduct risk overly-focused on the front office?		
Does the firm need to rebalance its focus so as to capture conduct risk across operational and control functions?		
Have the potential benefits of mapping the conduct risk framework into the Enterprise Wide Risk Management Framework been properly considered?		
Approach and the cross-comparison of risks		
Does the firm routinely consider the potential applicability of risks and issues from one area to other business areas?		
Does the firm categorise conduct risk separately from other key applicable risk types?		
Is the firm appropriately factoring non-financial misconduct into its conduct risk management framework?		
Is the firm paying sufficient attention to the behavioural / developmental skills required in order to foster a healthy and functional working environment?		
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?		
Cultural influence		
Is 'tone from the top' demonstrated effectively within the firm on a relatively frequent basis?		

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QUESTION	RESPONSE	ACTION POINTS & ACCOUNTABILITY
Do senior management actually practise what they preach?		
Is there a good reason why the firm has not implemented a Code of Conduct – assuming that one (or something equivalent) does not already exist?		
Has the firm expressly considered the potential merits of a tailored supervisors' Code of Conduct?		
Does the firm require annual individual declarations / attestations from all relevant staff?		
Does the firm explicitly link ownership of conduct to individual objectives, remuneration, recruitment and promotion processes?		
If not, is there a good (and persuasive) reason for this?		
Does the firm routinely and specifically incorporate conduct and culture considerations / assessments into its recruitment process?		
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?		
Supervision, procedures and management information		
What conduct-related management information is generated, and at what level of granularity?		
Does the firm utilise a conduct risk dashboard, with similar indicators as above? If so, does the dashboard incorporate risk tolerances? If not, wouldn't this be useful?		

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QUESTION	RESPONSE	ACTION POINTS & ACCOUNTABILITY
Does the firm routinely reconsider conduct risk metrics after a conduct incident has occurred?		
Governance		
Is there sufficient demonstrable focus within the firm's governance framework on conduct risk? How readily (and comfortably) could this be explained to the FCA?		
How does the firm assess staff attitudes towards conduct? Is there room for improvement?		
Risk appetite		
Does the firm set risk appetites for conduct risk? By whom is this undertaken and overseen?		
If conduct risk appetite is set at zero, is this realistic?		
Training		
Do conduct and conduct risk feature sufficiently prominently in the firm's recruitment process and ongoing training and awareness programme?		
Does such training include tailored 'real-life' scenarios?		
Are supervisors sufficiently well-equipped / knowledgeable to identify conduct-related issues?		
Escalation / speaking-up		

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QUESTION	RESPONSE	ACTION POINTS & ACCOUNTABILITY
Is escalation emphasised in conduct-related training and internal protocols?		
Are escalation processes well-known internally?		
Are senior staff trained on how to receive and deal with challenge?		
Have there been any recent instances of non-escalation? If so, what was the root cause, and have any issues identified now been resolved?		
Whistle-blowing		
Does the firm routinely monitor the integrity and effectiveness of its whistle-blowing procedures and make enhancements where necessary?		
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?		
Do conduct and culture feature regularly on Board or ExCo agendas? If not, how do the Board and ExCo maintain appropriate visibility over these areas?		
Does management information focus on the full range of behaviours, rather than just poor behaviours?		
Would creating a (Conduct) Risk Committee represent a potentially effective enhancement for the firm?		
Does the firm utilise internal surveys and, if so, do they include conduct-related questions?		

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QUESTION	RESPONSE	ACTION POINTS & ACCOUNTABILITY
If not, why not?		
Are conduct and culture routinely considered by internal audit – whether on a standalone or other basis?		
Strategic considerations		
Does the firm proactively address potential conduct risks when considering strategic initiatives (exits, acquisitions, new business lines, products etc)?		
5) Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?		
Does the firm include a horizon-scanning element in strategic business planning?		
To what extent (and how explicitly) does the firm take account of conduct characteristics within appraisal, remuneration and promotion processes? Is this well-known across the firm?		
Does the firm currently capture all relevant conduct-related feedback during such processes (including from control functions)? Is there scope for improvement?		
Can the firm point to specific instances where an individual was 'marked down' on account of conduct-related issues or concerns? Has this ever happened? If not, might that suggest that the focus on conduct and culture is more form over substance? How would the firm respond to any such challenge?		

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