The importance of culture to improving conduct within the financial industry

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CHECK AGAINST DELIVERY

Good morning, ladies and gentlemen. Thank you for inviting me to speak at your conference today on regulation. As compliance and risk professionals, you all play a very important role in promoting good conduct within the financial industry.

The subject of my speech today is the importance of culture in improving conduct within the financial industry. But, before I take you through that, I would like to provide some context.

As part of ASIC's Strategic Outlook for 2014–15, we said that some of the key risks to our strategic priorities relate to:

- gatekeeper conduct in markets
- gatekeeper conduct in financial services.

We also said that:

- for gatekeepers in markets, conflicts of interest – which can arise from remuneration structures – can adversely impact on market integrity and investor outcomes
- for gatekeepers in financial services, weak compliance systems, poor cultures, unsustainable business models and conflicted distribution can result in poor advice, mis-selling and investor loss.

What is culture?

So, what do we mean by culture?

We recognise that culture is a very broad topic, and is often considered a somewhat intangible concept. Generally speaking, culture is a set of shared values or assumptions. It reflects the underlying mindset of an organisation. It lies at the heart of how an organisation and its staff think and behave. It shapes and influences people’s attitudes and behaviours towards, for example, customers and compliance.

From a legal perspective, the concept of corporate culture was introduced into the Criminal Code back in 2001. The Criminal Code defines culture as including:

- attitude
- policy
- rules
- course of conduct or practice.

From a regulator’s perspective, ASIC is concerned about culture because it is a key driver of conduct within the financial industry. Bad conduct flourishes, proliferates and may even be rewarded in a bad culture. A good corporate culture uncovers and inhibits bad conduct, and rewards and encourages good conduct.

Given there is a strong connection between poor culture and poor conduct, we consider it to be a key risk area with respect to our role as a conduct regulator.

Why is culture important?

I’m going to take a couple of minutes now to talk about why we should all care about culture within the financial services industry. Australia’s financial system is built on trust and confidence:

- trust in financial institutions and their staff
- trust in financial intermediaries
- trust in the regulatory arrangements that underpin them.

The integrity and transparency of our markets also impacts on investor and financial consumer trust and confidence.

As a regulator, ensuring the trust and confidence of investors and financial consumers is at the heart of everything we do. However, as you will appreciate, trust and confidence have significantly been eroded over the past few years due to poor conduct within the financial industry.

We had the global financial crisis several years ago. Domestically, we have the issues around poor advice both in large institutions and in smaller firms, and mis-selling of financial products to consumers and investors. There are also inquiries into financial benchmark and foreign exchange manipulation, both in Australia and overseas.

ASIC has been saying for some time that one of the core issues within our financial advice industry is poor culture. Poor culture is generally considered one of the root causes of the global financial crisis. It led to a lack of transparency and chronic underpricing of risk, which led to the credit freeze.

In order to restore trust and confidence, it is unquestionable that we need a fundamental shift in the culture of the financial industry. Culture should not just be about maximising profits at all costs. It needs to change to one that focuses on achieving and rewarding good conduct and good outcomes for customers.

Good conduct means not just ensuring compliance with the law and not just avoiding the boundaries or grey areas of the law. It means focusing on and preferring the interests of consumers and investors in the long term. Most financial products and services that matter are intended to meet a long-term financial need, or at least to foster a long-term relationship.

ASIC firmly believes that it is by focusing on the long-term best interests of financial consumers and investors that we will embed better conduct and, as a result, trust and confidence can be restored and preserved.

All that sounds fine, especially coming from a regulator who doesn't have to make a profit to survive. So why should the financial services industry also care about cultural change?

First of all, research has shown that businesses with a strong culture tend to have sustained high performance over the longer term. In addition, those businesses that have a strong customer focus tend to compete more effectively, have higher customer satisfaction, and better customer retention.

To illustrate, the Harvard Business School and Forbes completed an extensive research project detailing the corporate cultures of 200 companies and how each company's culture affected its long-term economic performance. One of their findings was that strong corporate cultures that focus on the needs of customers are associated with strong financial results. So there are quantified commercial benefits of a strong culture.

Conversely, poor culture doesn't just pose a compliance or risk issue to a business. It can lead to significant costs, which can range from:

- remediation costs
- fines
- compensation costs
- not to mention, the costs associated with damaging a business's brand and reputation – as you know, this usually takes a long time to establish, but it can take even longer to restore.

To provide more perspective, 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 250 billion between 2008 and 2012.

A report by KPMG also showed that, since 2011, the largest banks in Britain have paid almost 60% of their profits in fines and repayments to customers.

I'm sure many of you have also heard that recently:

- a major international bank was fined $AU 2.5 billion (or £1.66 billion) by regulators in the United States and the United Kingdom for trying to manipulate interest rates
- four major banks agreed to plead guilty to trying to manipulate foreign exchange rates, and six were fined $US 6 billion by regulators in the United States and the United Kingdom.

So, there are quantified commercial losses resulting from poor conduct and culture.

But let me speak plainly for a moment. When I talk about poor outcomes for customers, this is a genteel way of saying people got fleeced. And, sadly, those who get fleeced are usually everyday Australians, not wealthy people who can make a major loss and not blink. That is, those affected by poor culture are usually those who can least afford it.

Of course, when culture stinks and investments go sour, the situation will, eventually, be uncovered. But this is the thing – markets can recover, but often people do not. They are often left with a loss they cannot afford. And that is why cleaning up culture is crucial.

What do we mean by a positive culture that fosters 'doing the right thing' and 'good outcomes for customers'?

So, what do we mean by a positive culture?

As a conduct regulator, we consider a positive culture as one that supports:

- doing the right thing
- good outcomes for customers.

This should underpin:

- every aspect of a business operation
- every decision of the business
- the day-to-day conduct of its employees.

In practice, a positive culture is where a business:

- ensures the long-term interests of their customers first, both when things are going well and when they are not – for example, in any remediation process
- ensures that products that are designed to provide utility to a specific target market, take into account the needs of that target market and are appropriately tested
- ensures the right products and services are sold to the customers they were designed for, not just to any customer – who may not understand or be suited to the product
- has controls in place to support their culture – for example, how products are developed, approved, marketed, distributed, monitored, and reviewed
- has a recruitment, training and reward structure that is aligned to and reinforces the culture of 'doing the right thing' and 'good outcomes for customers'

- provides an environment that encourages staff to challenge accepted practices and raise issues when mistakes are made or when things don't seem right.

A negative culture is one that leads to and may even unwittingly reward poor conduct, which:

- undermines the industry's ability to meet customers' needs and interests
- affects trust and confidence and market integrity.

I mentioned a little earlier some cases of poor conduct that have led to multi-billion dollar fines and compensation payments. In these cases, poor corporate culture allowed this bad conduct to commence and take hold, and poor corporate culture prevented those who knew about it from taking responsibility and acting against it, until it was far too late.

What are the key drivers of a positive culture?

The next area I want to speak about is what we think makes a positive culture that supports good conduct and good outcomes for customers.

Our Investment Banks team has recently been doing some work that is related to conduct risk. As some of you would know, we have issued a targeted questionnaire to a number of the investment banks to better understand their appetite, attitude and approach to conduct. Following on from this work, we have provided feedback on our findings to:

- the board and executive committees of the participating banks
- their staff at various town hall meetings
- the Australian Financial Markets Association (AFMA) board.

Recently, we also announced the 'Three Cs' framework on conduct risk, which covers: communication, challenge, and complacency. To promote better awareness of the Three Cs framework, we are currently undertaking a roadshow among the investment banking community.

I want to emphasise we are not advocating a one-size-fits-all approach. We understand every business is unique; therefore, they need to tailor what I'm going to speak about to the nature, scope, size, and complexity of their business. We are also aware that culture will likely vary within an organisation; it is common for sub-cultures to form within an organisation. However, we think the drivers identified below are foundations of a positive culture.

Tone from the top

The first driver of positive culture is the tone from the top. The board and senior management are responsible for creating a culture where everyone has ownership and responsibility for 'doing the right thing' and ensuring 'good outcomes for customers'.

The board should set the values and principles of a firm's culture. They should be reflected in the business's strategy, business model and risk appetite. The leadership team should also lead by example by demonstrating the conduct that supports the firm's values. In other words, they should not only talk the talk, they should also walk the walk.

Cascading to the rest of the organisation

Second, the leadership team needs to cascade the firm's values to the rest of the organisation. They need to make sure the values are understood throughout the organisation. This is important, because quite often the message gets lost in the middle and does not make its way to the front line.

It is important that the middle and front line managers model the firm's values. This is because new staff and junior staff members often interpret rules based on what they have learned as acceptable conduct from their managers and colleagues.

To borrow a line from the Army's work on culture, 'the standard you walk past is the standard you accept'.

Translating into business practices

Third, the firm's values of 'doing the right thing' and 'good outcomes for customers' should be incorporated into all of its business practices. For example:

- how business decisions are made, including how new products are approved
- how the firm responds to customer complaints and claims
- how problems and mistakes are identified internally, elevated and fixed
- how staff behave
- the consequences for breaches of internal policies, procedures and internal limits.

Translating the firm's core values into business practices is important, because it ensures there isn't a gap between the firm's desired values and actual conduct.

Accountability

The fourth driver is around accountability. The accountability of staff is extremely important. All staff should understand the firm's core values and, most importantly, that they will be rewarded or held to account for their conduct.

Effective communication and challenge

The next driver relates to effective communication and challenge. The firm should promote a culture of open communication and effective challenge to:

- allow current practices to be tested
- encourage a positive, critical attitude among employees
- promote an environment of open and constructive engagement.

Recruitment, training and rewards

The sixth driver relates to recruitment, training and rewards. This means management should include behaviours and attitudes that lead to good conduct and outcomes for customers as part of staff selection. There should also be training to maintain staff knowledge about the firm's values and the attitudes and behaviours expected of staff.

On rewards, ASIC has been saying for some time that one of the issues in the financial advice industry relates to the incentive structures they use. We think rewards play a big role in driving conduct for two reasons:

- first, it affects an organisation's culture because it impacts on priorities and staff
- second, it acts as a motivator and reinforcer of conduct.

For those reasons, it is crucial that firms recognise performance in a way that not only promotes good conduct, but penalises poor conduct as well. This makes sure bonuses and promotions are linked to good conduct and good outcomes for customers, right across the whole organisation.

Governance and controls

The last driver is governance and controls. Under the board's stewardship, the leadership team should promote, monitor, and assess the impact of the firm's culture on conduct and make changes where necessary.

It's important that there is direct access to the board and leadership team. It's also important that there is a process in place for periodic reporting to the board.

What will ASIC do to promote a positive culture with the financial industry?

Finally, I'd like to touch on what ASIC is planning to do to incorporate culture into our role as a conduct regulator. We intend to focus on a couple of areas:

- first, incorporate culture into our risk-based surveillance reviews
- second, use the surveillance findings to better understand how culture is driving conduct among those we regulate
- third, communicate to industry and the firms where we have problem with their culture and conduct.

Areas we are planning to target are those where poor practices may increase the potential for poor conduct, and therefore increase the risk to trust and confidence. For example:

- remediation policy and procedures
- reward and incentive structures, including promotions
- recruitment and training policy
- whistleblowing policy

- conflicts of interest
- nature and level of complaints and complaints handling
- staff engagement
- corporate governance framework to support customer-centric culture (e.g. board oversight over product approval processes).

Conclusion

All of us have a role to play in changing the culture within the financial industry to help improve conduct – financial institutions, intermediaries, and regulator. It is going to be challenging, and significant time will be required to change culture and embed new attitudes.

We have all seen the damages from poor conduct. They have led to consumers losing out and this has eroded trust and confidence.

I'm sure you'd all agree with me that there is a need for a cultural shift in the financial industry – and that it needs to happen now.