

Conduct risk:

Aligning product, customer and value

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KPMG explores the challenges that the integrated Australian financial services sector faces when it comes to measuring and managing conduct risk and how we can ensure positive outcomes across product design, customer outcome and value for money.

“When it comes to conduct risk, people confuse compliance with culture, but compliance is the bare minimum; culture is something more. It encompasses the client outcome and how organisations align their interests with the customers’ long term interests.” So comments Michael Cunningham, Partner, Risk Consulting at KPMG, when reflecting on key conduct risks in the Australian financial services sector and how to develop a conduct culture that’s squarely focused on achieving the right balance of customers’ best interests and profitability.

This is a key issue right across the financial services spectrum – from banking to insurance to wealth management to financial planning, particularly in the vertically integrated model the Australian market is predominantly built on.

The continuum of ethical culture

The Australian market is certainly at a key point of transition in terms of managing conduct risk. The advent of Future of Financial Advice (FoFA) and the Turnbull Government’s response to the Financial System Inquiry has provided renewed focus on measures to improve consumer outcomes – particularly in regard to providing confidence in the wider financial system and ensuring consumers are treated fairly (see page 2 for more detail on regulation).

But market participants are now realising that regulation is just one small part of the equation – developing a culture of ethical conduct is about having the right people, systems and processes in place to:

- **establish** an ethical vision, that aligns product, customer and value
- **create** a practical framework to identify, measure, manage and mitigate risks
- **monitor and reward** ethical behaviour while ensuring there are clear consequences for unethical behaviour.

‘Conduct risk’ is the risk of inappropriate, unethical or unlawful behaviour on the part of an organisation’s management or employees.

ASIC’s definition of conduct risk

A key realisation is that ethical culture is a continuum. While bad culture and conduct is a clear problem that can be addressed and called out, and good culture and conduct is seldom recognised and rewarded. Many organisations ignore the problem of poor culture and conduct – that is, where the culture isn’t deliberately bad, but there are key failures or a lack of a consistent message about expectations around ethical policies, procedures and behaviour, notes Michael Cunningham.

“What’s important is articulating a clear vision and agenda for ethical conduct and the creation of an ethical environment led from the top. If this isn’t done, the vacuum is often filled by poor conduct and culture,” comments Mike Ritchie, Partner, Risk Consulting at KPMG.

The role of regulation and the bare minimum

For the first time in Australia, the government is seeking to require professional standards of financial advisers following on from the FoFA legislation, which introduced professional conduct obligations. The government will also introduce legislation that will enshrine new product design and distribution obligations. This would make issuers and distributors of financial products formally accountable for product offerings and communications.

These measures will provide greater power to ASIC at a product level, and build upon the work they are undertaking in relation to product design and the proposed new product intervention power. Organisations will need to ensure that their internal processes and procedures for identifying and mitigating conduct risks not only meet ASIC's expectations, but reduce the likelihood of future costly remediation events. They will have to embed consideration of customer outcomes into strategic decision making.

The requirements of FoFA are well known and are already changing the Australian financial services landscape. But is legislation the answer to creating real customer value?

It's a critical part of the equation, but by no means the most important. "If you're waiting for regulation to determine the framework, you're five years out of date," comments Mike Ritchie. "We should be five years ahead of the regulator and helping to set the agenda."

The issue is that compliance in and of itself sets a bare minimum that institutions don't tend to exceed. And when it comes to conduct, we should be aiming for best practice rather than bare minimum.

ASIC REP 474

Culture, conduct and conflicts of interest in vertically integrated businesses in the funds-management industry.



Highlights key issues identified in ASIC's review of the management of conflicts of interests within the funds management industry and ASIC's response.

ASIC CP 254

Regulating digital financial product advice.



Seeks feedback on how ASIC's organisational competence requirement should apply in a digital advice context and how digital advice licensees should monitor and test algorithms.

Future of Financial Advice (FoFA)

Improving the clients' best interest duty. Enhanced fee disclosure statement.



Key conduct risk and culture issues in Australian financial services

Poor customer outcomes are broadly split across three areas:

1. Inherent information asymmetry in sales and communications
2. Structures and behaviours that create conflicts of interest
3. Environmental factors that exacerbate conduct risk.

Rebalancing information asymmetry

Information asymmetry exists in sales of financial products when the provider of a product has a detailed understanding of the product, while a consumer is generally less well informed. Retail customers place a degree of trust and reliance upon the sales person to provide personalised advice based on their best interests. They generally expect an adequate and clear disclosure regarding the product or service.

Global regulators have criticised the sales process and clarity of customer communications as a driver of poor customer outcomes. This process can leave customers with products that do not perform as they were led to expect.

A new risk is also emerging due to an increasing focus on financial innovation, which can create unexpected and unique customer impacts (for example, the use of social media to promote products).

Historically, regulatory responses have sought to address these imbalances by providing prescriptive requirements for disclosure (e.g. a key facts document and product disclosure document). Also, by setting professional standards for sales advisers in an attempt to rebalance information asymmetry.

While disclosure requirements have always been detailed the Government is finally maintaining a register of adviser standards.

Firms will only truly embed conduct risk management into their business by looking beyond the potential regulatory enhancements.

Changing incentive cultures

In the past a key issue facing the Australian market has been the structure of sales incentives, and how this encourages or discourages great customer outcomes. An obvious and much discussed problem is the tension between the need for sales teams to meet ever-increasing targets versus the need to suit the right product to the right customer at the right pricing.

This issue has been even more problematic in the Australian market, where consolidation and the vertical integration of advice, banking, wealth management and insurance potentially amplifies conduct risk.

“The Australian market is highly concentrated, which means there’s less competition,” notes Jacinta Munro the head of KPMG’s Compliance and Conduct team. Competition can be a key driver for ethical conduct – when consumers have more choice the motivation to clearly benefit the customer is much higher. At the same time, vertical integration of wealth, banking and insurance can create environments that can be challenging when it comes to conduct, particularly around sales incentives.

With FoFA now gaining full momentum, the time is right for banks to confront this issue. And FoFA has indeed created a significant change. “There should no longer be an issue with conflicts around incentives thanks to FoFA,” comments Jacinta Munro.

New ways to measure conduct risk

Technology may just hold the key to moving forward when it comes to creating even better conduct risk frameworks. An exciting development is how emerging technologies can help measure and manage conduct risk. “There is trading technology that has the functionality to monitor 100% of transactions and identify misconduct,” comments Jacinta Munro.

In Europe we are seeing new forms of software and hardware and cognitive computing and predictive analytics eliminating the post-order sample checking process to identify aspects of misconduct as they occur. This could certainly revolutionise the measurement of conduct and ethical behaviour and help institutions differentiate themselves.

Environmental factors in focus

While information asymmetry and incentive and other remuneration structures are well within the control of the institution, there are bigger macro trends at play that may also heighten conduct risk. These include economic and market trends, particularly, technological innovation. The digital provision of products is generating ‘click risk’, which is essentially the risk that every time new terms and conditions or upgrade options emerge people tend to click without examining further.

At the same time, regulation around new capital requirements for banks and other financial institutions is creating more cost, which is being passed on to consumers. There are ethical implications around the extent to which costs like this should be worn by the customers.

Developing an approach to conduct risk to align product, customer and value

Conduct risk is driven by multiple factors in a firm's business model – all elements can impact customer outcomes.



Product design/strategy/development

- What are the drivers of organisation/BU level strategy?
- How are revenue goals balanced with long-term sustainability of the business model and customer needs?
- What are the values of the organisation and how are they driven through policies and processes to create positive customer-centric culture?
- Does product design focus on delivering to customer needs?



Communicating and marketing

- What processes are in place to ensure that customer communications are clear, fair and do not mislead customers? Are they effective?
- Does the firm's brand and values drive honest and open communication with customers?



Sales quality and advice

- Are staff trained in how to make a 'compliant' sale?
- How are sales incentivised? How does this drive sales culture?
- What is the degree of cross-subsidisation in the business model?
- How aligned are the incentive structures with the values of the organisation?
- Are there clear controls in place that ensure consistently good customer outcomes?



Sales quality assurance

- What processes are in place to provide assurance over the quality of sales and customer outcomes? How effective are they? Do they measure conduct risk?
- Are first line supervision arrangements appropriate and effective?



Product governance

- How are emerging and crystallised risks measured, monitored and identified?
- How are customer risks in the product design or sales process mitigated?
- What are the drivers for product enhancements?



Post sales and servicing

- How are good customer outcomes ensured post sale?
- Are customer needs and expectations central to policies and processes regarding arrears management, claims and servicing?

Good conduct is not simply about ensuring customer satisfaction, but delivering a good outcome for the customer. This goes beyond process and procedure – good conduct aims to deliver value for the customer and the shareholder with a balance of customer outcome and profitability for the organisation (for example considering the specific conduct risks that might arise from a particular product penetration strategy).

Case Studies

Conduct risk and control uplift – capital markets division of a major Australian bank

With the increase focus on conduct and culture particularly across the international capital markets industry, a major Australian bank proactively engaged KPMG to undertake an objective analysis of the conduct risk and control framework of their capital markets business. KPMG used UK Financial Conduct Authority “Fair and Effective Market Review”, ASIC Report 404 and global best practice as primary benchmarks. The work streams reviewed included governance and culture, personal conduct, monitoring and surveillance, risk profiles, training, policy, breach and event management and first and second lines of defence.

The nature of the review was a maturity assessment of both the design and operational effectiveness of each work stream. The output identified a series of key gaps, “quick wins” and recommendations. The outputs were categorised, prioritised and ultimately converted into an implementation road map.

The report provided the bank with a clear statement on the current state of their conduct risk and control framework. It further provided them with a set of implementable steps to improve the environment.

Supporting enforcement activity

The government, media and ASIC have all been intensely focussed on the financial advice industry for a number of years, seeking to both hold providers of financial advice to account and seeking to improve the conduct of financial advice providers.

KPMG has been engaged by a number of large financial advice providers to assist them in addressing regulator concerns and to improve their processes for ensuring advice is provided in a compliant manner. ASIC is continuing to show a greater expectation that financial services licensees will put in place processes to encourage and promote positive client focussed culture, while also expecting that licensees will take a firm view on conduct that is deemed inappropriate or unacceptable.

KPMG’s engagements have included acting alongside ASIC Enforceable Undertakings where our role sees us assessing the changes made by our clients and helping to ensure that the processes they put in place to manage the risk of poor conduct by the Advisers are aligned with ASIC’s expectations. We put ourselves in the regulator’s shoes and assess the changes being made by an organisation to address the regulator’s concerns. We are seeing an increased focus by the regulator on the cultural aspects of managing a compliant organisation and an expectation that the risks posed by poor conduct are considered and addressed.

Improving process for FoFA

This mid-size retail bank wanted to know early on what the FoFA impacts were likely to be on their sales and related processes. They were after clarity on which sales scenarios and sales people (i.e. which structures) would be impacted, how they could re-structure to minimise the negative impact, support desired sales conduct and maximise the opportunities presented.

The challenge was how to deliver a simple, low cost solution, that would ensure they remained competitive in the market and could still incentivise their sales people in line with what the company wanted to sell, what was in the best interest of their customers and not only where the advisor got the most commission.

The end result was a solution that could identify which sales people could apply which sales approaches at any given time to act in the best interest of the customer while being suitably remunerated. Support processes needed to be altered to match the outcomes, for example Statement of Advice templates, policies and commission structures. Advice models were also changed to reflect sustainable compliance and to allow for deeper relationships, with multiple touch points with a customer.



16:1

In the UK, for every £1 spent on upfront compliance, £16 are spent on remediation



\$125 million

Potential ongoing remediation costs in Australia if ASIC were to take a similar approach to CCI as the UK FCA



31,680

Complaints referred to the Financial Ombudsman Service in Australia last year demonstrating the level of dissatisfaction in the market



37%

Files that failed ASIC's assessment of life insurance sales as part of review 413*



£24 billion

The total size of provisions by UK banks in relation to PPI remediation



\$40

The potential remediation cost per customer in relation to add-on products if ASIC were to take similar action to the UK FCA

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