A question of risk

A speech by John Price, Commissioner,
Australian Securities and Investments Commission

RMA Australia and PricewaterhouseCoopers (Sydney, Australia)
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CHECK AGAINST DELIVERY

Thank you for the opportunity to speak here this afternoon.

It is probably a common misconception that regulators hate risk. Not so – risk is a part of all business activity. Earlier this year I wrote noting the importance of markets where capital is employed at some risk in order to achieve a return. There's nothing wrong with that. As long as investors are able to gain a sufficient sense of that risk–reward balance, the market should be allowed to run its course. That's what it does best.

Similarly, for people we authorise to carry out important roles in the financial sector (e.g. by licensing or registration), the focus is very much on how risk is managed rather than its elimination.

I just wanted to be very clear about this upfront, to provide some context for my thoughts today. I'd like to speak to you about three key items relating to risk, and I'd welcome your comments on each.

First, I'd like to talk about 'conduct risk' in the areas we regulate – what it means, its relationship to culture and, most importantly, what we are doing about it.

Second, I'd like to talk about some guidance that ASIC is working on regarding risk management and next steps in that area.

Finally, I want to talk about digital disruption and what that means for risk and compliance. As part of this I want to set out my views on the potential that data analytics and technology has for both regulators and the private sector alike.

Conduct risk

What is conduct risk?

Let's start with conduct risk – what is it?

ASIC sees conduct risk as the risk of inappropriate, unethical or unlawful behaviour on the part of an organisation's management or employees. That conduct can be caused by deliberate actions or may be inadvertent, because of inadequacies in an organisation's practices, frameworks or education programs.

From an ASIC perspective, our regulatory interest in conduct risk and culture is linked to our mandate. I'd venture this is the same for all regulators.

So, for example, a prudential regulator's interest in conduct is often focused around how it influences risks within entities, the potential weaknesses and vulnerabilities that may arise as a result, and the risks these pose to financial stability.

However, for ASIC, we focus on conduct risk through the lens of fair outcomes for consumers and investors, including:

- customers and investors being treated fairly
- financial products performing in the way that customers and investors have been led to believe that they will
- financial services firms having regard to consumers' behavioural biases and information imbalances.

We do that because of our mandate. We are a conduct and disclosure regulator tasked with making sure there is an appropriate standard of transparency and appropriate regard for consumers as set through the laws we administer.

All of this is a long way of saying that risk, like beauty, is in the eye of the beholder. It's always important to nail people down to exactly what they are talking about in discussing topics like conduct risk and culture to avoid confusion.

Relationship between conduct and culture

And that now leads me to the question of culture. You might ask 'If ASIC's statutory role is mainly around conduct and disclosure, why are we spending our time also taking about culture?'

The answer is very simple. If ASIC is to be more proactive in fostering good conduct and preventing bad conduct, we need to work out what influences people to act in a particular way.

In our experience, culture is a driver influencing why people act in a certain way – along with incentives (what people are paid to do) and also deterrence (the likelihood of being caught doing something wrong and the consequences if you are caught).

A positive culture – at both the firm and industry level – can be a driver of good conduct, which is central to investor and consumer trust and confidence, market integrity, and growth. These are things that ASIC is wanting to promote.

For example, this year we have set out in our Corporate Plan 'what good looks like' for each sector that we regulate. We see this as our view on what each sector should be trying to achieve in relation to conduct.

In summary, we think the conduct, product and disclosure practices within each sector we regulate should promote investor and consumer trust and confidence and market integrity.

We have further set out 'what good looks like' for eight sectors:

- financial advice
- superannuation and managed funds
- deposit takers, credit and insurance
- market intermediaries
- corporations
- financial reporting and audit
- market infrastructure
- insolvency practitioners.

Common indicators for 'what good looks like' in our Corporate Plan include acting professionally (avoiding conflicts of interest and treating consumers and investors fairly), ensuring that consumers or investors are fully compensated when losses result from poor conduct, and striking the right balance between innovation and risk.

It is not our role to micro-manage how boards achieve these sorts of objectives and take steps to avoid poor conduct. It is our role, however, to encourage firms to take action to consider conduct issues themselves – particularly in areas where poor conduct has the capacity to cause damage to customers or market integrity.

In our view, senior managers of firms and the board need to be aware of conduct within their firm, and this is about asking the right questions and seeking the right information to deal with conduct risk.

Make no mistake – conduct risk, particularly for financial services firms, is very real.

Misconduct can result in significant financial costs, including the cost of customer remediation, compensation and fines. For example, according to research by the London School of Economics and Political Science, the cost of poor conduct for the 10 most-affected global banks was approximately US$277 billion between 2008 and 2013.

Perhaps even more significant than fines and compensation is the reputational damage that misconduct can cause. A recent Financial Reporting Council (UK) report found that intangible assets – such as intellectual property, customer base and brand – now account for over 80% of total corporate value, compared to under 20% 40 years ago. This shift magnifies the impact on total value when a reputational crisis occurs.

Loss of reputation due to poor conduct destroys value in a firm. Even more challenging is that poor conduct may be technically within the law, but still have a negative impact on a firm's reputation. If consumers don't like the way a firm has behaved, they can take their business elsewhere and tell everyone else about it through the wonders of the internet!

What ASIC is doing

So what is ASIC doing about conduct risk? I'd encourage everyone here to look at our Corporate Plan (available on our website) on these issues. More than ever before we want to use concerns around culture and conduct to help inform our risk-based approach to surveillance. In particular, you will see we want to focus on culture and poor conduct, particularly within the financial advice, credit, insurance, superannuation and managed funds sectors. Areas to watch for us include:

- reward and incentive structures, including promotions
- recruitment and training policies
- whistleblower policies
- conflicts of interest and how they are managed
- the nature and level of complaints within firms and complaints handling
- remediation policies and procedures (how are customers treated when things go wrong?)
- corporate governance frameworks to support a customer-centric culture.

Guidance work on risk management

Another important aspect of ASIC's work around risk is providing guidance to help people benchmark and put in place better practice risk management arrangements, if that makes sense for their business.

I wanted to share with you two examples of this today.

Conduct risk survey

First, we are currently completing a survey of certain market participants on conduct risk. This survey looks at how firms are actually reflecting the firm's values in policies, business practices and governance structures. We think this is really important. Otherwise, messages about firm values and good conduct may not be adequate to change behaviour.

For example:

- new and junior staff often interpret rules based on what they learn as acceptable conduct from their managers and colleagues – and the attitude of their managers and colleagues towards compliance
- if staff see that the top performers are successful despite, or even because of, poor conduct, then the behaviour incentives may be at odds with the firm's values.

We plan to give private feedback to the firms that took part in the conduct risk survey. But to give you an early overview of general trends, we are seeing that:

- firms are implementing frameworks to address conduct risk. However, some have not yet distinguished conduct risk from other risk areas, such as operational risk
- a number of firms have scope to strengthen their arrangements to identify and monitor material conduct risk takers – these are the people whose remuneration is performance based and whose actions can affect an entity's licence
- some firms have policies dealing with detecting misconduct and communicated the consequences of misconduct clearly. Others showed gaps in these areas.

Risk management for responsible entities

Another example of risk management guidance we are planning to release to the market very soon relates to risk management arrangements for managed investment schemes. As Australian financial services (AFS) licensees, responsible entities of registered schemes and operators of unregistered schemes have an ongoing obligation under the Corporations Act to have adequate risk management systems.

Our role is to oversee compliance with this key obligation. We have issued some general guidance to AFS licensees on risk management arrangements in Regulatory Guide 104 *Licensing: Meeting the general obligations* (RG 104).

In recent times, there have been a number of significant developments in the managed funds sector that have highlighted the importance having adequate risk management systems in place. These include:

- an increase in the amount of assets managed. The funds management sector on an aggregated basis currently has more than $1.5 trillion under management (including superannuation)
- growth in the number of schemes operated. There are now approximately 448 responsible entities and 3,619 registered schemes. In 2002, the number of registered schemes was approximately 1,806
- a number of high-profile collapses of responsible entities. Some examples include Trio, Allco Wholesale Investment Limited, Fincorp Financial Services Limited and LM Investments Limited. Inadequate risk management arrangements inevitably played some role in these collapses
- diversification in the size, complexity and nature of the types of schemes managed by responsible entities
- the release of relevant international guidance and standards for risk management for managed funds and expectations for the regime of the local regulator. For example, the International Organization of Securities Commissions (IOSCO) publication *Principles of liquidity risk management for collective investment schemes* and the recent Financial Stability Board consultation paper *Proposed policy recommendations to address structural vulnerabilities from asset management activities*

- changing market conditions. Following the global financial crisis (GFC) there have still been periods of significant market volatility and flow-on impacts on liquidity and asset valuations.

With that in mind, we have undertaken proactive reviews of the risk management systems of responsible entities, some of which have been referred to publicly.

Most recently, in February 2015 we surveyed 118 responsible entities to examine the adequacy of risk management and disclosure practices in the current environment. The survey was in response to increased volatility in global and domestic markets and was referred to in Media Release (15-020MR) *ASIC enquires into risk management by responsible entities* (13 February 2015).

Based on our reviews, we identified that there were inconsistencies in the arrangements between various responsible entities, particularly smaller responsible entities. We also identified that improvements could be made to some responsible entities' arrangements to ensure they were robust enough to respond to relevant risks.

In response to these developments in the sector, and the findings from our review of responsible entities' arrangements, on 21 July 2016 we released Consultation Paper 263 *Risk management systems of responsible entities: Further proposals* (CP 263).

CP 263 outlines our proposed guidance for responsible entities on risk management systems. The proposed guidance does not impose new obligations on responsible entities, but gives more detailed guidance on how they may comply with their current obligations under s912(1)(h) of the Corporations Act to maintain adequate risk management systems.

Specifically, we are seeking to ensure that the risk management systems of all responsible entities:

- include minimum procedures and practices
- are adaptable to changing market conditions and remain effective in identifying and managing risks on an ongoing basis.

The guidance outlines our expectations for responsible entities to have:

- overarching risk management systems in place
- processes for identifying and assessing risks
- processes for managing risks.

Some aspects of the guidance are applicable at the responsible entity level, while others are applicable at the scheme level.

In terms of the overarching risk system, our key expectations include that:

- the systems are documented
- the systems foster a strong risk management culture. We consider strong risk management culture is crucial to the effectiveness of a responsible entity's risk management systems and is driven from the top down. It is important for the board

to demonstrate its commitment to risk management and fully embrace the value of risk management

- the systems include measures to ensure that the responsible entity and schemes operated have adequate financial resources to meet financial obligations and needs as they arise.

In terms of identifying and assessing risks, our key expectations include that:

- documented processes are in place to identify and assess risks, including maintaining one or more risk registers
- the systems implemented should address all material risks at the responsible entity and scheme level – which include, but are not limited to, strategic risk, governance risk, operational risk, market and investment risk, and liquidity risk.

In terms of managing risks, our key expectations include that:

- strategies are implemented for managing each of the risks identified. We have outlined in the guidance examples of key risks and strategies to manage these risks
- stress testing and scenario analysis in relation to liquidity risks is undertaken at least annually, and more frequently as appropriate. We also encourage responsible entities to use stress testing to determine the effectiveness of their risk management arrangements and to update or revise their arrangements as appropriate
- responsible entities comply with their other existing obligations as an AFS licensee. We consider these obligations are also relevant to assisting the management of risks – for example, having in place adequate financial and technological resources, compensation arrangements for retail clients, and ensuring that significant breaches are identified and reported to ASIC within 10 business days
- adequately experienced staff regularly review and monitor the risks identified, and there is regular reporting and escalation of issues to the board, risk management and compliance committee as appropriate.

The deadline for submissions on CP 263 was 1 September 2016. Preliminary observations from submissions to date has been broadly supportive. As the next step, we are considering the feedback received and the anticipated date for release of our proposed guidance is the next couple of months.

Digital disruption, risk and regulation

Benefits and risks

Let me turn first to the some of the benefits and opportunities of financial technology (fintech) and regulatory technology (regtech) – I'm sure you are all already familiar with those terms.

Put simply, fintech has the potential to do three things:

- reduce the cost and improve the efficiency of product and service delivery across the financial sector
- empower customers who will be able to deal directly with product and service providers
- empower businesses to deliver a better value proposition to their customer base through improved data analytics.

Regtech, in addition, has the potential to do three things:

- empower businesses to manage their compliance risks more efficiently at a lower cost
- improve confidence in risk management in businesses where liability is in question, such as correspondent banking and financial advice
- enhance our ability as regulators, through improved access to data and data analytic tools, to monitor and analyse risks. We will be able to devote more of our resources to being proactive and pre-emptive, rather than reactive.

I think Australians are well positioned to reap these benefits. We are among the biggest users of mobile phone and the internet, and have some of the highest internet speeds globally.

Yet these opportunities come with risks. Greater customer and investor control and direct engagement without appropriate understanding of the risks of the products and services they are accessing raises the risk of investor harm. There will be new channels though which fraud may be perpetrated both within and across borders.

The increased use of technology to capture, store and analyse data increases the risks of that data being misused, and the systems used to capture and store the data being subject to cyber attacks. There are also risks that data will be stored, used and shared with others against the wishes of consumers providing the data.

I think these are important issues for risk management professionals to carefully consider. ASIC can help in this regard. In March 2015 we released a report (Report 429) outlining some ‘health check prompts’ to help you consider your cyber resilience. We followed that up in March of this year with a report regarding the cyber resilience of the market operators ASX and Chi-X that commented more broadly on examples of emerging good practices in the cyber world. Most recently, with ASX we have written to companies in the ASX 100 index encouraging that they consider completing a voluntary cyber resilience survey.

ASIC’s work with the regtech sector

In concluding today, let me turn to regtech. ASIC considers that the regtech sector has enormous potential to help organisations build a culture of compliance, identify learning opportunities and save time and money relating to regulatory matters. ASIC also sees potential in regtech to complement the work we already do and, as such, we are looking

to increase our engagement with firms that are developing regtech products. In fact, we are already working on some pilot programs with regtech firms to test some of these ideas.

This brings me to an announcement that I am very excited to make today – ASIC will be hosting a regtech round table in February 2017. The purpose of the roundtable is:

- to hear a variety of views on the development of regtech in the financial services sector
- to learn more about the opportunities regtech presents
- to gain an understanding of the barriers and hurdles impeding the progress of regtech's progress – including what role, if any, ASIC can play in reducing those hurdles.

We encourage you to register your interest in this roundtable through our Innovation Hub website. We have only just announced this initiative but already we have 40 expressions of interest to attend – so it is proving to be very popular.

Thank you for the opportunity to speech today on some of ASIC's work relevant to risk management. I'd be happy to answer any questions you may have.

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