Managing conduct risk – Building Trust in Business Conduct

Introduction

There has been no shortage of well-publicized and highly damaging misconduct scandals within the global financial services industry over the past decade. This was propelled in light of the increasing number of financial scandals such as the Wells Fargo account fraud, the LIBOR-rigging scandal in the UK, and as recent as April 2018, a currency trader from HSBC was convicted of fraud for front-running. Based on a research by the Fixed Income, Currencies and Commodities Markets Standards Board (FMSB), banks globally have paid some $375 billion in conduct fines over the past five years.

Locally in Malaysia, Bank Negara Malaysia (BNM) reported that more than RM30 million in premiums were refunded to the affected policyholders due to mis-selling practices in the sale of life insurance products in the past. BNM had also directed insurers to refund the premiums in more than 700,000 cases involving the forced purchase of personal accident policies. In addition, insurers have been directed to modify or withdraw misleading advertisements, make call backs to consumers to confirm the products purchased without adhering to proper disclosure practices, as well as strengthen internal controls over sales and marketing practices with respect to bancassurance products.

Conduct is a lens into the culture of organizations, and conduct failings seem to be widespread across several jurisdictions, cut across financial services organizations and involve both the retail and wholesale sides of business. A large number of customers have claimed sizeable loss and there has been significant reputational and brand damage to firms. A raft of new regulatory initiatives, substantial fines and expensive remediation programs have also ensued. In April 2017, BNM issued the Code of Conduct for Malaysia Wholesale Financial Markets to set out clear principles and standards to be observed by market participants in preserving market stability. The Code also includes requirements for financial institutions to have robust systems and enhanced internal controls.

Improving conduct within industry is an essential part of rebuilding trust and supporting future sustainable growth. Further, the regulatory focus on conduct is expected to persist and firms will continue to face pressure to be alert to poor behavior. To help financial services firms be proactive about misconduct, Deloitte Centre for Regulatory Strategy, in its recent publication entitled "Managing conduct risk - Addressing drivers, restoring trust", explores:

- 8 fundamental drivers of misconduct
- Summary of approaches to address the identified drivers
- New Innovation in Technologies that can help to improve the effectiveness and efficiency of conduct management programs

Drivers of misconduct

Understanding and addressing the drivers of misconduct is an essential step in improving standards of behavior, being able to identify key conduct risks, designing pre-emptive enterprise-wide conduct programs and meeting regulatory and marketplace expectations. As such, we have explored the findings of various conduct related enforcement actions, regulatory and industry reviews, government inquiries and firm remediation programs to discover the common themes that lie beneath poor conduct.

The eight key drivers of misconduct that we have identified are illustrated in the table. The root causes identified are not behind all recent conduct failings. Rather, we have focused on those drivers that firms are more readily able to control and synthesized these into broader, more manageable themes. The eight drivers often overlap, have differing levels of relevance and can also work together, to create an environment that incentivizes, reinforces and spreads problematic behavior.

Approaches to address identified drivers

Industry, regulators and governments are designing ways to address the drivers of misconduct and raise standards within financial services firms, which in turn is helping to restore trust in the industry. Challenges, however, still remain. (note to editor: can be used as balloons)

Significant energy and resources are being invested by the financial services industry and its regulators to improve conduct. Addressing misconduct is one of the Financial Stability Board's (FSB) priorities and, to this end, the international body is pursuing "a major work program" that has seen a working group set up to drive efforts and recommendations on reducing misconduct in the financial sector. The importance of embedding a good culture and cultivating good conduct is recognized as key in restoring reputational capital, retaining customers, building a sustainable business and maintaining a competitive advantage.

This is perhaps even more pressing in the current environment where governments are looking for ways to augment and diversify competition in the financial services industry. Some of the responses to restoring trust are outlined in the table.

Drivers of Misconduct	Approach to address Drivers of Misconduct	Technology: Approach through innovation
Customer needs and suitability do not guide product lifecycle practices Poor conduct outcomes can arise when product design, marketing, sales and advice, as well as post-sale practices, are driven by concerns about "what will sell the most" rather than what the customer needs and what is most suitable for these needs (a question of "is this right for them?").	**Ensuring customer needs and suitability steer product lifecycle decisions** Many firms are continuing to identify better ways to incorporate the customer's needs and suitability into the entire product lifecycle; from design to marketing, sales, distribution and post-sale customer care.	Technology that supports the ongoing assessment of customer needs and suitability • Visual network analytics to find data relationships relevant to customer needs (e.g., data integration, dynamic relationship mapping). • Interactive visual analytics to reveal insights from large data sets (e.g., from public, cloud, social network, enterprise). • Customer value, customer segmentation, and customer satisfaction analytics. • Natural language processing to gain insights from a wider pool of customer data and facilitate automation of customer communications and suitability assessments.
Failing to have a "balanced scorecard" for human resource decisions Decisions on recruitment, remuneration, promotion, professional development, and dismissal that value short-term revenue generation over other important aspects of performance can incentivise misconduct.	**Building "balanced scorecards" for human resource decisions** - Organizations are placing increased emphasis on an individual's ethical, compliance and regulatory history. There has been significant focus on compensation and remuneration.	Technology that helps build a "balanced scorecard" for HR decisions • Cognitive computing to analyze context, content and relationships within big data sets and to reveal critical trends and findings about an individual or across cohorts (e.g., from professional registers, performance reviews, customer feedback, complaints). • Software that automates connections between performance management and organizational objectives.
Individuals and leadership are not responsible or held accountable for misconduct Just as conduct within a firm is heavily influenced by what is seen to be rewarded, failure to penalize individuals	**Ensuring individuals and leadership are responsible and accountable for conduct** Firms are focusing on ensuring the First Line owns risk in their business line, strengthening	Technology that streamlines and strengthens systems of accountability • Distributed ledger technology to strengthen the audit trail by simplification of record keeping, enhancing transparency, robust time stamping and protection

involved, as well as managers in charge, for ethically or legally questionable behaviors supports its perpetuation and can foster a culture of impunity.	Second Line challenge, and creating a ‘speak up’ culture.	against manual change. • Automated enforcement of escalation procedures.
Failing to identify and manage conflicts of interest When an individual has two competing objectives (a conflict of interest) and there is an incentive to act opportunistically, they may forgo compliance with a competing legal, professional or ethical obligation.	**Proactive processes for identifying and managing conflicts of interest** Firms are conducting enterprise-wide reviews to develop a deeper understanding of where conflicts may occur and designing controls to manage those conflict.	Technology that can proactively identify and manage conflicts • Master access control to set parameters and provide alerts when controls are violated. • Automated enforcement of ethical walls, segregation of duties, and watch lists. • Big data analytics and algorithms to map personal or business connections and internal and external networks. • Cognitive technologies and predictive analytics to accelerate conflict scenario simulation and analysis
Complex, disconnected or “growth at all cost” businesses models Conduct within complex or disconnected organizations can be difficult to manage. There may be a tendency to develop silos where different cultures, behaviors and operational practices incubate. This can erode enterprise-wide cohesion, communication and coordination on managing conduct. Further, business models and strategies that are solely focused on growth typically contain inherent conduct vulnerabilities that allow problems to spread and grow more rapidly.	**Creating a cohesive organization with a conduct-aligned business model** Governance, conduct and risk management frameworks are being designed to have enterprise-wide penetration and with direct lines to the executive. Business models are reviewed, making them more customer centric and identifying any other potential conflicts with desired conduct outcomes.	Technology that helps integrate systems and teams • Application programming interfaces and integration systems to facilitate interoperability and system communication. • Distributed ledger technology for enhanced transparency and access to a “single source of truth”. • Regulatory radar software to identify regulatory change and cognitive technologies to assess application and impact. • Mixed reality applications to improve communication and collaboration between remote teams and break down functional silos.

Manual and complicated processes and procedures Labor intensive or convoluted processes and procedures increase the chance of error and give people the incentive and opportunity to ignore controls that are designed to prevent misconduct.	**Automating and streamlining processes and procedures** Duplicate or overlapping requirements are being consolidated; contradictions clarified; and procedures and processes identified as unnecessary, low value or redundant are being axed.	Technology that automates and streamlines processes and procedures • Robotic process automation to automate routine processes. • Distributed ledger technology to strengthen against manual workarounds, reduce errors deriving from duplication and eliminate manual efforts required to perform data reconciliation.
Weak systems for monitoring and surveillance If monitoring and surveillance is nonexistent or inadequate, misconduct can go undetected and risks may not be appropriately managed. Further, some individuals may be more likely to engage in poor behaviors because they know the chance of being discovered is low.	**Strengthening and modernizing monitoring and surveillance capabilities** Firms are making improvements to their monitoring and surveillance capabilities such as scaling up headcount, applying sophisticated technology and analytics to leverage current data and create predictive and preventative systems.	Technology that modernizes and automates monitoring and surveillance • Machine learning algorithms to search and aggregate across multiple mediums (e.g., voice, email, video, social media, instant messaging) and flag potential violations. • Natural language processing to automate communications monitoring (e.g., phone, text, instant messaging). • Biometric technology to enhance identity verification procedures. • Relationship, behavioral and content analytics to facilitate pre-emptive and proactive measures. • Big data analytics and machine learning to predict future behaviors based on large-scale analysis of the particulars and patterns in prior incidents.
Disparate subcultures or a problematic prevailing culture Poor conduct can develop in a firm that has various disparate subcultures or when the prevailing culture does not balance short-term financial success	**Defining and embedding a clear unified culture** Improving firm culture is at the top of everyone's agenda today and is seen as central to the restoration and maintenance of	Technology that facilitates continual testing of cultural values and identification of red flags • Big data analytics to scan patterns of behavior across technologies and systems to surface potential vulnerabilities and model behavioral risk (e.g. from sources such as complaints, risks, incidents, near misses, staff feedback and employee surveys, social media,

with other important business and ethical imperatives.	good conduct within the financial services industry.	individual performance, remuneration and incentives, human resource and compliance data). • Modelling of organizational performance and risk culture. • Real-time pulsing of staff to test the mood of the organization, providing frequent and contemporaneous feedback on culture throughout an organization and at all levels (including external partners and value chain participants).

Conclusion

Expecting to eradicate misconduct incidents in financial services organizations is unrealistic, and hence the regulatory agenda continues to evolve its focus. Financial services organizations of all types are being expected to put in place a proactive framework to continuously identify and tackle poor conduct, and the role of technology cannot be ignored.

The promise of an organization that functions effectively with a strong culture and good conduct is worth the effort. Few will dispute that managing poor conduct is essential for maintaining the trust of customers, regulators and the broader market. Similarly, few would dispute that business success today is intimately connected with an ability to harness innovative technology quickly and enthusiastically.

We have sought to identify the common themes and drivers of misconduct in the financial services industry, with a view to helping firms identify and manage their conduct risk. We have also explored industry and regulatory responses for restoring trust and have suggested some potential RegTech solutions to help firms think about ways to optimize outcomes in a more cost effective way.

Designing the right conduct program supported by the right technology solution starts by bringing together business, technology and regulation experts. Tapping into this collective pool of knowledge will best draw out the strong foundation from which to build a conduct program that will inspire trust.