CONDUCT IN COVID

PREVENTING THE NEXT RISK SCANDAL

INTRODUCTION

In recent years, financial institutions have taken decisive steps to improve their conduct frameworks with varying degrees of advancement seen in approaches to process and controls, client and customer treatment as well as people and culture.

Efforts have largely been driven by regulatory scrutiny. The latest report from the Fixed Income, Currencies and Commodities Markets Standards Board (FMSB) estimates banks have paid some $375 billion in conduct fines over the last five years.[1] In the UK specifically, the Financial Conduct Authority (FCA) have brought in a growing number of regulations such as Market Abuse Regulation (MAR) and Senior Managers and Certification Regime (SMCR) following the litany of scandals within the sector, including PPI[2], MIFID II[3], LIBOR[4], and Office of Foreign Asset Control (OFAC) violations.

However, leading firms are recognizing that a robust approach to conduct is about more than siloed components such as conflicts of interest, treating customers fairly and stopping bad actors. At Capco, we believe conduct is about presenting employees with the optimum working environment; enabling staff to make the right decisions and pursue the right customer outcomes, consistently. COVID-19 and lockdown has redefined the industry environment and presented new challenges, such as staff living with someone who works for a different bank, security and surveillance of home set-ups and control of sensitive information. As firms continue to return to the office, now is the time for CEOs, COOs, CROs and heads of business to reassess and bolster frameworks to cater for a ‘new normal’, comprising higher levels of flexible or remote working, working from home and rotation through office space.

In this paper, we will outline Capco’s perspectives on how financial institutions could maximize the use of data insights, analytics and tooling, as well as targeted culture, behavior and engagement initiatives to not only mitigate conduct risk in a ‘new normal’, but leverage these as an opportunity to derive broader benefits including increased productivity, efficiency and staff engagement within their organizations. Ahead of a much-anticipated resurgence of COVID-19 expected towards the end of 2020, increased uncertainty, volatility and potential future lockdowns, has your organization done all it can to prevent the next risk scandal?

THE CURRENT INDUSTRY & REGULATORY LANDSCAPE

The financial sector has shown itself to be more resilient and prepared than the 2008/09 financial crisis, where the banking industry solely relied upon governments to act as a primary source of stability. Since the beginning of the COVID-19 lockdown, global banks have adapted quickly to remain operational and continue to service customers. UK banks, for example, have been encouraged to support firms on the brink of collapse, as well as giving forbearance to clients and customers who are struggling. The FCA have recognized this by stating that 'there has been no significant erosion of clients' access to services, business continuity arrangements appear to be working and "glitches" have been worked through. Overall, it feels as if firms are coping and adapting to this new normal.'[5]

Amidst a buoyant and volatile market where trading activity, notably in futures contracts and foreign exchange, has seen spikes and large sums of debt and equity capital is being raised daily, bankers have shown they can operate remotely, and banks have acted swiftly to remain operational during significant volatility and uncertainty[6] in the severe first phase of COVID-19.

Figure 1 below demonstrates the level of uncertainty across the industry with the Chicago Board Options Exchange Volatility Index (VIX), often referred to as the 'Fear Index' and regarded as an industry benchmark of market risk and investors' sentiments, suggesting significantly higher uncertainty for 2020 than the financial crisis of 2008. More specifically, Figure 2 illustrates a significant spike in the VIX rates[7] in March, at the height of the pandemic globally. In June, VIX averaged 33 points, which is still almost 15 points above its lifetime average of 19 points.

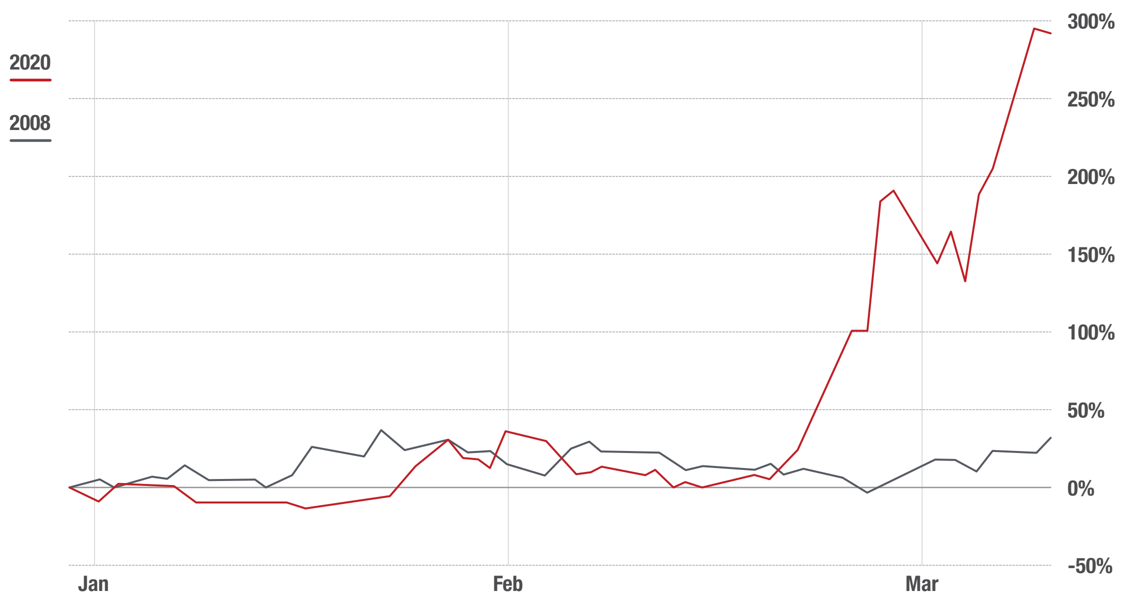

Figure 1: VIX 2008 vs VIX 2020 suggests significantly higher uncertainty than the financial crisis in 2008

Figure 2: VIX Rate 2020 YTD illustrates a significant spike in March at the height of the pandemic globally. In June, VIX averaged 33 points, which is still almost 15 points above its lifetime average of 19 points.

With indications being that we may not see a retreat in uncertainty anytime soon,[8] firms must now demonstrate greater resolve and look to ensuring robust and sustainable operating environments, starting with the return from lockdown and reimagining their post crisis future. Banks should see this as an opportunity to rediscover their purpose and build their reputation and trust with society by providing stability, leading communities and businesses safely and sustainably through the crisis.

In a welcome message to banks, the Financial Conduct Authority vowed to display fairness in assessing firms' responses to this unique, unprecedented pandemic.

However, in a series of recent publications including 'Dear CEO' letters and Market Watch newsletters,[9] the FCA has also made clear that it expects all systems and controls in place pre-lockdown to remain operational and effective regardless of whether staff are working in or out of the office. It reinforced its position that it is committed to 'clamp down with all relevant force' on any misconduct.[10] What is transpiring is that COVID-19 will be not only about testing firm's operational resilience capability, but the pandemic is likely to serve as the litmus test for the Senior Managers and Certification Regime, and whether senior executives have implemented sufficiently robust frameworks to meet a swathe of regulatory requirements.

NEW CHALLENGES CAUSED BY COVID-19

Understandably, the pandemic and the regulator's stance has caused a frenzy amongst many already stretched compliance, risk and monitoring functions now grappling with a myriad of new challenges, such as:

- **Living with someone who works for a different bank:** This can manifest as potential conflict of interest, increase security risks given the nature of information that people may be privy to, may give rise to potential competition law breaches and risk of insider trading.

- **Security of home setups:** Unsecured internet, hardware and phone lines can expose the employee and organization to a host of privacy and cyber security threats. In addition to this, 'smart' technology such as Amazon's Alexa and Google Nest have been shown to 'listen' continuously, therefore, increasing potential risk and exposure for breaches when working from home.

- **Surveillance of home communications:** Regulatory rules require traders' calls to be recorded and monitored, however, applications such as WhatsApp (Global) and WeChat (China) have end to end encryption and thus cannot be recorded or monitored. The key control of no personal phones or calls on trading floors has now been bypassed with some traders still working from home. With a shift to increased home working this may remain a key risk for the future.

- **Handling of material non-public information (MNPI):** In April 2020, the Securities and Exchange Commission (SEC) stated that 'in these dynamic circumstances, corporate insiders are regularly learning new material non-public information that may hold an even greater value than under normal circumstances.'[11] This statement was released due to several highly public examples of questionable securities trades that could indicate insider trading whilst in possession of MNPI. This messaging is crucially important and timely for banks as the scale of disruption to business and numbers of staff working from home caused by the crisis may mean protecting MNPI is not always front of mind.

- **Staff welfare:** The International Monetary Fund (IMF) has said that 'supervisors should consider postponing resource intensive activities'[12] in order to support staff welfare. In addition, a possible consequence of the pandemic is the detrimental impact that it may be having on people's mental health. This is a view supported by the World Health Organization (WHO), in which they suggest that fear, worry and stress are normal to perceived threats. This coupled with the realities of working from home, temporary unemployment, home-schooling of children, lack of physical contact with family members, friends and colleagues means that the focus on mental health should be greater than ever[13] and needs to be a key focus for organizations going forward, along with forward planning returning to work and the new ways of working.

Furthermore, in a volatile market requiring real time decisions to secure profits, delays in receiving advice from peers or management on the trading floor or compliance's approval could result in traders exercising personal judgement which can lead to poor conduct outcomes. Firms will need to get comfortable that employees working from home are doing so safely and securely without their primary detective and preventative control – in an office everyone can see what you are doing. Encouragingly, a study by Marco Angrisani at the Federal Reserve Bank of New York (FRBNY)[14] found that a sample of 56 traders and portfolio managers from London has indicated that 'the shock to social and economic life due to the pandemic has not significantly affected risk preferences.' Whether this holds true across the industry over time remains to be seen.

Culture, behavior & engagement

The COVID-19 pandemic and lockdown working arrangements have brought the themes of culture, behavior and engagement within financial services back into sharp focus. Although not a new challenge, the current climate has made it a greater one for organizations.

Especially as 'some misconduct is actually facilitated by the home-working environment, for example, managers cannot be sure that staff aren't colluding inappropriately over WhatsApp and it is easy to take a picture of privileged data when no one is near you to ask what you're doing.'[15]

The reality is that permanent remote working has placed employees in a greater position of trust than ever before leaving financial institutions with weaknesses in conduct and culture potentially exposed and vulnerable in a number of ways. These can be defined under three themes:

- **Out of sight, out of mind:** Due to home working, connections with others may decrease which can lead to demotivation and increased conduct risk, where work suddenly seems further away and rules and regulations that we need to follow seem less important.[16]

- **Shifting identities:** This theory states that people's behavior is impacted by the social group they belong to. As people are at home, their identity and mentality may change and this drives behavioral risk, leading to people weighing interest differently and taking riskier decisions.

- **Losing ethical cues:** 'Groups are our moral anchors'[17] and can help steer us onto the right path. Losing ethical cues and psychological distancing 'negatively impacts psychological safety and people's ability speak their minds, therefore, hindering people's desire to speak up about their doubts and concern.'[18]

Firms that actively foster strong cultures based on mutual understanding and collaboration between juniors and seniors, where staff speak openly and are heard, can benefit from fewer conduct incidents as well as better staff engagement thus driving opportunities for increased talent retention, productivity and lower costs.

SOLUTIONS

In order to tackle the new challenges caused by COVID-19, along with the ongoing need to evolve and enhance the organization's culture, behaviors and engagement, Capco believe organizations should focus on two main areas; 1) the use and adoption of experimental cultural assessment pilots and tools, and 2) targeted investment in data insights, analytics and tooling.

Cultural assessment pilots / tools

To reap the most impactful, sustainable benefits of a robust control environment under the current circumstances and for the future, industry leaders must look beyond complaints, incentives, conflicts of interest, whistleblowing and a supportive 'tone from the top'. A proactive approach and a strong control environment can help to pre-empt and detect fraud and misconduct.[19] In conjunction with a robust, holistic control framework, organizations should look to implement:

- **Cultural experiments:** These are grounded in pragmatism, owned at team level, and powered by an iterative, experimental, evidence-hungry change engine continuously testing, learning, and adapting.[20] There are a number of behavioral science service providers such as Ashridge, Mimoto and Cenfri, that can facilitate this approach. Conversely, this can be driven internally by the right actors and seniority of stakeholders. These tools penetrate the depth and breadth of the organization and can illuminate grass roots level subcultures and embrace mental health, wellbeing and new ways of working. In applying EQ (emotional intelligence) and behavioral science techniques firms will foster an environment in which staff are committed, empowered and make the right decisions and choices consistently.
- **Cultural insights tools:** The tangible ways of promoting good culture that are currently underway (overhauling speak-up policies, addressing tone from the top, looking at remuneration and reward) are going some way to improving conduct across organizations. However, maximizing the potential of data and technology can offer solutions to more intangible issues, such as assessing how employees use language and are behaving. For example, organizations such as, Behavox and Receptiviti are looking to use technology and data to 'monitor psychological variables manifested in the type and structure of language used by employees in their corporate emails.[21] Receptiviti in particular states that their use of data and programming creates a platform that includes a variety of applications for improving organizational health such as insider threat detection, risk culture measurement, and understanding cultural fit in the recruiting process.'[22] In times where physical supervision is strained and staff are away from the office, such tools could provide opportunities for organizations to build deeper insights into their culture and subcultures. Notably, through times of increased pressure, these tools can help firms proactively course correct where there may be hotspots of activity and de-escalate concerns before they materialize.

Data insights, analytics & tooling

At a time where fluctuations in liquidity can lead to pronounced market swings[23] and overnight trading activity is increasing across a global market, home traders, and therefore their supervisors, are faced with managing conduct in what can be, in effect, multiple trading days within a twenty-four hour period.

Here the effective use of data insights, analytics and tooling presents a more compelling opportunity for financial institutions than ever before, not least because the remote working environment can place limits on physical surveillance and supervision. It also remains a key focus for the FCA with Christopher Woolard, FCA Board Member and Interim Chief Executive, stating that 'despite everything else…focus is around both our routine supervision and our routine enforcement'.[24]

- **Supervisory tools:** From a pure conduct perspective, targeted investment in supervision and analytics capabilities can provide firms with real time data driven insights across a spectrum of behavioral, P&L and trade lifecycle related risks. Capco have supported clients on the delivery of programs to build industry leading supervisory tools for front office supervisors. These tools provide a range of key real time metrics helping to identify trends of unusual behaviors, red flags as well as demonstrating real-time breaches. This supports both proactive and reactive actions to mitigate breaks in controls. Such real-time insights will not only facilitate the early detection and response to warning signs before a risk materializes but can provide senior managers with a more comprehensive and holistic supervisory management toolkit. When implemented correctly in combination with existing measures and controls, these supervisory tools not only promote sound decision making but can be used to promote a more consistent, fair and balanced approach to staff appraisals.

POST-LOCKDOWN: CONDUCT IN THE 'NEW NORMAL'

There will no doubt be significant developments and much debate in the industry over the coming months as the impacts of COVID-19 and lockdown continue to surface.

Firms will need to think clearly and act decisively to reintegrate the workforce, implement new ways of working and re-invigorate efforts to drive long term productivity. Although firms may decide to make a cultural shift towards sustained home working, firms will need to pay heed to the FCA's clear guidance that SMCR and 'business as usual' enforcement remains a priority, and design workplace models that continue to ensure the right systems and controls around market abuse, conduct, and managing conflicts of interest are in place so that the integrity of the financial system is upheld.[25]

In addition, firms will need to explore how they can influence cultures and sub-cultures remotely, mitigating the risks of 'out of sight, out of mind', 'shifting identities' and 'losing ethical cues.' This needs to be done through existing initiatives and enforcement of 'tone from above'. However, if an experimental approach to culture and technology is used in conjunction with existing initiatives, an organization can drive truly impactful cultural change. Firms could stand to benefit from better decision making, loyalty, productivity, talent retention and by proxy, fewer regulatory fines.

Finally, the use of data insights, analytics and technology will support an organization to build a more robust control environment that will be effective when working both in the office and remotely. Leveraging such tools will provide a broader and deeper insight into potential risk signs related to staff and activities and help provide a more forward-looking view on where conduct strays from the firm's standards, values and risk thresholds.

Overall, the full extent of the COVID-19 impact on conduct and culture is yet to be determined and fully felt by the industry. What is known, however, is organizations must be responsive and look for opportunities to enhance their conduct and control environment, build operational resilience, plan for re-integrating the workforce post lockdown, and establish new ways of working to cope with the pressures and stresses caused by the shift to the 'new normal'.

How Capco can help you drive your conduct agenda:

- Capco supports organizations in designing and delivering their conduct agenda and has helped COVID-19 affected clients manage their employees' return to work programs.

- We have developed a comprehensive 'ways of working' toolkit that addresses both the immediate need to optimize new ways of working and a strategic re-imagination for the 'new normal.'

- Through our deep knowledge and focus on the financial services industry, experience of large-scale conduct program delivery and record of delivering change in conjunction with clients and third-party suppliers, we understand what is required to deliver an organization-wide change management program.

- Our track record in using data insights, analytics and technology to deliver similar programs of work and ability to mobilize quickly can support organizations to both proactively and reactively manage conduct risk.

- Capco helps organizations to improve their decision making, ensuring there is a reduced likelihood of disruption in crisis, greater compliance with incoming regulations and greater customer satisfaction through our application of a military concept to enhance operational resilience.

Should you wish to discuss your COVID-19 response and how Capco can help you with conduct, operational resilience, re-integrating the workforce or ways of working, please contact us.

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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