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Approaching the crossroads of conduct and culture

Improving culture in large corporates and the financial services industry

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Introduction

Nearly a decade after the financial crisis, instances of misconduct (i.e. professional misbehaviour, ethical lapses, and compliance failures) continue to be reported in the press with troubling frequency, many of which have resulted in widespread impacts to customers and the markets, and significant monetary and reputational costs to organisations. This issue is by no means limited to the financial services sector, we've also seen significant misconduct issues across other sectors such as retail, automotive and utilities industries.

The coverage of conduct failures strikes an uncomfortable contrast with the intensity of effort the industry and the regulators have showed in reforming and remediating the weaknesses that were brought to light. Overall, this environment has further strained the public's failing trust in the integrity of the financial services industry and in large corporates as a whole, including the people they employ and the markets they support. The critical question now is what must happen, or what must the public see, to trust that businesses are working to meet a threshold of care for their customers and the markets?

KPMG believes that to regain the public trust, businesses need to rebuild and enhance their relationships with customers, regulators and shareholders to those that are based on balancing and considering the needs and interests of all stakeholders in an ethical and transparent manner – and not emphasising the needs of one stakeholder group over the other. Further, organisations must behave according to sound moral and ethical principles that are nurtured and supported by a strong, positive culture, one that promotes and reinforces "doing the right thing" at every level of the organisation – notably a respect for the letter and spirit of the law, and placing the interests of all stakeholders at the center of the business strategy. Such a culture would serve to strengthen a business' reputation and the life of its brand, sustain the business into the future, and should prove to be the best defence against material misconduct and heightened regulatory interest. The regulators will likely take progressively harsher actions against firms and individuals should material misconduct fail to abate, and in an effort to accelerate correction or stem any potential for systemic risk, they may also move toward imposing explicit requirements to tie culture to prudential supervision.

Sally Freeman
Partner in Charge,
Risk Consulting

Culture as the root of misconduct

Following the financial crisis, lawmakers and regulators have focused on rules requiring financial institutions to implement stronger governance structures, including the establishment of effective risk culture frameworks built on a clearly defined risk appetite and clear expectations regarding individual and organisational behaviours. At the same time significant conduct failures outside financial services sector have prompted calls for greater accountability right across the business landscape.

While the spotlight has fallen firmly on corporates, it's important not to forget that conduct issues arise in any type of organisation. Just as corporates face serious misconduct issues, corporates and non-listed entities, not-for-profits, public and private institutions and unions are by no means immune to similar problems.

Governance efforts have been supported by a presumption that risk controls and compliance management systems should be applied across the enterprise and over product life cycles. Processes and procedures are built with risk controls designed to resolve both financial stability and misconduct issues with a focus on the sustainability of business.

To date, much effort has been put into the risk, compliance and controls frameworks, policies and mechanisms as a way of mitigating issues, however for culture, this has not proved to be the answer. Breakdowns in conduct have continued to occur despite this heightened attention, signaling to regulators that the solution to material misconduct cannot be achieved simply by requiring firms to develop new policies to coincide with prescribed procedures. The ability to test the "effectiveness" of culture and how well the process controls are implemented is a more challenging task, primarily because it can be more difficult to test actual versus expected behaviours.

"At its most basic, culture fails that impact conduct are rooted in a misalignment between what people are expected to do and what is actually rewarded; between the stated conduct and the celebrated or demonstrated conduct," comments Mike Ritchie, Partner, Risk Consulting.

> "Culture matters to ASIC, to business and to customers. Culture matters to ASIC because culture is a key driver of conduct. Good conduct leads to good outcomes for investors and consumers. The converse is also true. Inevitably, it is the stories of poor culture and poor conduct in the financial industry which are splashed across the front page of the newspaper, which pop up in our newsfeeds, and which are the subjects of heated discussion on social media sites."[1]
>
> Greg Medcraft, ASIC Chairman March 21, 2016

Within the financial services sector, the regulatory focus has now turned to shortcomings in the prevailing culture as the root cause for continued misconduct. More simply, they equate poor conduct with poor culture. The regulators suggest the scale and scope of the incidence of misconduct since the financial crisis has been too large to assume that merely a few "bad apples" are responsible; when in fact it is the tree that is rotten, with the actions stemming from the prevailing attitudes and behaviours rewarded within organisations more widely[2]. This is clearly the case well beyond just financial services – so whilst the culture question eclipses one industry it's highly applicable to all.
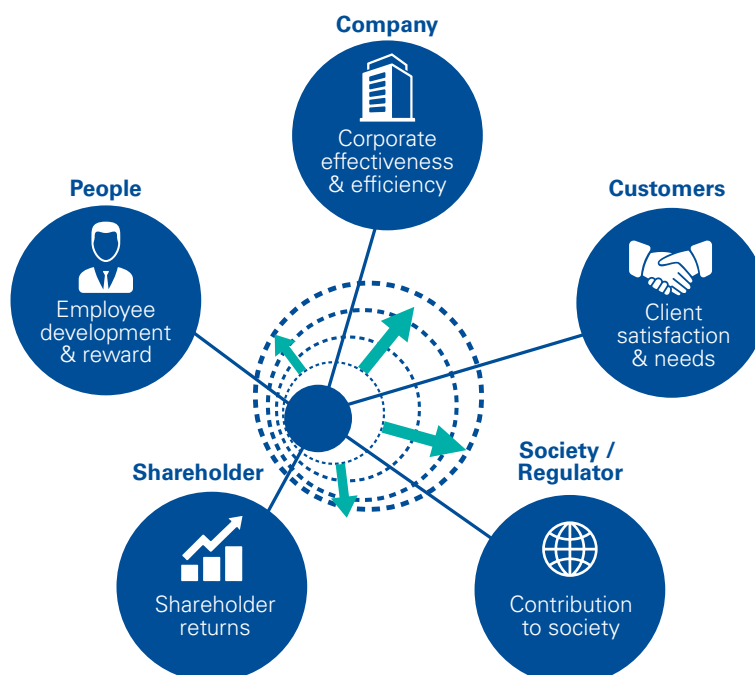
Cascading responsibility for conduct

Regulators hold Board members and senior management, as the leadership of their organisations, directly responsible for establishing and maintaining their firms' culture and now expect them to push their organisations towards cultural and ethical change. But it is critical to understand how culture and conduct cascade throughout an organisation. "There is often a fault line where the right things are said and done at Board level, but as that trickles down throughout an organisation they are either blind to, or unwilling to recognise, what happens beneath the fault line," comments Ritchie.

This means organisations need to be far more aware of the micro-cultures within their business that actually shape behaviour. Employees are more likely to adopt the levels of behaviour of their peers and direct management, rather than the values espoused by an often invisible Board. "One on one conversations that take place within the business, for example with performance managers, can build or damage a culture quickly" comments Karen Orvad, Partner, Risk Consulting. It's also critical to understand how those micro-cultures interact and the unique pressures that can push them towards misconduct.

Competing stakeholder interests can result in conflicting priorities; creating complex dilemmas. This ranges from the need to ensure customer satisfaction and value versus the need to drive revenue and shareholder returns; or the need for corporate efficiency versus the need to reward and develop staff. This is why it's important to have a systematic approach to cultural change that manages these dilemmas properly when making strategic business decisions. It is the emphasis on managing these dilemmas during the decision making process that is important because that is when the competing interests are most at play and need to be thought about systematically.

Company — Corporate effectiveness & efficiency

People — Employee development & reward

Customers — Client satisfaction & needs

Shareholder — Shareholder returns

Society / Regulator — Contribution to society

A new paradigm for change

The regulators suggest that to restore public trust, it is imperative that each firm implements business strategies that place the interests of customers (retail, commercial, and wholesale) and the integrity of the markets ahead of profit maximisation[3]. That is, they must conduct business in the "right" way (i.e. right price, right product, fair treatment followed by ongoing execution) – doing what they "should" rather than what they "can".

Beyond this directive, limited regulatory guidance has been made available and firms are largely responsible for defining their own parameters of a "good culture".

> "Finance depends on trust. In fact, in the end, it can depend on little else. Where trust has been damaged, repair has to be made. In the end, though, you can't legislate for culture or character. Culture has to be nurtured, which is not a costless exercise. Character has to be developed and exemplified in behaviour."[4]
>
> Glenn Stevens, Reserve Bank of Australia Governor, 29 April 2015

The risk of misconduct will remain a current and pressing concern as firms individually, and the industry more broadly, take steps to instill cultural changes that promote good actions and good conduct.

Organisations must show that the root causes of the behaviours driving poor conduct are being taken seriously and will be fully addressed. Regulators will need to see what actions organisations are taking to assess and improve their risk culture as well as the commitment of the Board and senior management to execute the necessary changes through to fruition. In other words, ensuring that employees – at all levels of the organisation – are held to account for any misconduct or behaviours that do not align with the expected standards. Regulators will also look closely at the degree to which line and middle managers, who are frequently responsible for implementing organisational changes and strategic initiatives, are committed to adopting and manifesting the required cultural change.

Where the Board and management may fall short, the regulators will rely on available authorities to effect change and correct shortcomings identified through the supervisory process, including product interventions, restrictions on business lines, capital requirements, and public enforcement actions. In the near term, the possibility of the introduction or increase in fines is becoming more likely, following trends in the US and the UK where fines, though already quite significant, will likely remain elevated and could escalate.

> "An issue that we are delving into across all of the industry sectors that APRA supervises is culture. Our interest in culture reflects our prudential mandate: a good culture helps protect against poor outcomes. A little over twelve months ago, we also instituted a new standard that, amongst other things, introduced an explicit requirement on Boards to form a view about the risk culture of their institutions…I think it also fair to say that they are still grappling with how best to do this in a robust and systematic manner."[5]
>
> Wayne Byres, Australian Prudential Regulation Authority (APRA) chairman, 18 March 2016

Factors that contribute to failures of culture

Leadership: lack of clear direction for employees and tangible demonstration of role-model behaviours. Tone from the top forms a critical part of an organisation's culture and the extent to which "values-aligned behaviours" are embedded within an organisation, such as in its policies and processes (intent) and operationally (execution).

Governance gaps and fault lines: such as where micro-cultures operate within specific groups or business lines according to values and principles that are inconsistent with the stated values and priorities of the firm. Similarly, multiple management layers can block clear lines to senior management's values and expectations creating 'fault lines' and opportunities for misinterpretation or misinformation. Governance gaps can also be related to issues with information sharing, technology constraints, measuring the effectiveness of compliance, and independent testing and review.

Inconsistent application: processes may be in place, but the application of those processes may be very inconsistent.

Competing objectives: such as a focus on short-term financial performance rather than long-term franchise sustainability, or a focus on revenue goals without consideration of compliance costs.

Employee dynamics: increased employee turnover, which can inhibit the development of firm loyalty and desire to protect the firm's brand.

Increasing complexity: in the size and scope of financial services organisations, as well as in the types of product and service offerings, making managing and monitoring culture more difficult.

Shifts in the business model: such as an increasingly depersonalised approach to the business caused by moving away from a client-based orientation, which focuses on building long-term relationships, to a transaction-based orientation, which generally reduces customers to the role of a trading partner or counterparty. Likewise, the introduction of "cross-subsidy" models, where one product or service is supported by revenues generated from another product or service, can promote adverse sales behaviour or result in customer detriment.

Indicators of culture

Culture is the intangible that is reflected in the choices and behaviours, or conduct, of a firm's employees. It has been described as the implicit norms that guide behaviour, i.e. "the way we do things around here". Culture exists within every firm whether it is recognised or ignored, whether it is nurtured or neglected.[6]

The values, goals and priorities chosen by a firm to define business success work together to create a firm's culture. A "good culture" is marked by specific values — integrity, trust, and respect for the law — carried out in the spirit of a fiduciary duty toward customers (that is, keeping the customer's best interests at the heart of the business model) and a social responsibility toward maintaining market integrity.

It embodies the ethic of reciprocity at all points of interaction between a firm and its customers and between the individuals that compose the firm, fostering an environment that is conducive to open communication and reporting of behaviours inconsistent with values, timely recognition, escalation, and control of emerging risks and risk-taking activities that are beyond a firm's risk appetite.

Indicators of a "good culture" include:

– Tone from the top – the Board and senior management set the core values and expectations for the firm and their behaviour is consistent with those values and expectations

– Transparency – the firm values and demonstrates transparency and sharing of issues and challenges openly from the top down

– Accountability – all employees know the core values and expectations as well as that consequences for failure to uphold them will be enforced

– Effective challenge – at all levels, decision making considers a range of views, practices are tested, and open discussion is encouraged

– Incentives – financial and non-financial compensation is available to all levels of employees to reward behaviours that support the core values and expectations.

A strong and positive culture can:

Reduce the risk of misconduct

Reduce the risk of regulatory scrutiny and monetary fines

Strengthen asset quality

Enhance a firm's reputation and brand differentiation with all stakeholders (e.g. being recognised as an employer of choice, supplier of choice or client of choice)

Promote innovation and new product development designed to serve customers

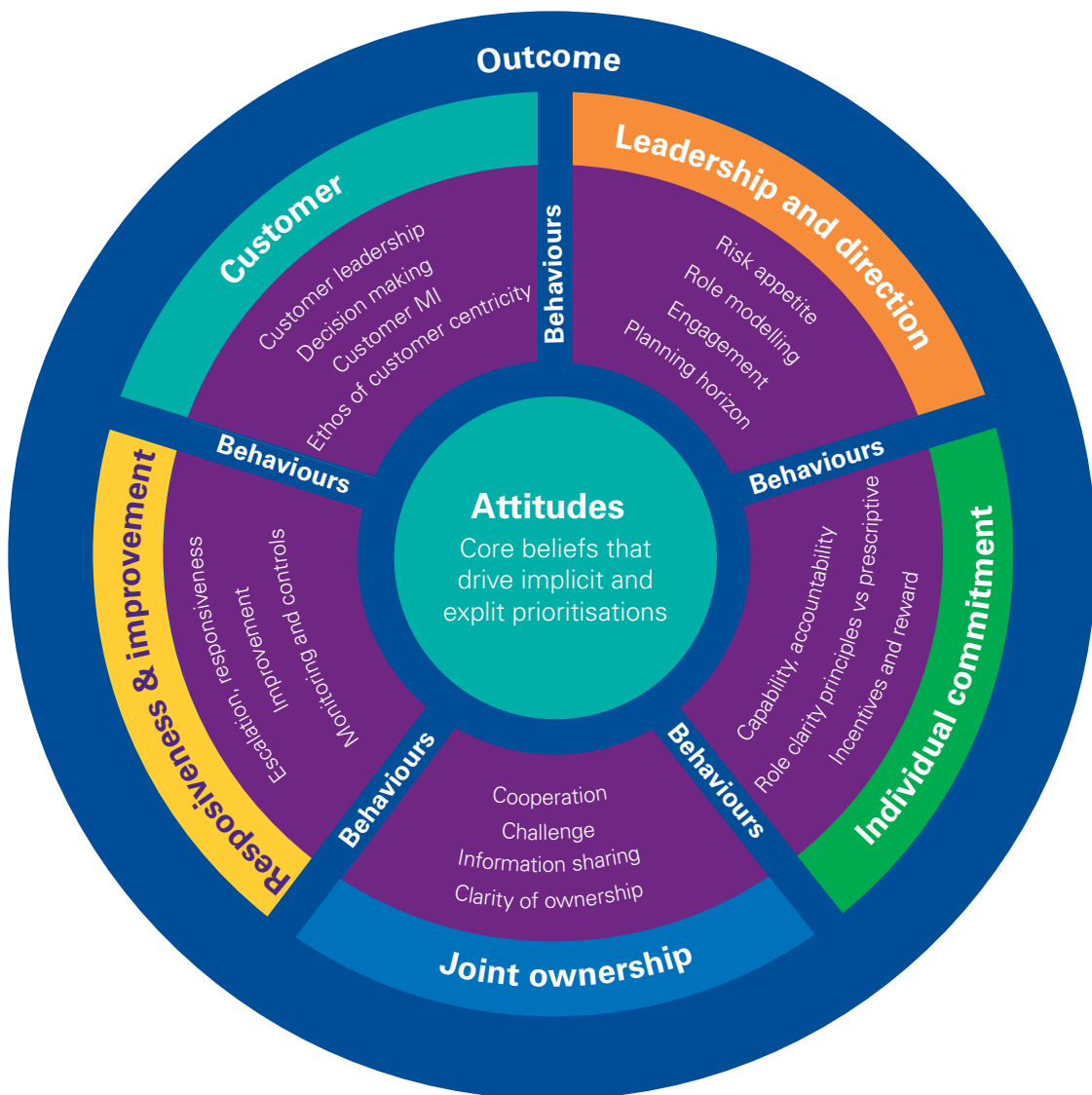**Attract and retain** highly qualified talent that similarly values a strong positive culture

Protect the life of the brand

Protect the life of the brand

A framework for influencing risk culture

Outcome

Customer
- Customer leadership
- Decision making
- Customer MI
- Ethos of customer centricity

Behaviours

Leadership and direction
- Risk appetite
- Role modelling
- Engagement
- Planning horizon

Behaviours

Attitudes
Core beliefs that drive implicit and explit prioritisations

Individual commitment
- Capability accountability
- Role clarity principles vs prescriptive
- Incentives and reward

Behaviours

Responsiveness & improvement
- Escalation, responsiveness
- Improvement
- Monitoring and controls

Behaviours

Joint ownership
- Cooperation
- Challenge
- Information sharing
- Clarity of ownership

Behaviours

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Influencing culture: KPMG's framework

It is possible for an organisation to evaluate its culture as well as to measure the system of values and behaviours throughout the organisation that shape risk decisions. KPMG has developed a conceptual framework to aid in this assessment.

The framework is broadly organised around the following four categories that capture key aspects of influencing behaviour changes:

Leadership and direction – The way in which senior leaders set expectations for the organisation relating to good risk ownership and the way in which strategy and direction influence conduct and culture.

		Negative behaviour	Positive behaviour
A. Leadership and Direction	Risk Appetite	Staff do not understand the risk appetite and what it means for them in their role	There is a clearly defined risk appetite that is articulated by Senior Management, understood by all members of staff
	Role Modelling	Leadership demonstrates through their everyday behaviours that risk and compliance are not critical to the organisation	Leadership provides clear and consistent messaging regarding risk and compliance and encourages others to always comply with risk policies and procedures
	Engagement	Leadership do not understand how the business manages risk and compliance and do not get involved	Leadership is in touch with how the organisation manages risk and compliance and is keen to get involved and listen to issues
	Planning Horizon	Decisions are often short-sighted and made with short term goals	Decisions are made with consideration for the long term consequences of the organisation and its stakeholders

Individual commitment – An individual employee's attitude and behaviour towards the management of issues affecting conduct and culture. Individuals must believe in the value added by risk management, and must be committed to the firm's risk appetite and risk management approach.

B. Individual Commitment		Negative behaviour	Positive behaviour
	Role Clarity	Individuals do not understand their responsibility towards risk and compliance and what it means in their role	Risk and compliance is embedded in every individuals role description giving them the authority to manage risk according to their level
	Capability	Individuals are capable of identifying, understanding, assessing and mitigating conduct risks that affect them in their role	The organisation provides effective capability development and employees have the right knowledge, skills and behaviours to effectively manage risk and compliance
	Accountability	There are no consequences for poor risk management or bad customer outcomes	There are significant consequences when risk and compliance are not taken into account appropriately when making business decisions
	Incentives and Rewards	The firm's reward framework concentrates on sales volume and profit without consideration of quality, risks or customer outcomes	The firm's reward framework (including incentive schemes) is transparent, recognises quality and supports the fair treatment of customers and good risk management

Joint ownership – How the different functions within the organisation interact, cooperate and take joint ownership and accountability for the management of conduct and culture.

C. Joint Ownership		Negative behaviour	Positive behaviour
	Challenge	The risk and compliance functions are incapable of challenging the front office about risk and compliance	The risk and compliance functions have a good understanding of what the front office does and will challenge them if there could be risk and compliance issues
	Cooperation	All lines of defence work in clearly demarcated silos with little or no collaboration	Each line of defence has strong working relationships between its own members and other lines of defence, which allows members to work together to proactively manage risk
	Infomation Sharing	Risk and compliance related information is not easily available or accessible in the organisation	Useful risk and compliance related information is shared within and across each line of defence
	Clarity of Ownership	There is a lack of ownership for many end-to-end processes and activities	There is ownership for end-to-end processes and a clear understanding of ownership of all activities

Responsiveness and improvement – What happens when there are conduct-related incidents and breaches within the organisation, how issues are addressed and what lessons are learned for future improvement.

		Negative behaviour	Positive behaviour
D. Responsiveness and Improvement	Escalation	There is a culture of fear of recrimination if individuals escalate/whistle-blow	Individuals are willing and able to immediately escalate any risk incident or compliance issue that they come across appropriately
	Responsiveness	Bureaucracy and red-tape are the root cause for poor responsiveness	The organisation reacts quickly to risk incidents and compliance issues, with individuals empowered to take the appropriate action
	Improvement	Similar risk and compliance incidents frequently occur with no clear remediation plan	The organisation is committed to learning from its mistakes and continually improving its risk and compliance activities
	Monitoring and Controls	There is a lack of effective management information (MI) for monitoring risks and controls	Risks and controls are reported and managed through effective MI

Customer – The extent to which customer-centricity is embedded within the culture.

		Negative behaviour	Positive behaviour
E. Customer	Customer Leadership	Managers do not communicate what the fair treatment of customers means for them and their staff and staff do not understand what the fair treatment of customers means	Fair treatment of customers is central to the behaviour and values of all managers, they communicate messages about the fair treatment of customers effectively to their staff
	Decision Making	Decisions do not reflect consideration of the impact on customers	Decision making at all levels reflects the fair treatment of customers
	Customer MI	Customer protection cannot be evidenced through controls, as there is minimal MI on treatment of customers	There are controls integral to the risk framework, including MI, that aim to ensure and demonstrate the fair treatment of customers
	Ethos of Customer Centricity	The vision is unclear/blurred or contradicts the fair treatment of customers	There is a clear vision which supports the fair treatment of customers

Improving culture: What to do

There are three steps management needs to take to strengthen risk culture: assess, analyse and improve.

Assess

Board members and senior management, with the assistance of line and middle management, must initially assess the current culture within their organisation. This involves consideration of the following:

– Have values, goals and expectations been established by Board and senior management?

– Have values, goals and expectations been communicated throughout the organisation?

– Is communication co-ordinated, reinforced in writing, public statements and actions of the Board, executives and middle management?

– Are entity-level instruments (policies, procedures, guidelines that make up the framework) and cultural drivers consistent with established values, goals and expectations?

– Do employees understand the stated values, goals and expectations?

– Do employees perceive that the values, goals and expectations are supported by the culture?

– Do key stakeholders perceive or experience the values, goals and expectations being supported by the culture?

– What does stakeholder feedback indicate in this regard?

Much of this analysis can be derived from the review of existing documentation (entity-level instruments) and interviews with stakeholders. Feedback mechanisms such as customer complaints, employee surveys and legal disputes can also provide useful references and sources of information.

Analyse

Based upon the information gathered, senior management can begin to qualitatively analyse the firm's current culture, employing additional workshops and interviews to ascertain a deeper understanding of the relationship between the different elements of the framework (the entity-level instruments and the cultural drivers). Management can use the information gathered to analyse the strengths and weaknesses of the existing framework and how it is being implemented, including:

– Consideration of the nature and strength of the relationship between the different elements of the framework

– Consideration of whether – and to what extent – the stated values, goals and expectations could be strengthened to better articulate and promote a strong positive culture.

– Determination of what attributes of a positive culture exist e.g.:

  – Visibility of desired behaviours at Board, executive and middle management levels

  – Complying with the letter and spirit of the law

  – Serving the best interests of all stakeholders

  – Emphasis on "how" rather than "how much" revenue is generated

  – Self-policing, self-correction and self-reporting of misconduct

– Rewards and incentives for behaviours that align with values, goals and expectations

– Escalation of risks in a timely manner

– Responsiveness to stakeholder feedback/complaints.

Improve

With a clearer picture of the culture that functionally exists within the organisation, the Board and senior management can begin to develop a plan to actively establish a set of values, goals and expectations that sustain a strong, positive culture and encourage consistent employee behaviour. It is critical to anticipate the process will be lengthy and iterative, requiring continuous management, measurement, and reinforcement.

– Based on the results of the Assess and Analyse phases, develop a plan to actively establish a set of values, goals and expectations that sustain a strong, positive culture and encourage consistent employee behaviour

– Ensure that the Board, executives and middle management confirm the values, goals and expectations and visibly demonstrate these to both internal and external stakeholders

– Ensure that the values, goals and expectations are reflected in all facets of the organisation (e.g. strategy, risk, operating models, products/services, partnerships, contracts etc)

– Implement the plan consistently and thoroughly across the organisation, with consideration of:

– Measures and metrics to test the effectiveness of communication of culture and adherence to the standards set

– Measures of the firm's effectiveness at meeting its goals with regard to fiduciary duty and market integrity

– Promotion of escalation channels to encourage transparency and accountability at all levels without fear of retribution

– Proactive assessment of potential risks based on organisational or industry issues.

Questions to ask to improve culture and conduct

Firms that are making progress in improving culture and conduct are asking tough questions and working toward having credible responses for their organisations as well as their regulators.

01 How does our culture impact the level of trust we elicit from our stakeholders? To what extent are our desirable values practiced throughout the organisation?

02 What are the capabilities, values, and principles that define our desired culture?

03 How do we encourage the adoption of our desired culture across multiple businesses and markets?

04 How do we monitor, assess, and report on our culture for audit and regulatory purposes?

05 How has our culture enabled or dissuaded misconduct and how do we improve?

06 Why has our culture-change program stalled?

07 What is the relationship between our corporate culture and our customer experience?

08 When an event or crisis arises, do we endeavor to improve our culture to mitigate the risk of a future event occurring?

09 What will the right culture be in the future and how can we start incorporating those values today?

10 Do we monitor people risks in the same way and in the same forums as operational, market, or credit risk?

Compensation and Culture

A number of regulators have suggested that compensation structures can be used to enhance culture and promote financial stability by tying a portion of an individual's compensation to the long-term performance of the firm. Comments Wayne Byres, APRA chairman, "We are very interested in what those (customers being treated unfairly) episodes tell us about the culture within financial institutions, and the extent to which incentives might be operating to encourage imprudent behaviour."[7]

Compensation and incentives frameworks, including claw back and forfeiture provisions, could be designed to take into account conduct, credit, and market risks, as well as customer outcomes, thus aligning the interests of the individual with the values, goals, and expectations of the firm. Regulators are also looking to the relationship between incentives structures and individual accountability, and are increasingly initiating actions against individuals personally to account for their misconduct in addition to taking actions against their employers[8]. Such actions can include monetary fines, sanctions, and industry bars.

Effectively measuring the influence that compensation structures may have on culture will only be possible if, after establishing the values, goals, and expectations, benchmark metrics related to performance measures or initiatives can be derived, which if achieved, could be shown to correlate with meeting the culture standards. The measurement and assessment would also serve to inform management where additional training and communication is needed.

Footnotes:

1   www.afr.com/business/asic-on-mission-to-weed-out-bad-apples-20130306-j1205

2   http://download.asic.gov.au/media/3583028/rep474-published-21-march-2016.pdf

3   http://www.smh.com.au/business/markets/asic-warns-corporates-to-clean-up-culture-20160320-gnmilv.html.

4   http://www.abc.net.au/news/2015-04-28/rba-governor-stevens-notes-retirees-facing-greater-investment-r/6426826

5   http://www.apra.gov.au/Speeches/Pages/Opening-statement-to-the-House-of-Representatives-Standing-Committee-on-Economics-March-2016-.aspx

6   William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, October 20, 2014, Enhancing Financial Stability by Improving Culture in the Financial Services Industry, Remarks at the Workshop on Reforming Culture and Behaviour in the Financial Services Industry

7   18 March 2016 http://www.apra.gov.au/Speeches/Pages/Opening-statement-to-the-House-of-Representatives-Standing-Committee-on-Economics-March-2016-.aspx

8   http://www.aic.gov.au/media_library/publications/rpp/57/rpp057.pdf

Conclusion

Industry participants are quite familiar with the "why" of heightened regulatory attention on culture but are less familiar with the "how" of going about an evaluation of the culture within their own organisations. The task of managing risks related to the behaviours, choices, and values of individuals is clearly more problematic than managing to numerical thresholds or other quantifiable metrics. Risk management, however, is fundamental and familiar to business and it lies at the heart of the focus on culture.

Boards of directors and senior management must gain an understanding of the culture that exists within their organisations and, to the extent they determine there is a need for improvement, begin to develop a plan for making the necessary changes. The broad concepts of tone from the top, accountability, effective challenge, and compensation/incentives are critical to this effort and should be reviewed closely by the Board and senior management as they are indicators and drivers of "good culture" and will guide regulatory reviews. Additionally, consideration should be given to the "tone at the middle," the access of the legal and compliance departments to the Board, and the opinions of customers, all of which can impact the effectiveness of cultural improvements. Firms should be prepared to document and explain their efforts, anticipating that regulators will want to understand the "what" and "why" of their efforts. KPMG's conceptual framework approach offers clients a way to begin the process of assessing, analysing, and improving an organisation's cultural environment.

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