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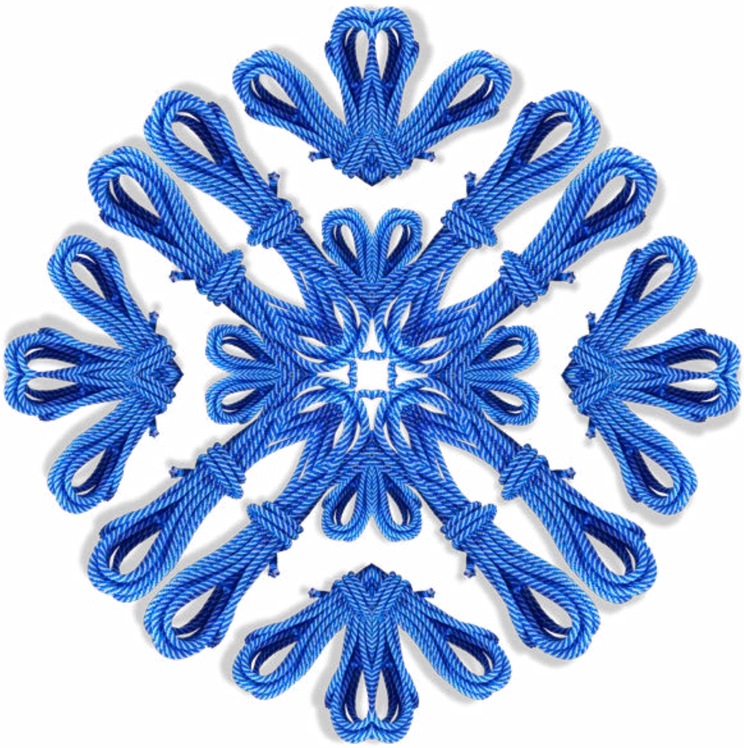

Wholesale Conduct Risk Management

Introduction & Background

While protecting consumers has been at the heart of the Central Bank of Ireland's ("CBI") strategy for many years now, more recently we have seen Wholesale Market Conduct Risk increase in importance. This is due in part to a number of global wholesale market risk scandals and in part to the increase of investment banking, broker dealing and wholesale banking activity in Ireland post Brexit. We have seen from other jurisdictions what happens when issues arise from a wholesale market conduct perspective; frequent rogue trader scandals, manipulation of benchmark borrowing rates and investigations into the integrity of FX markets are examples that remind us that this is an area of risk that requires constant reinvention and management.

Recognising the changing risk landscape in Ireland post Brexit, the CBI has been quick to act by establishing a dedicated Wholesale Market Conduct Risk division. They have publically announced that in the design of a new supervisory framework, their approach will be one that seeks to:

- Provide high levels of investor and market protection;
- Require high levels of price and product transparency;
- Is centred on governance and Senior Executive Accountability;
- Require trust by those seeking to raise funds and investors; and
- Prioritise resilience, with a focus on times of stress and recognising the need to innovate, when the market so requires it.

In order to assist firms with the implementation of an effective Wholesale Market Conduct Risk Framework, the CBI has issued two industry communications, highlighting their expectations[1] and early observations[2] in the Irish Wholesale Conduct Risk environment. These expectations include practices related to:

- Market Conduct Strategy
- Governance and Organisation
- Risk Management
- Culture and People
- Metrics Monitoring

Following initial engagement between the CBI and Wholesale Market participants, the CBI highlighted a number of common deficiencies which were observed. These included:

- Inadequate market conduct risk frameworks
- Inadequate governance of market conduct risk
- Failure to identify the risk of market abuse

This article will discuss the key elements of managing risk through a Wholesale Market Conduct Risk Framework and the challenges and opportunities faced by businesses that will seek to enhance how they will do so.

1 https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/wholesale-markets/wholesale-markets-dear-ceo-letter.pdf?sfvrsn=9
2 https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/securities-markets/wholesale-markets/securities-market-conduct-risk---dear-ceo-letter.pdf?sfvrsn=7

Wholesale Conduct Risk in the Context of COVID-19

Traditional market conduct risks have been exacerbated during the COVID-19 pandemic due to volatile market conditions and large-scale remote working. The drastic measures taken by countries in the fight against COVID-19 have resulted in a major shock to the global economy and high uncertainty within the financial markets. This intensified market volatility and the increase in trading volumes has heightened the risk of market manipulation, an example being the increased risk of the dissemination of fake news to drive pricing up/down. Owing to market volatility, many firms are experiencing a substantial increase in market abuse alerts generated by their automated surveillance systems. Naturally, alerts that have been calibrated for normal market conditions have not responded during the COVID-19 pandemic; recalibration may be urgently required to enable the surveillance models to become responsive. Extreme variations in market volumes, liquidity, and securities valuations can give rise to breaches of restrictions in the approved investment mandates, Value at Risk, and other portfolio tolerances.

Large-scale remote working has in itself created a web of interlocking challenges in terms of conduct risk hazard. The rapid move to operating remotely at unprecedented scale gave firms very little, if any, preparation time and many have had to rely on the rapid adoption of relatively untested technology. This lack of stress testing and scenario analysis may lead to the worsening of situations in which the technologies fail. Newly adopted technology may not be captured in a firm's standard systems and controls (e.g. communications recording and trade surveillance) and data protection requirements may not meet current standards. The risk of insider dealing is also enhanced with access to information regarding a firm's response to the epidemic or impaired financial position. Delayed corporate finance deals results in additional material non-public information, which is being held by persons discharging managerial responsibility for longer periods of time. Concerns are also arising around the risk of inadvertent sharing of inside information within households; employees from different organisations working remotely within the same household has also become an area of risk.
Conduct risk strategy should be central to decision making on a firm's medium and long term response to the COVID-19 pandemic.

Key Wholesale Market Conduct Risk Considerations

(i) Governance

Appropriate governance around the management of the risk, with clear ownership, roles, responsibilities, reporting lines and accountability, is key. This is more important than ever given the anticipated implementation of a Senior Executive Accountability Regime (SEAR) in Ireland. Firms should define the roles and responsibilities of the Board and Senior Management with regard to market conduct risk management and mitigation. Where the firm is part of a larger global group, it is imperative that the local senior management have ownership of market conduct risk, in order to facilitate effective challenge and adequate oversight. Roles and responsibilities across the first, second and third lines of defence should also be clearly delineated and linked to job specifications, all of which must be embedded within the firms' Fitness and Probity processes.

While conduct risk frameworks have traditionally been viewed as something that have been owned by the compliance and risk functions, lessons learned from other jurisdictions have shown that this might not be the most effective way of ensuring sufficient buy-in and accountability from the first line. Therefore, a more effective way of ensuring buy-in, embeddedness and effective decision making is implementing a framework that is owned by the first line and monitored by the second line. In addition to this, and in order to ensure buy-in from "Middle Management", it is important that accountability linked to the management of wholesale market conduct risk is clearly set out in job specifications, and metrics relating to responsibilities for managing wholesale conduct risk are monitored and evidenced as part of performance management.

(ii) Culture

The culture of a firm is the sum of the conduct of the firm's staff, their behaviours and ethics that exist among them. It also captures how the firm rewards, encourages and incentives behaviours, how it designs and sells products and its mission, objectives and general purpose. It is often measured by its reputation, and when it all goes wrong, by scandals, breaches, regulatory sanction and loss of business. It's important to ensure that the conduct of employees is such that it does not intentionally or negligently pose a risk to the protection of investors and the integrity of markets. Many quote the frequently used phrase, "Tone from the Top", as being critical to a sound culture. However, recent scandals have shown that the "Mood in the Middle" is as important a driver to the lack of buy-in where it is needed the most and a very important area to get right, not to mention the "Tone at the Till". While the aforementioned approach of documenting accountabilities for Senior and Middle Management will go a long way, there also needs to be an extra incentive to do the right thing. Designing appropriate reward structures is one thing, but few firms in the past have meaningfully measured performance against risk management Key Performance Indicators.

(iii) Risk Assessment – Risk Identification, Taxonomy/ Assessment

Wholesale market conduct risk does not exist in isolation of other conduct related risks such as financial crime risks, fraud risk, operational risks etc. and there will often be very similar, if not the same, drivers and controls linking them. In undertaking a risk assessment it is wise to consider the inclusion of some existing risks on a firm's register as related to or sub-risks of the wholesale market conduct risks. These may include those relating to suitability and appropriateness, best execution, product governance, price disclosure and transparency.

In particular the identification of market abuse, is pertinent to an effective Wholesale Market Conduct Risk Framework. This should manifest itself in the form of adequate systems and controls in order to ensure compliance with the Market Abuse Regulation and related legislation. The firm should have in place effective arrangements to prevent, detect and report abusive behaviour. Failure to effectively mitigate market abuse could lead to potentially significant ramifications for the firm, its customers and potentially the securities market as a whole.

The expectation is that the risk identification and assessment exercises are undertaken on an annual basis, or when there is material change in the business. The key stakeholders necessary to the process include Front and Middle Office, Risk, Compliance, Operations and Senior Executives from across the business. This process should be a formal, annual exercise with demonstrable buy in from all functions.

Horizon scanning of regulatory change, new product developments, and new services being proposed should also inform the risk assessment to ensure that risks remain continuously relevant and suitable to the firm's business. Upon identification of the relevant risks firms will be expected to rate the risks and map controls accordingly.

(iv) Control Environment

Given the level of regulatory change across the markets and investor protection provisions under MiFID II including potential upcoming MiFID II reforms, it is likely that firms will have spent time recently reviewing and enhancing their control environment in this area. Controls would be expected across an array of different themes such as Governance, Reporting, Rewards and Remuneration, Systems and Operational Resilience, Trade Surveillance, Product Design and Investor Protection. It is important to map these controls to the risks identified in order to assess whether there are any gaps within the control environment from a design perspective, in advance of assessing the effectiveness of such controls in the mitigating of conduct risks.

Themes and Challenges

In the development of any risk framework, the design of the framework can be reasonably straightforward. Measuring the appropriateness of the framework on the control environment, and its effectiveness in mitigating conduct risk, can be challenging. The Deloitte EMEA Centre for Regulatory Strategy has published a paper identifying the fundamental drivers of misconduct in the financial services industry, with a view of helping firms drive sustainable solutions to improve conduct and restore trust. From lessons learned in other jurisdictions, CBI industry communication and upstream landscape changes, the following reflect some of the key challenges to operationalising and embedding the Conduct Risk Framework:

Staff appreciation of market conduct risk

Where conduct risk frameworks have, in the past, been predominantly owned or co-ordinated within the second line of defence, it has been difficult to get the necessary buy-in from across the business, particularly from Front and Middle Office, where one could say conduct risk may be the highest. In order to effectively monitor behaviours from a conduct risk perspective, this requires absolute buy-in from middle and senior management, Heads of Desks and other Executives in the Front and Middle office to challenge themselves with questions such as:

- Do we actually know where conduct risk arises within our business and how effectively we are managing it?
- What type of conduct/decision making drove profit over the last quarter on this desk?
- Do we consider conduct behaviours as part of remuneration decisions and are we able to evidence when and how we do so?
- Do we meaningfully holding individuals to account for behaviours/ conduct?
- Is our control environment established in such a way that poor conduct is capable of being detected?

Outsourcing

Outsourcing of material and non-material functions has become an increasingly prominent feature of financial markets in Ireland and globally. It presents an opportunity for scale and creation of centres of excellence for operational efficiencies and effectiveness. In the post-Brexit landscape, many large and systemically important institutions which have moved their businesses to Ireland have retained certain elements of their front office to be carried out from centres of excellence in London, subject to local oversight and control. Overseeing and managing conduct and behaviours of individuals based in another jurisdiction is not without its challenges and making sure that a robust outsourcing framework is intertwined with the Conduct Risk Framework will be crucial to ensure that risks are identified and mitigated appropriately.

Management Information

A consistent challenge in the measurement and management of market conduct risk throughout the financial services industry is the inadequate conduct related Management Information (MI). The EMEA Centre for Regulatory Strategy has identified 10 principles of strong conduct risk MI that we believe serve as a sound foundation for conduct risk MI across all financial services firms. While MiFID II prescribes that firms' management must have in place adequate arrangements in relation to access to MI, the CBI in a recent communication highlighted the difficulties some firms are experiencing in understanding (i) the appropriate market conduct risk MI to generate and (ii) who is the most appropriate person to mitigate this risk.

An effective risk framework should be supported by accurate, timely and proportionate MI, which is disseminated to the appropriate senior management and the Board. Where the firm is part of a wider group, as is the case in many recent entrants to the Irish market, local management along with group risk management should review the market conduct MI, in order to effectively learn, calibrate and act on the MI.

Algorithms

While traditionally conduct risk focused on the conduct of individuals acting on behalf of the company and attributing their behaviours to the company, today, given the take up of algorithmic and electronic trading, the conduct of those algorithms would also require assessment and management from a market conduct risk perspective. While MiFID II prescribes rules in relation to the governance of algorithms for in-scope MiFID II business, a firm should also assess the need and appropriateness of extending some or all of those rules to other algorithms used across the business where conduct risk may arise.

Regtech

When Wholesale Market Conduct Risk is appropriately managed through the analysis of behaviour, patterns and transaction opportunities will be presented within the firm on how to remediate behaviours, identify issues from a commercial perspective and take a more proactive and predictive approach to managing regulatory compliance across the organisation. Increasingly, large firms are looking to RegTech solutions to support them in assessing behaviours and conduct risk within the Front Office. These solutions can provide richer and more enhanced analytics around product sales in line with target market, pricing and execution quality, transaction analysis and suitability reviews. Algorithms developed by RegTechs enable a more efficient approach to monitoring and surveillance and facilitate the presentation of MI in such a way that can inform product design, target market assessments and product sales and pricing more effectively in the future.

3 https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-managing-conduct-risk.pdf

Conclusion

The risk landscape of the Irish Financial Services sector is changing. The increased size and complexity of financial services institutions operating in Ireland has posed challenges to both the Central Bank and regulated entities, in many regards. Wholesale Market Conduct Risk now poses different challenges in the Irish market, and as such has become a priority for the CBI and firms alike. Increased scrutiny from the regulator translates to increased emphasis throughout the financial services industry. A strong Market Conduct Risk Framework, encapsulating:

- governance arrangements;
- culture;
- conduct risk identification; and
- the control environment, which is embedded in the business, is key to managing Wholesale Market Conduct Risk and meeting regulatory obligations.

As with all challenges, this presents firms with opportunity and impetus to engage with market conduct risk, and develop a strong risk framework which is embedded in the firm's culture, thereby mitigating the risk to the firm, its employees, its customers and the wider financial services industry.

How Can Deloitte Help?

Deloitte operate within the EMEA Regulatory network and have specifically developed tools and methodologies based on EMEA best practice that can help to address the challenges outlined in this Article. We have a team of experienced risk professionals in Ireland who specialise in conduct risk.

Our Wholesale Market Conduct Risk services include:

- Designing Wholesale Market Conduct Risk Frameworks, Policy, Procedures
- Designing Wholesale Conduct Risk MI, including Indicator Reporting
- Undertaking Risk Assessments and designing methodologies for Assessments
- Undertaking Deep-Dive Reviews across Conduct Risk Governance, Product Governance, Market Abuse/ Trade Surveillance, Sales Processes and Culture, Algorithmic Governance etc.

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