CONDUCT AND CONTROL

Culture as a Cornerstone of Control - 2014

Maurice Evlyn-Bufton,
Armstrong Wolfe, Managing Director
“The command and control framework within the military and commerce are in place to enable effective day-to-day management of resources and to create a framework for enabling and managing change.”
Executive summary

At a Armstrong Wolfe COO Forum, there was a collective recognition that the present intensive phase of industry evolution is generational, offering no simple, short-term fix. Today’s executive has a responsibility to set the foundations for control and conduct to ensure success and sustainability for the next generation. There was also tacit acknowledgement that cultural change would not be complete until today’s generation had exited the sector, taking with them the legacy of previous practices and reference points of bygone days.

Cultural change must be driven and owned by front office, the business, where bridging traditional practices of managerial development with sales and trading staff has proven ineffective and impractical. This gap in need and intent to do the right thing, and the best way to achieve it, became central to the closing comments of the debate (see ‘Working group test case’ below).

The markets and its executive talk enthusiastically of embedding a control or risk culture into the industry, repositioning and reinforcing its DNA in the face of on-going scrutiny by the
regulators, politicians, public and media. However, we have to approach the transformation of the industry’s culture holistically in order to achieve the desired result. The end culture would be based upon an ingrained sense of individual and collective accountability and responsibility, built on traditional and perhaps until recently unfashionable well-tested values of integrity and value based professionalism.

**Command and control**

The debate was pre-positioned with a thought-provoking presentation by Chris Severson, previously of Barclays. Chris, a retired TOPGUN instructor of the US Marine Corps, offered an insight and comparisons in relation to the impact of culture, control and conduct from a military perspective, weighed against his experiences since moving into the banking sector. The basis of the command structure for the USA, the UK and more generally any member of NATO and its armed forces is the operating ethos and practice of ‘command and control’.

The US Department of Defense Dictionary of Military and Associated Terms defines command and control as: ‘The exercise of authority and direction by a properly designated commander over assigned and attached forces in the accomplishment of the mission. Also called C2.’ Command and control functions are performed through an arrangement of personnel, equipment, communications, facilities and procedures employed by a commander in planning, directing, coordinating and controlling forces and operations in the accomplishment of the mission. Commanding officers are assisted in these tasks by specialised staff officers and enlisted personnel. These military staff provide a bi-directional flow of information between a commanding officer and subordinate military units. In this context, the purpose of a military
staff is mainly that of providing accurate, timely information which, by category, represents information on which command decisions are based. The key application is that of decisions that effectively manage unit resources. While information flow toward the commander is a priority, information that is useful or contingent in nature is communicated to lower staffs and units.

This in itself sounds similar to how any commercial or corporate entity would run its own management and communication structure. The command and control framework within the military and commerce are in place to enable effective day-to-day management of resources and to create a framework for enabling and managing change. Again, similarities exist. However, it misses one fundamental point. Command and control in the military is a robust, immoveable and pyramidal structure, where training from selection to induction to on-going development underpins this supposition. The very ethos it creates and sanctions is an adherence to absolute leadership. The success of the military, where its risk
assessment is quite literally a matter of life or death, rests upon this structure enabling the military to ‘march on its stomach’ and fight effectively, demands logistical support that also relies on this ethos.

This is not to say that inspirational leadership itself does not play a role, for clearly history shows it does, but inspirational leadership alone cannot achieve the goal. Conversely, individual leaders at all levels are given room for thought and decision-making, but all decisions are ultimately tied to the overall mission. With the launch of missions in Iraq and Afghanistan, the military, like the banking community, has been under media scrutiny and has also had to respond to improving practices and, as a de facto public entity, has to work within an increasingly regulated environment. When operational, the command and control ethos, married to a deep-rooted sense of service creates a strong culture of individual and collective responsibility that underpins and supports control.

A CEO of a large company and their managing directorate do not have this absolute structure in place to manage and drive the business. There is of course a pyramidal structure, where the chain of command can be found, but there is not an automatic adherence to the commands that come down these communication channels. All management, irrespective of sector, has to lead by example to maximise performance through respect. In commerce, however, this can be easily fractured if management is poorly executed. To be effective in commerce an executive manager has to possess a box of levers – options to help execute and expedite management’s tasks and objectives correctly, invariably using incentives. These can be career advancement and promotion or relevant to banking, financial reward or, increasingly, the implementation of regulations that create an absolute lever to frame and even quantify individual and corporate conduct.

This returned the debate to how and what could be done. What additional levers could be provided to management and what
could the industry design, implement and embrace market-wide as common managerial levers? In this context, leadership training was discussed as a medium that should deliver in part a cultural change across the industry. However, all agreed that while such training programmes within the infrastructure or non-revenue departments are manageable and valuable, it was impossible to implement meaningful programmes in the front office, as loss in associated revenues when taking rising stars and/or established managers off-line was commercially unviable.

Working Party Test Case

The discussion above led to the suggestion: could there not be a centralised academy that all bank employees attend upon entry into the sector, to be revisited throughout their career and upon promotion to VP, Director, Managing Director and the board?

Each stage would be mandated to deliver a consistent message as to ethics and professionalism expected within banking, the accountability to self, colleagues, employer, industry and society and an understanding of regulations, all supported by case studies that have led to the evolution of the industry. This outline was proposed as the initial subject to pass to the appointed working group to assess, validate and represent to the Steering Committee.

What is Conduct Risk?

The closing phase of the debate took the conversation from culture into the rising subject matter of conduct. According to Reuters’ Conduct Risk Report, 2013: ‘Conduct risk is the next step in regulatory evolution. Given the deliberate lack of precise detailed rules and prescriptive requirements from the regulators it might
even be considered a revolution.’ This proved to be accurate and advance thinking.

Following its inception in April 2013, the Financial Conduct Authority (FCA) put conduct risk at the top of its regulatory agenda. The ‘FCA Risk Outlook 2013’ detailed the regulator’s approach to analysing the root cause and emergence of conduct risk. At the outset of the Risk Outlook, it was clear that the FCA had opted to purposely not provide any working definition of conduct risk. Instead, it sought to broadly contextualise the risk, indirectly observing that it refers to ‘consumer detriment arising from the wrong products ending up in the wrong hands, and the detriment to society of people not being able to get access to the right products’ However, leading market protagonist Professor McCormick believes that conduct risk is ‘no more than a new term for a part of legal risk’ and ‘legal risk is a sub-category of operational risk’.

In any event, banks are expected to develop their own ‘I know it when I see it’ conduct risk definitions and promote bespoke strategies to meet their specific risks and needs. In other words, there is no ‘right’ or definitive way for a bank to effectively manage its conduct risk. Simply ticking a regulatory compliance box and not continuously critiquing their market conduct is a recipe for disaster. This approach to risk management is symptomatic of a greater expectation from regulators that banks deliver ‘good’ outcomes for customers and the industry as a whole. Accordingly, a more holistic approach is needed to examine the scope of conduct risk.

In essence, conduct risk generally refers to risks attached to the manner in which banks, and their staff, ‘conduct’ themselves. This incorporates matters such as:

- How are customers treated by banks? Are they getting financial services and products that meet their needs?
• What are the risks of banks prioritising commercial interests over consumer issues? Are innovations in financial products and services in the consumer’s best interest?
• How do banks need to behave to restore trust in the industry?
• How does a bank manage its conflicts of interest?
• How does a bank compete fairly with its peers?
• How does a bank ensure that the integrity of markets is at the heart of how it runs its business?
• How do remuneration schemes shape the behaviour of staff?
• How does management’s ‘message from the top’ articulate the right culture or incentivise ‘good’ behaviour?
• How does the behaviour of a bank and its staff impact on market stability and price information?
Conduct risk, therefore, marks a regulatory shift from reactive to pre-emptive. With a forward-looking we may able to identify fault lines across the global financial system more quickly and seek early preventive measures. The lack of regulatory guidance on a working definition of conduct risk does have its drawbacks, as emphasised by one commentator:

‘In different contexts the term ‘conduct risk’ is often conflated with issues such as operational risk, cyber security and data privacy, all of which are areas of rapid regulatory evolution. In March, the FCA fined JP Morgan’s UK wealth management business £3.1 million for failing to keep complete and up-to-date information on client objectives, risk profile and risk appetite placing them at risk of receiving inappropriate investment advice. This example is particularly interesting because it was not related to human failure or a failure of controls alone. Instead, the regulator argued that the firms’ computer systems did not allow sufficient client information to be retained. This is indicative of the way in which narrow definitions of conduct risk cannot be taken at face value or viewed independently.’

If obtaining an industry-wide definition of conduct risk is a difficult task, measuring a bank’s appropriate conduct risk appetite or what a robust conduct risk-management framework should look like will
prove to be one of the greatest challenges for the banking sector. Conduct risk will constantly change, so we will always have to review our approach to assessing and managing it. As time passes, a gap analysis should be carried out to assess if any additional conduct risk controls are needed and clear lines of accountability for conduct risk should be established. What responsibility the COO community may hold in this initiative is yet to be determined, but it is likely to be a central one.

Barring the definitional issues, conduct risk promises to be a cornerstone of how regulators and banks will approach risk management in the future. To this end, it will be resident in the COOs in-tray perhaps for a generation or more.