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Wholesale Conduct Risk  
Internal Audit's role in the  
refocused regulatory agenda

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# Wholesale Conduct Risk as a concept

Since the global financial crisis, regulators globally have been grappling with a multitude of conduct related matters, which have put the integrity of wholesale markets under intense examination. High profile examples include:

- manipulation of benchmark borrowing rates, the LIBOR ‘scandal’;
- investigations into the integrity of FX markets; and
- investigations into the sales of wholesale products to non-wholesale customers, for example the interest rate hedging product review implemented in the UK by the Financial Conduct Authority (FCA).

Poor conduct amongst firms and employees is a common factor in many of these issues that have arisen since the financial crisis. Thus the term ‘Conduct Risk’ was borne by regulators. While regulators may have previously primarily focused on the conduct of firms interacting with retail customers, as exemplified by the Financial Services Authority’s (FSA) ‘Treating Customers Fairly’ initiative, there is now a strong realisation that the potential knock-on effects of wholesale market misconduct are so great that heightened regulatory scrutiny of wholesale markets is necessary.

There is a very strong expectation that conduct risk management arrangements in wholesale market participants will have been significantly enhanced since the financial crisis, and firms can expect regulators to be increasingly intrusive and challenging of firms’ approach to Wholesale Conduct Risk.

## What is Wholesale Conduct Risk?

While the term ‘Conduct Risk’ has evolved, the elements that underpin the concept are not new, and should be familiar to any internal auditor with some experience in the market. Indeed, the FCA’s Principles for Business, inherited from the FSA and dating back to 1998, contain some very simple pointers on what regulators mean by conduct risk. For example, any regulated firm, retail or wholesale, is expected to ‘conduct its business with integrity’ (Principle 1) and to ‘observe proper market standards’ (Principle 5). More recent regulatory focus has identified firms’ culture and competition matters as important aspects to consider.

The table below sets out a more detailed analysis of how present-day Wholesale Conduct Risk might be defined.

Wholesale Conduct Risk – the concept	
<b>Wholesale Conduct Risk is:</b>	The risks that the conduct of a firm directly, its employees, associates or representatives gives rise to: <ol style="list-style-type: none"> <li>Undue financial or non-financial detriment to clients, customers, or counterparties, whether the firm deals with them directly or via third parties</li> <li>damage to the integrity of the financial markets</li> <li>ineffective competition in the markets in which the firm participates</li> <li>non-compliance with the law or the requirements and expectations of regulators and other authorities</li> </ol>
<b>What does this mean</b>	
<b>Conduct Risk can emerge due to:</b>	<ul style="list-style-type: none"> <li>• The failure of the firm to uphold and ensure good conduct and behaviour of employees and representatives</li> <li>• Poor culture, leadership, incentives and remuneration practices</li> <li>• Failure to provide adequate resources, systems and controls</li> </ul>
<b>Undue detriment can manifest in:</b>	<ul style="list-style-type: none"> <li>• Clients’ distress, inconvenience, reduced choice, loss of opportunity or benefit</li> <li>• Damage or distortion to the competitiveness and/or integrity of the financial markets that the firm participates in</li> </ul>
<b>Mitigants are:</b>	<ul style="list-style-type: none"> <li>• To allocate clear responsibilities for managing and controlling conduct risk in the 1LoD in each business line</li> <li>• To use a risk based approach to focus management attention and resource on the material conduct risks identified in a Wholesale Conduct Risk specific assessment processes</li> </ul>

## Impact of the creation of the FCA on the conduct risk agenda

For firms subject to UK regulations, a fundamental change occurred in April 2013 with the creation of the FCA. The FCA is more outcomes focused than its predecessor, the FSA, and requires firms to think about the impact of their business activities on customers, clients and counterparties. This requires more focus on ‘fundamental drivers’ of wholesale conduct risk, meaning those factors inherent in the business activities of a bank that increase the likelihood of conduct risk matters emerging.

The introduction of a competition objective for the FCA marks another important shift in focus on conduct matters. In this regard the FCA has launched a number of detailed 'market studies' to understand the competitive dynamics of various markets, and include analyses of whether competition in the market is delivering effective outcomes for customers. Central to this theme, is a focus on products' value, which represents a significant change from the previous regime. Depending on findings, these studies could lead to market 'remedies' where the FCA does not believe competition is functioning effectively. A market study of Investment and Corporate Banking was launched in May 2015, with initial feedback due in March 2016, which will set out any areas of concern on which remedies may be proposed.

<b>Drivers of Wholesale Conduct Risk</b>	
Conduct risk in wholesale markets has the following fundamental drivers:	
<b>Driver of conduct risk</b>	<b>Examples</b>
Information asymmetries	<ul style="list-style-type: none"> <li>• Insider trading is driven by the abuse of information asymmetries</li> <li>• Individuals execute trades that could be viewed as manipulative</li> <li>• Banks are experts in the risks of an underlying transactions but their counterparty or client may not be</li> </ul>
Conflicts of interest	<ul style="list-style-type: none"> <li>• Firms exploit knowledge of a client's trading intentions to deal ahead (front running a client order and make a proprietary trading profit)</li> <li>• Firms or individuals are incentivised to carry out transactions that are not in the client's best interests, e.g. payment for order flow</li> </ul>
Economic and regulatory pressures	<ul style="list-style-type: none"> <li>• Reduced trading margins and falling volumes caused firms to move into new activities or find ways of increasing margins</li> <li>• Adjustments to business models and cost controls can lead to conduct risks if systems, risk management and governance become unsuited to new levels of complexity or to changes in the scale and risk profile of a business</li> </ul>
New technologies and the pace of change	<ul style="list-style-type: none"> <li>• Technological advances have increased firms' dependence on systems meaning that the integrity of IT infrastructure has become increasingly important</li> <li>• Recent failures include: customers being unable to process payments and 'flash crashes'</li> <li>• Legacy IT Infrastructure and systems prevents firm's management from effective oversight of conduct risks and behaviour</li> </ul>

### **FCA latest direction**

Wholesale Conduct Risk featured in the 2015/16 Risk Outlook, which formed part of the FCA's Business Plan. In particular the document noted:

- the FCA's continued focus on driving cultural change within wholesale markets, including through a focus on ensuring that firm structures, processes and incentives support better conduct outcomes;
- some specific topics that will be the focus of thematic reviews – controls over flow of information, benchmarks, dark pools and a continued focus of conflicts of interest;
- supporting the UK Government's 'Fair and Effective Market Review' of wholesale markets and undertaking a review of competition in the investment and corporate banking sector.

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**"It is vital that firms, in wholesale and retail markets, ensure that cultural changes have been made, to prevent poor conduct in future."**

FCA Business Plan, 24 March 2015

# Framework, Governance and Implementation

## Frameworks

We see that for most in the industry, the approach to the governance of wholesale conduct risk has been to build 'bolt-on' frameworks to or augment their existing operational risk frameworks to give Wholesale Conduct Risk the required prominence. And this reflects the industry's recognition of the fact that a large portion of all operational risk losses are caused by conduct or behaviour of staff. Furthermore, Wholesale Conduct Risk features prominently in the operational risk capital calculations of banks, ranking pari passu with all other risks in the firm.

## Governance and implementation

While there are no specific 'conduct risk framework' requirements – Wholesale Conduct Risk can be managed within existing governance, risk management or Management Information (MI) structures – there are a number of factors that firms should consider:

- the focus of the FCA has shifted from the compliance function as owner and advocate of Wholesale Conduct risk to the first line of defence, the risk owners and takers, to evidence effective management of the inherent conduct risks due to the business activities they undertake;
- in contrast to retail or private banking conduct model – the customer life-cycle approach is an unsuitable as a basis for considering Wholesale Conduct Risk given the transactional nature of wholesale markets;
- for institutions subject to the new PRA/FCA Senior Managers Regime, a new set of conduct rules came into force in March 2016, with a subset of these new rules applying to almost all employees.

## Common challenges for firms in implementing effective Conduct Risk management:

### Ownership



Ownership is often an issue. It best sits within all three lines of defence. However clear and expressed accountability within the Significant Influence Functions and middle management as well as the control functions is often missing or not formalised.

### Collaboration



Wholesale Conduct Risk management requires collaboration between Front, Middle and Back Office, Operational Risk, Compliance, Internal Audit, HR and crucially Senior Management. Firms in the market struggle with the level of collaboration needed, mainly because the individuals involved had not focused on WCR in the past and did not realise that existing good practices could be communicated better within the firm and be more widely adopted and standardised.

### Management information



A high volume of MI is provided at multiple levels of the firm without sufficient prioritisation and assessment of quality or relevance. A lengthy process of iterations is required to clean up and calibrate the data to an effective set of MI. In spite of volume, senior management does not receive the MI they require to take informed action on emerging conduct risks.

### Tone from the top versus message from the middle



Top senior management within firms is now well versed in setting the required tone from the top of the house. However, there is a significant risk that this tone from the top is muddled or diluted by middle management, whose everyday focus is not on meeting regulatory conduct expectations, but in getting the daily operational tasks completed. This may be a barrier to installing organisational wide cultural change to support good conduct outcomes.

# Role of Internal Audit in assessing Wholesale Conduct Risk

Given the current regulatory focus, Internal Audit functions will need to build conduct risk explicitly into their programmes. Those Heads of Internal Audit who have an ongoing relationship with FCA supervisors can expect regular challenge and questioning on the adequacy of coverage of conduct risk. The table below sets out some conduct risk dimensions that should be considered by internal auditors.

## Conduct risk dimensions that Internal Auditors should consider

<b>Market integrity</b> <ul style="list-style-type: none"> <li>• Market abuse</li> <li>• Conflicts of interest</li> <li>• Control of confidential information</li> <li>• Financial crime</li> </ul>	<b>Customers, clients and counterparties</b> <ul style="list-style-type: none"> <li>• Client categorisation</li> <li>• Product complexity and disclosure</li> <li>• Product pricing, value for money</li> <li>• Target market</li> <li>• Stress testing</li> </ul>
<b>Competition</b> <ul style="list-style-type: none"> <li>• Market segmentation</li> <li>• Transparency in the cost of services, bundling</li> <li>• Availability of data</li> <li>• Vertical Integration</li> </ul>	<b>Bank infrastructure</b> <ul style="list-style-type: none"> <li>• Governance</li> <li>• Management information</li> <li>• Client service and reporting</li> <li>• Risk management</li> <li>• CASS</li> <li>• Transaction reporting</li> </ul>

Internal Audit functions will need to ensure coverage of the firm's material conduct risks (generic high level model shown above), including the respective conduct risk appetite and associated governance, risk management arrangements and management information. The annual planning processes should articulate how the plan adequately covers customer outcomes, and the influencing factors.

Individual review planning arrangements should specifically identify Wholesale Conduct Risk and where relevant should identify audit testing of relevant controls, as well as sampling key front-line processes supporting market integrity and good outcomes for customers, clients and counterparties. Audit programmes should also consider the extent to which 'first line' functions are taking sufficient responsibility and accountability for good the Wholesale Conduct Risk that is generated due to their business activities.

## How should the regulatory focus on Wholesale Conduct Risk influence Internal Audit programmes?

- Integrate the assessment of Wholesale Conduct Risk into the annual audit programme, alongside all other risks types;
- Drive a risk based assessment of material inherent conduct risks and assessment of the adequacy of the conduct risk control environment;
- Promote testing of the alignment of inherent and residual Wholesale Conduct Risk with the conduct risk appetite as expressed by the Board;
- Shift the audit approach from auditing conduct compliance to auditing the effectiveness first line of defence controls;
- Promote the testing the effectiveness of governance arrangements, systems and controls, policies and procedures, MI and Training on all material inherent conduct risks.

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“Internal Audit should evaluate whether the organisation is acting with integrity in its dealings with customers and in its interaction with relevant markets.”

# Key contacts

## Financial Services Internal Audit

### Paul Day

Lead Partner, FS Internal Audit  
020 7007 5064  
pauday@deloitte.co.uk

### Russell Davis

Partner, Banking Internal Audit  
020 7007 6755  
rdavis@deloitte.co.uk

### Terri Fielding

Partner, Investment Management  
Internal Audit  
020 7303 8403  
tfielding@deloitte.co.uk

### Matthew Cox

Director, Insurance Internal Audit  
020 303 2239  
macox@deloitte.co.uk

### Mike Sobers

Partner, Technology Internal Audit  
020 7007 0483  
rdavis@deloitte.co.uk

### Jamie Young

Partner, Regions FS Internal Audit  
0113 292 1256  
jayoung@deloitte.co.uk

## Regulatory Compliance

### Nikki Lovejoy

Partner, Regulatory Compliance  
020 7303 2921  
nlovejoy@deloitte.co.uk

### Daniela Strebel

Senior Manager, Regulatory Compliance  
020 7007 7888  
dstrebel@deloitte.co.uk

### Phil Nicholls

Associate Director, Regulatory Compliance  
020 7303 8983  
phinicholls@deloitte.co.uk

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