Defining the Indefinable

The evolution and responsibilities of the Group Control Officer

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Executive Summary

The role of Control Officer carries, you could imagine, self explanatory connotations. This is, of course, if this role is not within a multi-faceted and complex banking environment, where the simplicity in title is not married to the responsibilities and deliverables in practice.

This role now occupies a space at the top of the executive agenda, as banks scramble to meet regulatory obligations and head off media and political posturing and venomous assaults. Employee and investor confidence is sought and control is required to avoid the catastrophic events of the recent past.

Whether the appointment of a corporate Control Officer will be the pilot to steer each bank and the sector out of troubled waters is unlikely. Although such appointments could play a key role in doing so, both in practice and by perception (by the appointment in title alone).

Whilst the market grapples with the control issue and some seek to meet this question with a Control Officer appointment, themes are unfolding feeding this debate:

I. Trust and Control

• They are synonymous and both take time to build and establish but can be lost easily.
• They are not treated as differentiators today by banks in the way they were in the 50s/60s/70s and part of the 80s (really pre-‘big bang’).
• The fallacy is, today, society has been trusting IT companies more than Banks (Edelman argues IT companies are more insecure than banks).

II. Control and Reputational Risk

• The Control/Legal/Compliance functions are the "custodians" of the reputation of the firm.
• Arguably reputational risk is the most important thing that a Control Officer/Function should be focussed on. (e.g. when Standard Chartered Bank was fined by the U.S. regulator; the fine was trivial compared to the $8-9bn wiped off the share price in the following few days; this is the "price" of reputational risk and what a Control Function should be mandated to serve).
• Control Functions lack the tools and experiences to undertake their role; most are unskilled in social media and "search and discovery" tools and processes and instead are focused on the traditional regulatory face-offs and internal controls, and even then they lack the tools to track what can be called "big regulation".
• The biggest external threats are from "big data"/ "social media /the "dark web"/cyber attacks, and in the investment banking functions these skills are not valued in the way a quant or trader is.
• Conversely these skills do exist in the retail banks, but the silos prevent them from being leveraged and integrated into the control.
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Examples cited, such as JP Morgan within this paper, can be read as control failures and even mooted as such, where managing risk and losses in the trading sense is key to managing ‘control’. However, many perceived control failures could also be read differently, such as JP Morgan’s recent issues, where many argue the real issue was a conflict of interest within the CIO function, namely when does liability management become investment management and alpha creation, is this a control failure that could have been mitigated by control processes, most think not.

Our own interim conclusions are that going forward the Control Function and Officers need to be polymaths; not only conversant in Investment Bank Regulation and the risks inherent in the core business (market, counterparty, operational), but also conversant and equipped with the tools to manage the broader risks of “big data”/“dark internet”/cyber and denial of service attacks/ etc. Too many of these bankers are administrators, transactional and not enough of them lateral thinkers envisioning where the real threats are, what to do about them, and how to creatively leverage lateral skills and tools to manage them.

The argument between quantitative and qualitative assessment, as a differentiator between market, credit and operational risk would appear to be present here. However, unlike these risk disciplines, the Control Officer will need to bridge both effectively. No easy task and no easy path exits for this function and its leadership.

Control in Evolution – Basel sets the stage

As the flourishing banking sector raced towards the 21st Century, the Basel Committee distributed numerous papers to the supervisory authorities worldwide in the belief that the principles presented would provide a useful framework for the effective supervision of internal control systems.

‘Control’ was on the agenda, although it was propping up other more important revenue generating items from far down on the list of corporate priorities. Today, it sits at the top, overseeing, overbearing and pre-eminent in its position.

As 2014 comes into view, control has developed its own agenda and is unquestionably at the top table, the main course for discussion, dissection and digestion at employee to Board level. How did this promotion to pre-eminence happen and what does it mean in practice?

In this context, in the late 1990s, the Basel Committee wished to emphasise that sound internal controls were essential to the prudent operation of banks and to promoting stability in the financial system as a whole. While the Committee recognised that not all institutions would have or indeed would implement all aspects of this framework, banks were encouraged to work towards adoption.

The guidance previously issued by the Basel Committee had typically included discussions of internal controls affecting specific areas of bank activities, such as interest rate risk, and trading and derivatives activities. In contrast, this new guidance had presented a framework that the Basel Committee encouraged supervisors to use in evaluating the internal controls over all on- and off-balance sheet activities of banks and consolidated banking organisations.
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However, this guidance did not focus on specific areas or activities within a banking organisation. The exact application depended on the nature, complexity and risks of the bank’s activities. It was evolutionary as opposed to revolutionary and left itself open to interpretation and inconsistent implementation, due largely to the qualitative and untested ambiguous nature of its recommendations.

It was a valiant attempt to build a regulated, operating framework to reduce the chances of [individual banks] making the same mistakes of the past, through a new approach to operational risk management and capital allocation. Such areas, where a breakdown in control had been highlighted, became the focus for this new regulatory and risk framework, but were found to be woefully inadequate as the financial sector galloped headlong into a storm that became known as the Credit Crunch. This financial cataclysm was a series of interlocked events and consequent after quakes that still ripple through the sector today, each delivering a call, a demand for further regulation.

It is clear, despite the arrival of the Basel regulatory initiatives and subsequent market-wide attempts to introduce control mechanisms to mitigate organisational, enterprise wide and systemic risk, that the early attempts at regulation failed. The ‘in defence of Basel’ argument being things could have been much worse without it, but how much worse is questionable.

**Too big to fail – A call for control**

It was in the shadow of these valiant attempts at building a market consensus to control that the tumultuous events of the Credit Crunch led to the banking sector finding itself under intense scrutiny. From the unwinding of Lehman Brothers to the present day, seemingly every action is eyeballed, every stone turned over and every discovery played out on the media stage.

By now the need to further implement company and market wide control was clearly understood, self defining, but equally so was/is the need to be publically seen to be doing it. The media and politicians demanded it, clambering for executive and corporate scalps, and by default the general public became judge and jury [of the banking sectors and bankers generally] on the side lines.

The banking sector was found guilty on all counts and rehabilitation into the realms of respectability and responsibility would only be achievable if the banking sector’s individual members and as a collective, embraced regulation and were seen to be leading its further development and nailing their colours unequivocally to the mast of control.

To understand this dynamic, perhaps the best and most well covered example relating to this unfolding control drama, is JP Morgan Chase & Co.

In July 2013 Reuters* reported that JP Morgan Chief Executive Jamie Dimon said the U.S.’s largest bank was bracing itself for more legal and regulatory scrutiny in the coming weeks and months, but defensively had outlined a series of steps the Company had taken to improve operations in a memo to employees in early July.

Aligned to this memo, JP Morgan, which was already facing a wide range of probes from several regulators and the U.S. Department of Justice, stated it was devoting "unprecedented" resources to fix its risk, legal and compliance operations. Simultaneously, Dimon had also begun meeting with regulators directly to improve relationships.

*reference: Reuters reporting by David Henry and Lauren Tara LaCapra; Editing by Gerald E. McCormick and Nick Zieminski
"Unfortunately, we are all well aware of the news around the legal and regulatory issues facing our company, and in the coming weeks and months we need to be braced for more to come" Dimon stated.

By this time JP Morgan had added 4,000 staff to its control groups since 2012 - three quarters of them in 2013 - and increased spending on this effort by about $1 billion. The bank's control group including risk, compliance, legal, and finance, technology, oversight and control and audit functions.

Reuters also stated that Dimon said the bank had been trying to simplify its operations by getting rid of businesses that are not core to its business model. For instance, JP Morgan had stopped selling identity theft protection and credit insurance to customers, Dimon further said. Earlier that month, the bank also said it was getting out of the student loan business, and was also planning to exit physical commodities trading.

As such, JP Morgan is also conducting a review of its foreign correspondent banking business and paying closer attention to outside vendor partners, Dimon further outlined. The divesting of non-core business lines is seen across the market, as all banks look to revert to the core and reduce the risk of diversification.

JP Morgan and Dimon himself had come under intense fire since in 2012, when a large, money-losing derivatives trade came to light, eventually costing the bank more than $6 billion in trading losses, and leading to the indictment of two former employees. The bank expected to pay [and did] at least $700 million to settle civil law investigations into this matter.

As if not under enough inspection, JP Morgan was also facing probes by the U.S. Department of Justice, the Securities and Exchange Commission and other government agencies that are looking into subjects including energy trading, possible bribery in hiring practices in China, and possibly fraudulent sales of mortgage securities.

At this stage, Dimon had not specified what new legal and regulatory issues he expected the bank to face, but emphasized that JP Morgan's control undertaking was a company-wide priority.

After acknowledging mistakes, he said the bank and its employees were "facing [our] issues and rolling up our sleeves to fix them."

Following the "Whale" scandal, the 57-year-old CEO faced a bruising battle with some shareholders to retain his Chairman title earlier this year, and has since been under pressure to improve the bank's relationship with regulators.

In the memo, Dimon also said he will now personally meet with bank examiners "on a regular basis" and hold town hall meetings [in May and June] for examiners from top U.S. regulators and staff who regularly deal with those examiners.

More so in context to this discussion, as the by-product of this series of events, JP Morgan also had what Dimon described as a "state-of-the-art control room" at its corporate headquarters in Manhattan, from which staff devoted to control and operational risk matters could retrieve data from across the firm to spot problems. Dimon called the control initiative an "unprecedented effort" for JP Morgan Chase.

"Never before have we focused so much time, effort, brainpower, technological power and money on a single, enterprise-wide objective," Dimon said.
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The arrival of the Group Control Officer

To spearhead this well publicised effort, JP Morgan has appointed a Global Control Officer to oversee this financial and resource effort and are one of many banks to have done so. Whether this becomes a standard market-wide appointment will be seen as we run into and through 2014. Some feel they will be compelled to do so, as not having such an appointment will leave them exposed to the regulators questioning ‘why not?’ and to market and media negative perceptions.

As such the market move to make such an appointment does raise a number of questions. Not least is the possible confusion and mixing of the high level concept and idea of a Chief Control Officer, why such an appointment is required and so on, with the need to understand how such an appointment fits in at the granular level within the established audit and risk system. This confusion cannot however negate the simple fact that these established functions failed and therefore the exact role, reach and mandate of a Chief Control Officer will have to, arguably, stretch from the granular to the high value and level. In some cases the Board are moving to being additionally titled the Risk Management Group, differentiating themselves from risk management and its staff. Questions are in abundance as this process unfolds:

I. What is the mandate of the Control Officer and how can this investment be effectively managed; can it be quantified in return on investment?

II. With regulatory pressures aligned to investor demands and political interference, how will internal supervision, compliance, audit and operational risk collaborate with and not replicate the effort of the ‘Control Office’?

III. How can the Control Officer and his/her direct and extended team work across the established control functions to drive collaboration and benefit, and avoid potential conflict and duplication of effort?

IV. What are the organisational and established component parts which the Control Office will own directly and how, with this mandate, do you frame an integrated bank-wide control framework [working with the non owned and established control functions]?

V. What are these established internal control functions? All of the control activities which are performed under the governance and organizational structure established by the bank’s Board of Directors and Senior Management and in which each individual within the organization must participate in order to ensure proper, efficient and effective performing of the bank’s activities in accordance with the management strategy and policies, and applicable laws and regulations and to ensure the integrity and reliability of accounting system and timeliness and accessibility of information in the data system;

VI. What is the accepted internal control system? All of the financial, operational and other control systems which are carried out by internal controllers and which involve monitoring, independent evaluation and timely reporting to management levels systematically in order to ensure that all the bank activities are performed by management levels in accordance with current policies, methods, instructions and limit;

VII. What constitutes the internal audit (inspection) system? A systematic audit process which is carried out by internal auditors independently as a part of the internal control function and in the form of financial activities and compliance audit independent of the bank’s daily activities, considering the management’s needs and the bank’s structure; which covers all the activities and units of the bank, mainly the internal control system and the risk management system, and which enables the assessment of these activities and units, wherein evidences and findings used in assessments are obtained as a result of reporting, monitoring and examination;
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VIII. What is the internal supervision (control & audit) system? The integrated process consisting of the internal control system and the internal audit system;

IX. The risk management system? All of the mechanisms concerning the process of standard-setting, reporting, verifying the compliance with standards, decision-making and implementing, which are established by the Board of Directors in order to monitor, to keep under control and, if necessary, to change the risk/return structure of the future cash flows of the bank and, accordingly, the quality and the extend of the activities;

Stakeholder Management
The subtle art of building a Control framework

In addition to the Control Officer mobilising the above to the common good, there are also other factors playing a role in defining and managing the control framework [from one centralised Control Office], as follows:

I. Senior Management: The bank’s General Management and Deputy General Managers, and managers of operational departments who hold signature authority;

II. The Inspector: a staff member who inspects the conformity of the bank’s activities with the banking law and the internal regulations of the bank;

III. The Internal Control Unit: A unit that organizes, manages and coordinates the bank's internal control process;

IV. The Internal Controller: A member of staff of the bank, other than inspectors, who is authorized by the bank management to monitor, examine and control the activities of the bank on an on-going basis;

V. The Risk Management Group: The whole structure that comprises the Executive Risk Committee, Bank Risk Committee, and Risk Management Committees of the individual operational units, centralized or decentralized, established in order to manage the risks the bank is exposed to in a systematic way;

VI. Asset/Liability Management Committee: The committee assigned by the Board of Directors with the duties of determining the policies for asset/liability management and mobility of the funds and taking decisions to be executed by relevant units within the framework of the bank’s balance-sheet management and monitoring implementation of the activities;

VII. Risk Management Staff: Staff in risk management committees who are responsible for such issues as defining, verifying, and assessing risks to which the bank is exposed through certain criteria, quantitative and analytic techniques, and have adequate knowledge and experience in risk management; who work in coordination with internal controllers in accordance with the provisions and procedures set out by the Board of Directors.

It is into this melee of established control functions and into the realm of fiefdom and personality that the Control Officer will have to forge his/her consensus and deliver upon the corporate mission, starting with the question of ‘what is a Control Office and how do you define its mandate?’
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Defining the Operating Model

The vertical v horizontal debate

Across the market, where established, a Control Office appears to be a team mandated for coordinating all existing control elements into a consistent and logical model, tasked with ensuring future developments in the business are integrated into this model.

It represents a corporate commitment with an emphasis on maintaining and enhancing a robust and effective control framework, not just for meeting regulatory requirements, but to deliver upon the core values and promise to the bank’s staff and investors.

In some banks the Control Office is split into Infrastructure and Front Office Risk and Control functions, working independently, but in partnership. In others there is a fully integrated front to back and cross divisional Control function.

In either model, the Control Officer is generally tasked to deliver a seamless controls framework across the company with ownership shared by all. In every model the military analogy of having lines of defence and strengthening each, aligning each more closely to each other, plays an increasing part.

Control is now at the forefront of Front Office tasks and responsibilities, being the first line of defence. However, it is now seen as the role of the Control Officer to link the arteries and veins that run through vertically the bank’s business functions [on the horizontal i.e sales and trading, operations, product control and so on: see diagram 1]. This will be the Control Office’s primary task and challenge.

Some argue these horizontals should remain firmly independent and some that Front Office is separate to the infrastructure. Whatever the argument, collaboration and communication and making sure all understand there is one, common and absolute objective, will help ensure the success of any configuration. This esoteric stand point will become the hardened, unassailable and achievable mission if, like Dimon, the bank’s Executive are unequivocal in the Board’s commitment to this initiative and the Control Officer is given the budget, the head count and the mandate to deliver upon its directive.

Many banks are at first base and/or working towards it. What is less understood is how any function will operate and divide the task of delivering this integrated approach to control, where it is generally accepted this task is split into design, behaviour and strategy/forward thinking. Some have suggested banks could collaborate in this design, to mobilise these collective resources, to deliver market wide common and best practice and in so doing, be ahead of regulation, leading self regulation. An interesting view and one for further discussion.

In the interim, how the Control Officer will navigate across risk, supervisory and the established control functions is key, central to the success of such an appointment. He/she will have to possess well proven, soft, stakeholder, relationship management skills, that will play an important part when chairing and running committees and change groups.

This complexity in responsibilities and deliverables [within the Control Officer role] demands diversity in competencies for any lead member of the Control function. In part needing to be strategic and understanding the end to end process, in equal part having an inquisitive and risk, audit driven mind set. To be able to identify risks and/or understand how to join the control arteries and veins from one part of the bank or group to another.

Despite this demand and despite the present negative fervour about banking and the need to restrain, control, regulate the irresponsible banking sector and its occupants, it is a storm that will pass and when it does the sector will be better managed, more robust and controlled.
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Dealing with a historic perception

Winning political, media and public confidence is key to quantifying success.

What has made the banking sector such a success – innovation - has also been its downfall. Such controls will be designed to deal largely with historic innovation, not future development. Tomorrow’s bankers will find routes to bypass regulation, to pass by control measures, where their innovation and entrepreneurialism will ultimately lead to further regulation. The aim of today’s market investment in control initiatives is to ensure this regulation has been anticipated and that the banking sector is seen to be managing its shop in good order, delivering control mechanisms and processes in time, in advance and not in response to financial disaster.

Whatever the outcome, however the banks resolve their common issue today, history has remained consistent as to its view of the role of the banking sector. The sector has a historical and entrenched negative view to deal with, exacerbated in today’s climate of mistrust [following recent scandals]:

[Speaking about international bankers in 1831] “You are a den of vipers! I intend to rout you out, and by the Eternal God I will rout you out. If the people only understood the rank injustice of our money and banking system, there would be a revolution before morning.” . . . “If congress has the right under the Constitution to issue paper money, it was given them to use themselves, not to be delegated to individuals or corporations.”

U.S. President Andrew Jackson, 1829-1837.

Or perhaps even more damning, when Abraham Lincoln stated [echoing the present day comprehensive lack of trust in the banking sector].

“I have two great enemies, the Southern Army in front of me and the bankers in the rear. Of the two, the one at my rear is my greatest foe”.

It is now the shared responsibility of today’s Control Officers, with executive support, to break this historic mould and view, to establish a sustainable banking model that will manifest itself with a banking sector serving its employees, its investors and with recognition and applause by politicians and the general public.

However, even here, the moral objective needs to meet and marry the pragmatic limitations of the sector to deliver this change. Where the two meet will define the success and wider acceptance of the banking sector moving forward, where control will be ‘the’ central pillar to acceptance.

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