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Restoring trust in financial services

Three levers for conduct risk management

Contents

Getting culture right and driving good conduct

Getting culture right – and thereby driving good conduct - has been an area of regulatory focus since the financial crisis. While overall trust in financial services has improved over the last five years, it remains the least trusted industry globally.[1]

Periodic headlines in business reporting contribute to lower levels of trust in the financial sector. These high-profile cases across retail and commercial banking, capital markets, and wealth management keep the conduct failings of the industry in the public eye. In Canada, banks and other financial institutions have paid out millions in fines due to anti-money laundering breaches. Traders have also been accused of breaching consumer trust by sharing confidential customer data to gain competitive advantage.

Against this backdrop, regulatory authorities have introduced new requirements and expectations. These range from new accountability regimes to consumer protection frameworks, guidelines on sales practices, and an increased focus on culture.

As a result, strengthening controls surrounding conduct risk has emerged as a higher priority in many financial institutions.

Firms are reviewing their approach – ranging from redefining their policies to the renewal of their management frameworks, including a conduct risk taxonomy, detection and monitoring procedures, issue escalation, accountability models, and incentives.

However, restoring trust requires that financial institutions do more than address individual instances of bad behaviour or undertake reviews of their approaches to conduct risk; firms will need a deep understanding of their own culture to design robust programs that drive good conduct.

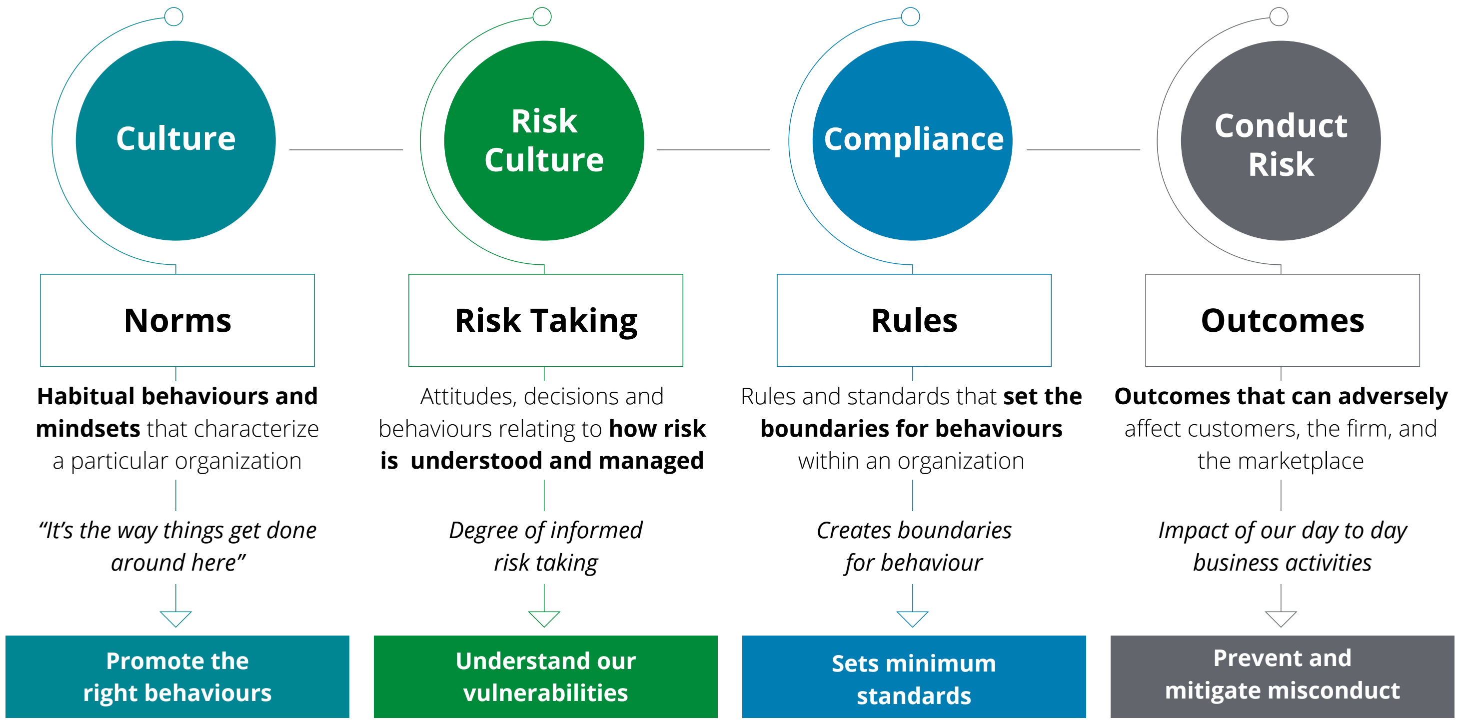
Deloitte believes in the value of three levers – culture, conduct framework, and conduct analytics – that can each help financial institutions strengthen conduct risk management and accountability across all of their business activities, and ultimately rebuild and restore trust.

A multi-faceted approach

Mitigating misconduct requires a multi-faceted approach. Three levers – culture, conduct framework, and conduct analytics – can enable organizations to better manage conduct risk, and design the appropriate mechanisms to restore trust.

Conduct risk can be defined as individual or group actions that could cause **unfair outcomes** for clients, counterparties and/or agents, **undermine market integrity**, and damage the firm's **reputation and competitive position**.

What is Conduct Risk?
Figure 1: Defining Conduct, Risk and Culture



Recent regulatory developments

In April 2018, the Financial Stability Board (FSB) released a toolkit for supervisors and firms to mitigate conduct risk.[2] The FSB used its members' shared experience in dealing with misconduct to develop the toolkit, which completes an important element of the FSB's 2015 work plan to recommend measures to reduce conduct risk. It consists of 19 tools classified into three overarching themes (Figure 1). The FSB's work serves as a foundation for the approaches to conduct risk supervision of member jurisdictions.

Figure 2: Three themes in the Financial Stability Board (FSB) toolkit

Mitigating the cultural drivers of misconduct

Tools to effectively develop and communicate strategies for reducing misconduct in firms, and for authorities to effectively supervise such approaches

Strengthening individual responsibility and accountability

Tools to identify key responsibilities and functions in a firm, and assign them to individuals to promote accountability and increase transparency

Addressing the "rolling bad apples" phenomenon

Tools to improve interview processes and onboarding of new employees, and for regular updates of background checks to avoid hiring individuals with a history of misconduct

Three levers for conduct risk management

With the increasing regulatory pressure, financial institutions in Canada will need to strengthen trust with their stakeholders by going beyond compliance and instead building a resilient organization with the appropriate incentives and reinforcements. To achieve this, there are three levers at the disposal of financial firms - culture, conduct framework, and conduct analytics (Figure 3).

Figure 3: Three levers for conduct risk management

Culture

Financial institutions will need to examine their culture, including the habitual behaviours and mind-sets that shape attitudes, decisions, and behaviours within their organizations though surveys or deep dives on risk culture. This will allow them to better understand their vulnerabilities, which in turn can be used to evolve their culture in order to promote the right behaviours, ensure strong risk management and accountability, and improve monitoring across all business activities.

Conduct framework

Firms will need to design and implement conduct risk frameworks to improve risk management discipline and accountability on supervision and surveillance activities. As well, they will need to build and implement processes and controls to meet regulatory expectations on fair outcomes for customers and protecting the integrity of the marketplace against abusive and manipulative practices.

Conduct analytics leveraging data

Firms will need to consider how they can leverage the use of data and analytics to proactively monitor and enhance their culture, as well as identify early warnings of misconduct. This can involve connecting the dots across different data silos; designing KPIs to link product sales or customer feedback to individual performance, compliance, and HR data; and transforming low added value controls used to detect misconduct into more meaningful and actionable reporting for enhanced oversight by management and the board.

While these three levers have been presented as separate categories, they are by no means fully independent from one another. Rather, they are connected and mutually reinforcing – robust management of conduct risk will certainly have to consider all three in tandem.

Culture

Transitioning toward a desired culture is a priority for many financial institutions. In practice, this means that they will need to continually measure and monitor their culture profiles to become culture conscious.

Although financial institutions recognize that a common understanding of the organization's culture is a necessary condition for managing conduct risk, most remain in the early stages of building a strong culture in support of good conduct risk outcomes.

Getting culture right – and thereby driving good conduct – has always been difficult. This has led to a certain amount of culture fatigue in the industry. The Group of Thirty (G30) noted a desire in financial institutions to "get on with business" in its 2018 Banking Conduct and Culture report. In the same report, the G30 also emphasized that culture programs need to be long-term and fully internalized by an organization rather than made and then forgotten.[3]

Building trust from within

In addition to culture fatigue, we expect that there will be a continued emphasis from regional supervisors, and the global bodies to which they belong, on getting culture right. While the approach to culture supervision is often nonprescriptive, regulators will expect to see firms expending effort to understand and build a robust approach to culture management. Building trust from within organizations through a culture that drives good conduct, and establishing robust governance frameworks are priorities that will need to be top of mind for firms in the coming years.

Becoming culture conscious

Overcoming culture fatigue and meeting the expectations of regulators requires a systematic approach to shaping and evolving culture. A structured framework can help financial institutions become more culture conscious and improve the programmatic elements of its culture.

Firms will need to develop a strong understanding of their cultures, including the overall awareness and attitudes toward risk, and how risk is identified and managed within their organization. Measuring and monitoring risk culture profiles across population demographics is critical for gaining traction on transitioning toward an organization's desired risk culture.

Deloitte's approach to these issues is to look at risk culture through our framework of four risk culture influencers broken into sixteen risk culture indicators (Figure 4).

Periodic survey assessment against these risk culture indicators can help firms illuminate where issues may sit in areas like organizational culture, employee engagement, or behavioural drivers. As well, it is important to contextualize survey data through benchmarking against both financial services and nonfinancial services players both within Canada and around the world.

Figure 4: The four risk culture influencers and sixteen indicators (Deloitte UK)

Looking forward – emerging trends in culture

Many financial institutions are looking for ways to improve their understanding of their risk culture and inform the analysis of survey or benchmarking results. An in-depth look at emerging global supervisory trends reveals several focus areas that may be useful for financial institutions to consider:

- **Purpose:** Looking beyond the mission statement of a firm to see what the firm is trying to achieve in practice. Regulators will be interested to see how a firm's purpose translates practically into customer outcomes, the extent to which its purpose is tied to profit, and if the firm is focused on compliance with rules rather than a commitment toward acting as a good member of society.

- **"Tone from above":** The limitations of "tone from the top" as most employees take their cues on culture and conduct from their immediate managers, rather than senior executives or board members. There will be growing interest to see that those in management functions at all levels of an organization are able to reflect, promote, and embed good culture and conduct within the firm.

- **Diversity and inclusion:** The make-up of an organization, and who dominates conversations matter. Regulators are increasingly interested in seeing rigorous debate, which is better facilitated by a group with diverse thoughts and backgrounds. This is not only important for top levels of an organization, but also throughout a firm.

- **Open communication:** Creating a culture where employees are able to share their opinions or admit errors without fear of retaliation or overreaction is what allows issues from the lower levels of an organization to flow up to higher levels. Fear-based suppression of misconduct keeps boards and senior management in the dark, and limits their ability to understand and assess what is really going on at the front lines of their business. Regulators may look to test not only employee knowledge of escalation procedures, but also try to understand their perception of how they work in practice.[4]

An industry view

Deloitte's discussions with regulators and industry players have shown that financial services industry executives who consider their organizations to have made headway toward greater culture consciousness generally employ several similar approaches, including:

- **Designing appropriate incentives and training**
  To ensure ethical conduct when dealing with clients, successful players conduct intensive employee training on fair dealing practices, and focus on designing appropriate incentives for employees in risk-taking roles to enhance the link between conduct and remuneration.

- **Continual monitoring of conduct risk**
  Successful players put in place comprehensive culture indices to monitor their culture profiles and conduct periodic surveys of employees regarding their perceptions on ethical behaviour in the workplace. Results from these surveys, and lessons learned from previous successes and failures in conduct risk management, are regularly showcased and communicated to all employees.

- **Adopting a customer-focused orientation**
  In order to better incorporate customer needs and suitability into the entire product life cycle, successful players are adept at using customer insights to measure their outcomes and experiences, assess whether the products are fit for purpose, and determine if their actions are in the customer's best interests.

Key challenges confronting financial institutions in Canada include:

- A lack of clarity on the best approach to develop a cost-effective, efficient, and repeatable methodology to measure and monitor their organization's risk culture profile;
- Indecision over which indicators should be used to measure and monitor risk culture; and,
- The need for a benchmark to make comparisons across the risk cultures of both financial and nonfinancial institutions.

Conduct framework

Financial institutions in Canada will need to go beyond developing a code of conduct to designing holistic, sustainable conduct risk management framework with the appropriate incentive and compensation structures.

Deloitte has observed a number of financial institutions seeking to develop more effective conduct risk management framework, with front-office roles, such as Chief Conduct Officers, Market Conduct Leaders, or Heads of Culture & Conduct, taking ownership of the enforcement of conduct initiatives across their organizations. The ownership of these initiatives and other voluntary principles are critical as firms look at designing and implementing conduct risk frameworks to improve risk management discipline and accountability on supervision and surveillance activities as well as ensure good outcomes for their customers.

Designing a successful conduct risk management framework

Conduct risk is becoming a separate risk category that financial institutions will need to manage as part of their overall risk management framework. A code of conduct is often the bedrock of a conduct risk management framework. The code of conduct sets the foundation for each employee to understand that honesty, integrity, and fair dealings with customers is of utmost importance. However, a successful conduct risk management framework will have a wide range of elements, which include, but are not limited to:

- **Incentives,** which should be designed to promote ethical behaviour and compliance with the relevant laws and regulations, as well as the organization's mission, values, and objectives
- **Governance,** in the form of board and senior management oversight through formal committees and other business forums
- **Risk taxonomy,** which defines and describes the key conduct risk vulnerabilities relating to market abuse, collusion, and inappropriate disclosure of information
- **Compliance and internal audit,** which include measures to incorporate conduct risk in compliance assessments and internal audits
- **Sharing of best practices,** with the objective of enabling stakeholders to proactively address common conduct vulnerabilities across business units and geographies
- **Metrics, monitoring, and reporting,** used in combination with behavioural analytics, to identify outlier behaviours, activities, and individuals that could potentially put the firm and employees at risk of misconduct
- **Disciplinary actions,** to be taken against employees who engage in misconduct, with escalations coming from both internal channels, such as whistleblowers, supervisors, compliance, or human resources, and external sources, such as client complaints

"Robust policies and procedures will need to be put in place to deal with cases of misconduct."

How does a conduct risk framework function?
A successful conduct risk framework needs to be embedded throughout a firm. This begins with the right "tone from above", meaning the right buy-in and messaging modelled by management and the board. Well-defined governance structures that establish a clear separation of duties between the board and management are critical. Efforts should also be made to increase management accountability to ensure that heads of business lines and line supervisors are made accountable for employee misconduct that occurs under their watch.

Furthermore, control infrastructure – including control and support functions such as Human Resources, Risk, Legal, and Compliance – should be part of the design and oversight of the conduct risk framework framework. Robust policies and procedures will need to be in place to deal with cases of misconduct.

A conduct risk framework must also be owned by all three lines of defence as each of the lines has a role to play in managing conduct risk. How responsibilities are organized and ownership of conduct risk is defined and allocated can vary across the three lines. Employees across all lines should be able to articulate how their conduct risk management roles and responsibilities differ from the other lines, how they are accountable for risks taken, where challenge is necessary, and what skills they need to carry out conduct risk management.

Finally, firms will need to consider how their risk appetite is applicable to conduct risk objectives and how these objectives are communicated to team members. This should also have an impact on compensation, as performance management should be linked to conduct. An effective compensation structure should align compensation with the organization's mission, values, and objectives, and support the desired employee conduct.

Conduct analytics

Although there are many broad applications for the use of analytics in managing conduct risk, financial institutions in Canada can benefit from a more structured process toward conduct analytics, and the adoption of an employee risk view.

In recent years, there has been a proliferation in the number of analytics applications that financial institutions can employ to support them in managing their conduct risk. For example, big data analytics and machine learning can be used to predict future behaviours based on large-scale analysis of the particulars and patterns of prior incidents and additionally, help identify conduct risk. As artificial intelligence becomes more embedded in financial institutions and automated processes takeover tasks typically performed by people there is the risk that the causes of misconduct can be embedded in algorithms (e.g., inappropriate segmentation of customers). When combined with cognitive technologies, predictive analytics can also be leveraged to map personal or business connections, internal and external networks, and accelerate conflict scenario simulation and analysis.

While advanced analytics techniques can enable financial institutions to glean meaningful insights from huge pools of data in a fraction of the time it would take a human, organizations can also benefit from adopting a structured process in their use of conduct analytics. However, this will first require the development of an integrated data architecture to provide more meaningful insight into the ways in which organizations can transform low value-added controls into more actionable reporting for enhanced board and management oversight.

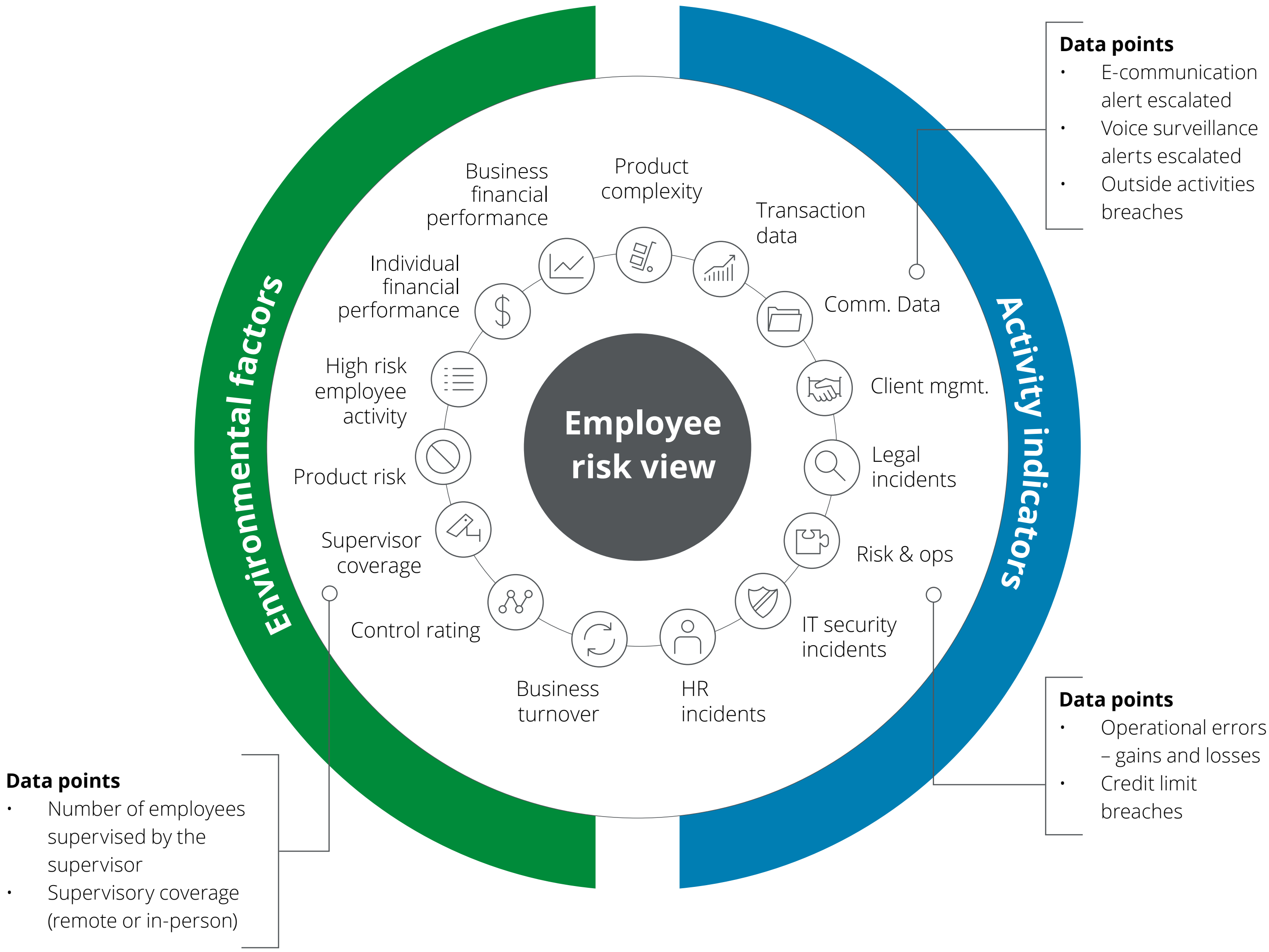
Specifically, in order to connect the dots across different data silos—from employee and customer issue escalations to disciplinary processes, and monitoring and surveillance activities—it is necessary for financial institutions to design integrated key performance indicators that link data across the various functions, including product sales, customer feedback, individual employee performance, and compliance data.

Adopting an employee risk view

Financial institutions can adopt an employee risk view that aggregates data across activity indicators and environmental factors to identify outliers and employee behaviours that pose risk to the organization. The environmental factors should include contextual characteristics of the business environment and the employee in question (Figure 5).

Specific examples of these data points could include operational errors, credit limit breaches, voice surveillance alerts, control ratings, and IT security incidents. The aggregated data can then be analysed for correlations to identify outlier transactions, activities, and client portfolios, and enable financial institutions to uncover potentially risky employee behaviours so that they can take pre-emptive measures to mitigate the conduct risk.

Figure 5: Activity indicators and environmental factors in an employee risk view



A Domestic look at culture and conduct

In Canada, a 2017 news report alleging that Canadian banks had been engaging in inappropriate sales practices lead to parliamentary hearings and resulted in a request for the FCAC to conduct an industry review. Since the FCAC issued their report on retail sales practices, both OSFI and the FCAC increased the priority of examining aspects of culture and conduct in regulated financial institutions.[5]

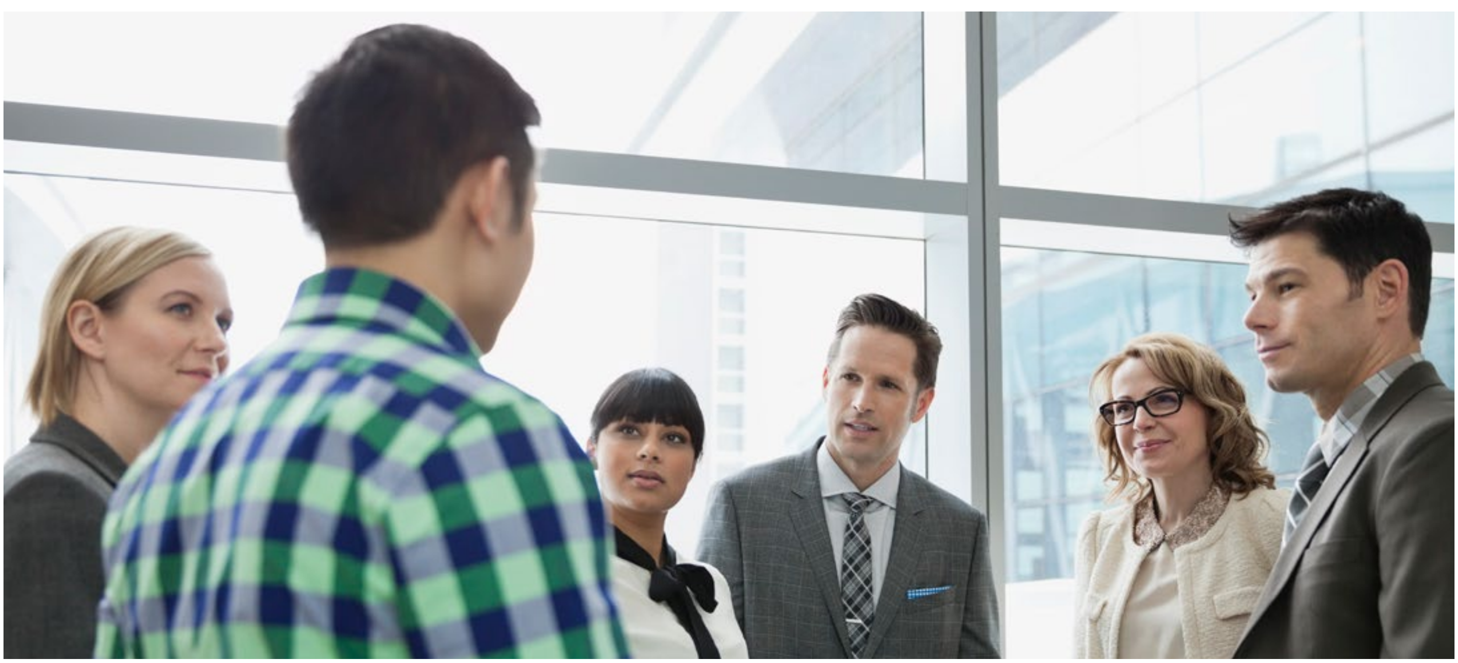
OSFI

In 2018, OSFI created a Culture & Conduct Risk Division. The division has been given a mandate to provide expertise on culture and conduct risk to help identify risks facing federally regulated financial institutions as well as system-wide issues and trends. In 2019, OSFI undertook an industry culture scan. The scan took stock of the frameworks, communication mechanisms, software, key performance indicators/key risk indicators, and initiatives that institutions use that shape and support their culture. OSFI has since shared its observations, including the range of recommended practices, with the participating institutions. One of OSFI's findings from the industry scan is that while the board and senior management discuss culture-related matters, they do not always treat culture as a stand-alone topic for strategic discussion. Ensuring that the regulator considers a broad perspective is one of the reasons why OSFI created the Culture External Advisory Committee (CEAC). The CEAC consists of retired senior leaders from the financial services industry, academics, as well as senior leaders from other industries (e.g., energy) that have a strong safety or risk management culture. The first meeting of this group took place in October 2019 and it has already begun providing practical guidance for OSFI to consider.

FCAC

In 2017, the FCAC lead a review of domestic retail sales practices in Canada's six largest banks and found that while there was no evidence of systemic concerns they concluded that "the retail banking culture encourages employees to sell products and services, and rewards them for sales success. This sharp focus on sales can increase the risk of mis-selling and breaching market conduct obligations. The controls banks have put in place to effectively monitor, identify and mitigate these risks are insufficient." [6]

In 2018, the Federal Government passed Bill C-86, which amends the Bank Act to consolidate and strengthen Canada's consumer protection laws. The Financial Consumer Protection Framework will consolidate most of the Bank Act's existing consumer provisions and regulations into a single section of the Act. Among the changes include enhanced sanction powers for the Commissioner of the FCAC and which raise the size of financial penalties for breaches to these provisions. Recently, in part because of the global COVID-19 pandemic, the deadline for the full introduction of the Framework has been extended to Spring 2022 to allow organizations additional time to achieve compliance with the proposed regulations.



Global insights

A number of progressive regulators have chosen to prioritize the assessment of culture and conduct in their supervision frameworks. These include but are not limited to regulators in the United Kingdom, Australia, the Netherlands, Ireland, and Singapore.

United Kingdom

According to the FCA in the United Kingdom, if firms and their employees do not make efforts to continue cultivating their cultures in the current climate, and consider what culture means for them in a dispersed environment, cultures will begin to fragment as employees lose informal contact with their colleagues. The FCA concluded that firms that get culture, conduct, and crisis management wrong, run the risk of poor conduct, low staff morale and ultimately, weak future performance. However, those that find ways to nudge behaviours in the right direction have the chance to build business models and resilient cultures that adapt to the new circumstances with positive outcomes for customers, employees, and investors.

In the latest updates from the FCA, related to their five conduct questions program, the regulator noted that conduct and culture change programs are having positive effects in financial institutions where they have been deployed. However, complications of COVID-19 continues to create new conduct risks. For example, thoughtful and proactive engagement with staff who are now working from home is a critical activity to help support and maintain strong organizational cultures during this unprecedented disruption.

Netherlands

The Dutch Central Bank is focusing on analysing observable forms of behaviour, such as decision-making and boardroom/senior management dynamics, to identify patterns relevant to culture and conduct issues and better understand what kind of interventions will be most successful in their own respective industry.

The De Nederlandsche Bank (DNB) monitors the behaviour, cultural aspects, and organizational set-up (governance) of supervised institutions. They *perform examinations and* ***on-site inspections at supervised financial institutions to analyse and understand their governance, behaviour, and culture***

"Human behaviour and governance are essential aspects in determining sound and ethical business operations. Through our supervision, we want to direct institutions towards adopting desirable behaviour. This may be different for each institution and that is why we individually assess the risks ensuing from an organization's conduct"

Australia

The Australian Prudential Regulatory Authority (APRA) expects that the board of any financial institution has a view of an institution's risk culture and that it is appropriate for ensuring that the institution operates within its risk appetite. Boards must identify any desirable changes to the risk culture and ensure the institution takes steps to address those changes.

In February 2019, the Haynes Royal Commission made the following industry recommendations:

- **Assess the entity's culture** and its governance;
- **Identify** any **problems** with that **culture** and **governance**;
- **Deal with those problems**; and,
- Determine **whether** the changes have been **effective**.

Ireland
The Central Bank of Ireland published a report assessing the culture and behaviour of the four main retail banks across Ireland. A finding similar across all four banks found that there was a lack of collective understanding of what consumer focus means and what behaviour is required to place customers at the centre of the organizations strategy and develop a more customer centric culture internally. .

Singapore
In Singapore, the Monetary Authority of Singapore (MAS) has set up a behavioural sciences unit to scale its capabilities in this area of conduct and culture regulation and support supervisors with methodologies developed through research and empirical studies to enable them to enhance policy design and increase the efficacy of their interventions. Comprising psychologists and behavioural science professionals, it was established with the goal to manage conduct risk through "culture and research empirical studies", with a view to enhancing policy design work and the efficacy of its supervisory interventions through applied behavioural science techniques.[7]

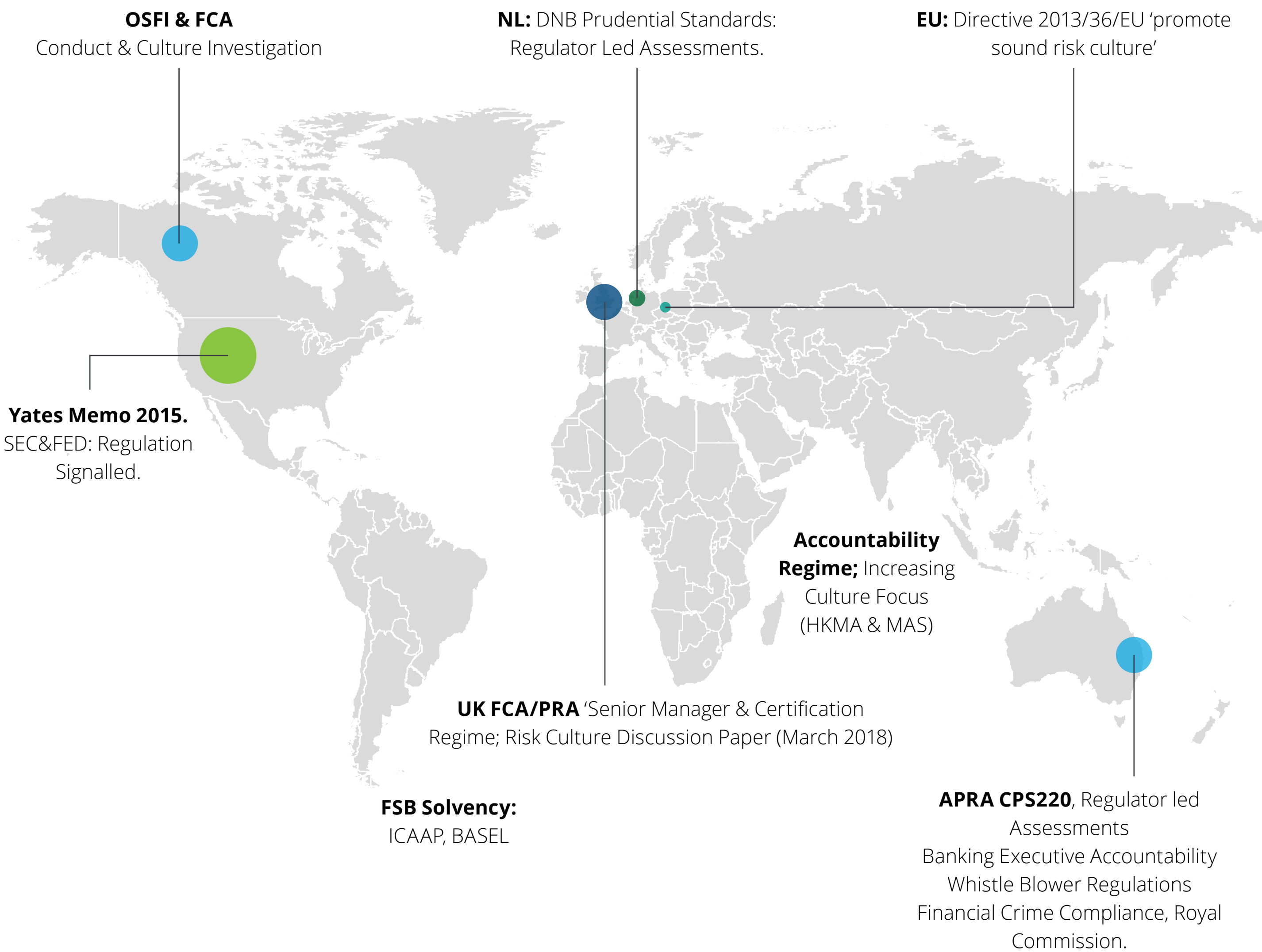
Recently in Singapore, MAS and industry associations collaborated to set up the Culture and Conduct Industry Steering Group for banks, and the Insurance Culture and Conduct Steering Committee for insurers, to strengthen (i) ethical business practices that safeguard customers' interests and ensure fair treatment, and (ii) prudent risk-taking behaviour and robust risk management that support the financial institutions' safety and soundness.

In September 2020, MAS published a paper on culture and conduct practices within financial institutions. Again, the emphasis was on preempting potential misconduct by having in place a sound organizational structure. Nine detailed outcomes are explored throughout the paper and serve as excellent reference for organizations wishing to ensure robust conduct and culture practices. These range from strong governance, hiring and onboarding practices, incentive systems to individual accountability and robust communication and feedback channels.

International standard bodies
In 2018, the International Monetary Fund released a working paper entitled A behavioural approach to financial supervision, regulation, and central banking to examine the case for adopting behavioural science in financial policymaking. According to the report, most of the post-crisis regulatory reforms to manage conduct focused on corporate governance rather than how an individual makes decisions. A wider application of behavioural science-inspired policymaking, it notes, could have an impact on understanding and managing individuals' decision-making.[8]

Figure 6: Global view of culture and conduct regulatory initiatives

The diagram below illustrates some global examples where different regulators across the European Union, North America, and Australia have implemented measures dictating standards for culture and conduct, such as the European Union directive promoting a sound risk culture or, in the instance of Canada, OSFI's investigation into culture and conduct in the work place.



Restoring trust in financial services

Over the last decade, there has been no shortage of well-publicized and highly damaging misconduct scandals within the financial services industry. To many observers, these conduct failings are a lens into an industry with widespread culture shortcomings.

Amongst financial institutions, there has been broad recognition that improving conduct is an essential part of restoring trust and ensuring the sustainability of the industry's future growth. Looking ahead, the focus on conduct is also expected to persist as regulators step up the pressure on financial institutions to be alert to poor behaviour, and place expectations on financial institutions of all forms to establish proactive mechanisms to continuously identify and tackle poor conduct.

In this paper, we have presented a framework comprising three conduct risk management levers – culture, conduct framework, and conduct analytics – that financial institutions could consider as a more systematic and well-rounded approach toward tackling the root causes of poor conduct.

Financial institutions can be better positioned to uncover risky behaviours and intervene with appropriate pre-emptive mitigation measures by articulating conduct risk as part of a firm's larger risk management framework, continuously benchmarking their risk culture indicators, and leveraging the use of analytics to identify outlier behaviours.

Of course, it is unrealistic to expect to completely eradicate misconduct incidents in financial institutions. It is our belief, however, that the promise of a financial services industry that delivers desired customer outcomes while possessing a strong culture and demonstrating good conduct is well worth the effort.

This endeavour is not a single initiative, nor something that can be accomplished overnight, but with sustained efforts, constant industry dialogue, and cross-sector collaborations, we can rebuild, restore, and reinforce valuable trust in the industry.

Culture and conduct - Best practices to test your current culture and conduct practices

Evaluating where you are as an organization can be a difficult process to begin. Deloitte have prepared the points below to get you started on making the changes necessary to strengthen the culture and conduct principles and give you a stronger competitive edge in the market

- Ensure you are appropriately cultivating regulatory relationships to better manage escalating regulatory risks associated with poor conduct
- Define your organizations future state policies for the culture and conduct that you want to target
- Train all your staff members, especially front-line staff, to ensure the customer service experience is tailored to your target culture
- Examine how you are currently serving your community and customers to ensure you have the consumer and community confidence to operate effectively
- Ensure senior executive management have the right level of insight to be aware of conduct throughout the organization, especially customer serving staff
- Prioritize executive leadership to promote the company culture and principles throughout the organization
- Conduct a vulnerability inventory check. Where is your organization vulnerable to going wrong? This may focus on Products, Distribution, Customer Experience, and Systems and Governance.
- Use data to help predict and prevent risks. Data analytics will play a fundamental role for screening entire populations rather than unrepresentative customer samples. Unlock the power of your data to take action, and deliver better customer outcomes

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