The human factor: Is conduct risk on your radar?

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CHECK AGAINST DELIVERY

Introduction

Thank you very much for having me at your conference today.

It is probably a common misconception that regulators hate risk. Not so – risk is a part of all business activity.

Investors put money into markets where this capital is employed productively at some risk – from which the investor hopes to achieve a return. This is critical to allow markets to fund the economy. But conduct risk – when it crystallises in misconduct – can have a significant impact on the trust and confidence of investors and consumers.

Misconduct happens when someone in the firm at some point decided to do the wrong thing for their customers, often because they were incentivised to do the wrong thing and put personal or shareholder interests ahead of those of customers. Or sometimes it can be that systems and processes failed, or were not designed correctly.

This is a type of risk that investors or customers did not agree to take on. It can also – as I will explain – have a significant impact on the businesses in which misconduct occurs.

So today I'd like to speak to you about what 'conduct risk' means, why ASIC cares about conduct risk, and the relationship of conduct risk to culture. Then I'd like to talk about what ASIC is working on regarding conduct risk.

What is conduct risk?

Firstly, conduct risk – what is it?

Conduct risk is 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 vision. We want investors and consumers to have trust and confidence in the financial system.

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, and
- financial services firms having regard to consumers' behavioural biases and information imbalances.

We are a conduct regulator tasked with making sure there is an appropriate standard of transparency and appropriate regard for consumers.

Relationship between conduct and culture

I would now like to talk about the relationship of conduct with culture.

In our experience, culture is a key 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, and market integrity.

For example, last year we 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. We have 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, and
- 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 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.

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, Boston Consulting Group has estimated that the banks have paid US$321 billion in fines since the financial crisis, including US$42 billion in 2016. Former Senior Vice Chairman of Citibank William Rhodes said recently that 'investors should view cultural failure as material to profitability and long-term success and sustainability of the banks'. He also said 'as the wrongdoing continues and the fines rise, so it seems at times as if some bankers believe that the enormous settlements are just a cost of doing business. Bank empoloyees and board directors who take this view should be replaced'.

Perhaps even more significant than fines and compensation is the reputational damage that misconduct can cause. A recent UK Financial Reporting Council 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. AON's latest Global Risk Management Survey showed that damage to brand and reputation had jumped to number one in this year's risk rankings, up from number eight two 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 social media and traditional media – this is the power of the crowd.

What ASIC is doing about conduct risk?

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.

Conduct risk survey

Recently, we completed a survey of certain market participants on conduct risk. This survey looked at how firms are actually reflecting their 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 gave private feedback to the firms that took part in the conduct risk survey, including letting them know where they sat in relation to their peers.

To give you an overview of general trends, we observed the following:

- 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.

Technology is enabling the development of tools to identify cultural issues, including using predictive behavioural analytics. Through analysing large data sets, key predictors of certain behaviour can be distilled, and then used to identify misconduct risks – and possibly prevent misconduct – in the future.

At ASIC, we are also currently running two pilot projects to implement our approach to culture. One is in relation to the sale of direct life insurance, and the second relates to breach reporting practices.

In both of these projects we are considering whether the firm has stated values that focus on delivering good consumer outcomes and supporting strong compliance – for example ‘doing the right’ thing by their customers, as well as accountability, integrity, and honesty. We will then consider how these values are embedded in policies and processes of the organisation and translate in to actual behaviour ‘on the ground’.

Conclusion

I want to conclude by saying that – from both my perspective and from your perspective – culture and conduct matter. I hope what I have just said helps to explain why we think culture and conduct are critical issues relevant across a range of businesses.

Having good culture and ensuring good conduct is about building trust and confidence in our financial institutions. It can take a long time to build trust and confidence. However, the same trust and confidence can be lost very quickly when there is misconduct, and can take even longer to restore.

If the culture and conduct of a firm genuinely reflects ‘doing the right thing’ (often the ‘front page test’), this will be rewarded with longevity, customer loyalty and a sustainable business.

Thank you.