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# Embedding Conduct (Risk): Rebuilding Trust in Banking

BBA webinar: 21st June 2017

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# Embedding Conduct Risk

## Agenda:

**I. Introductions**

**II. Administration**

**III. Outline**

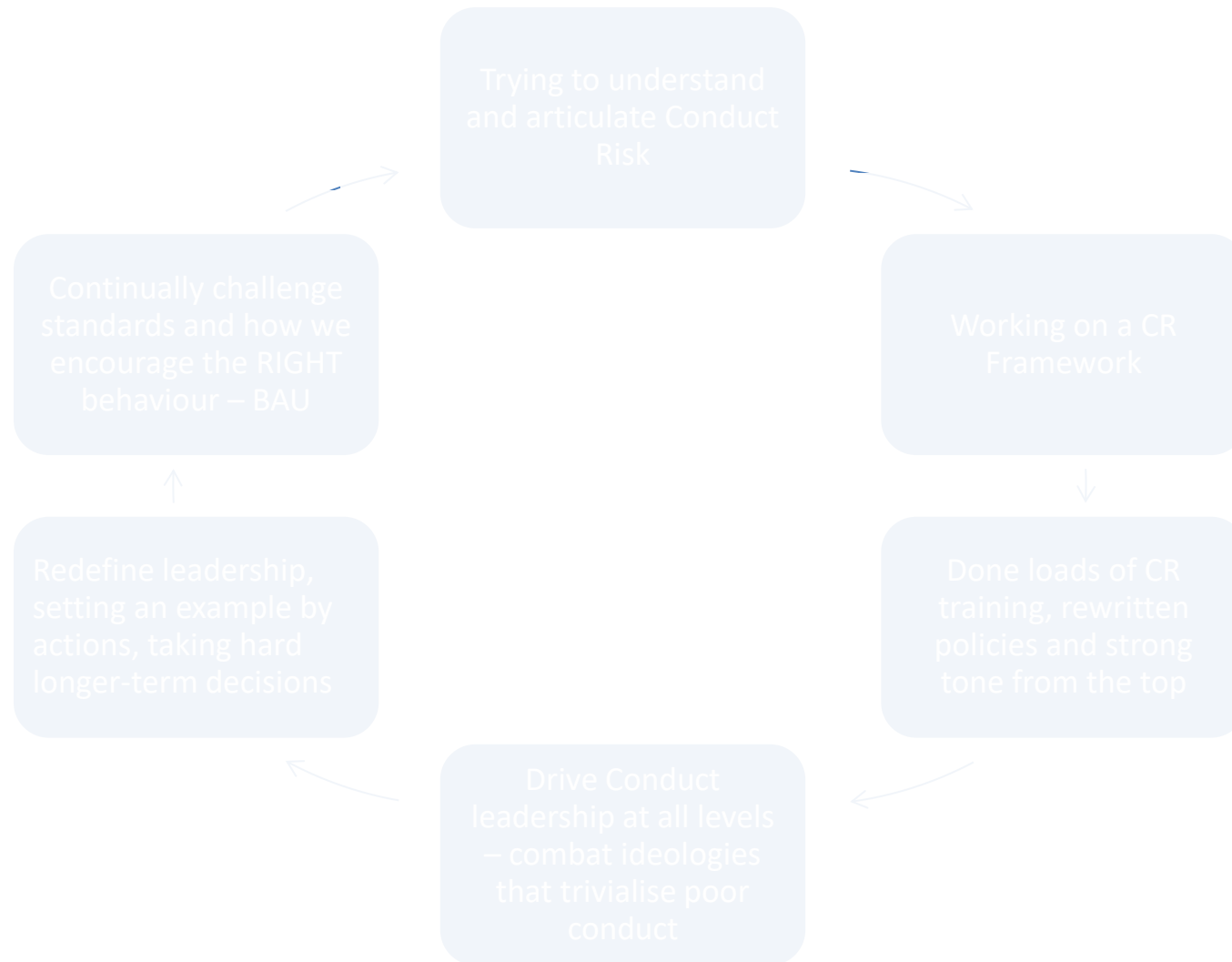
# Embedding Conduct Risk

## Outline

- What's driving conduct regulation?
- What underpins misconduct?
- “What does good conduct look like?”
- How can we use this to stimulate positive change (behaviour + culture), to embed good conduct, rebuild trust in the industry and *build lasting business value*?

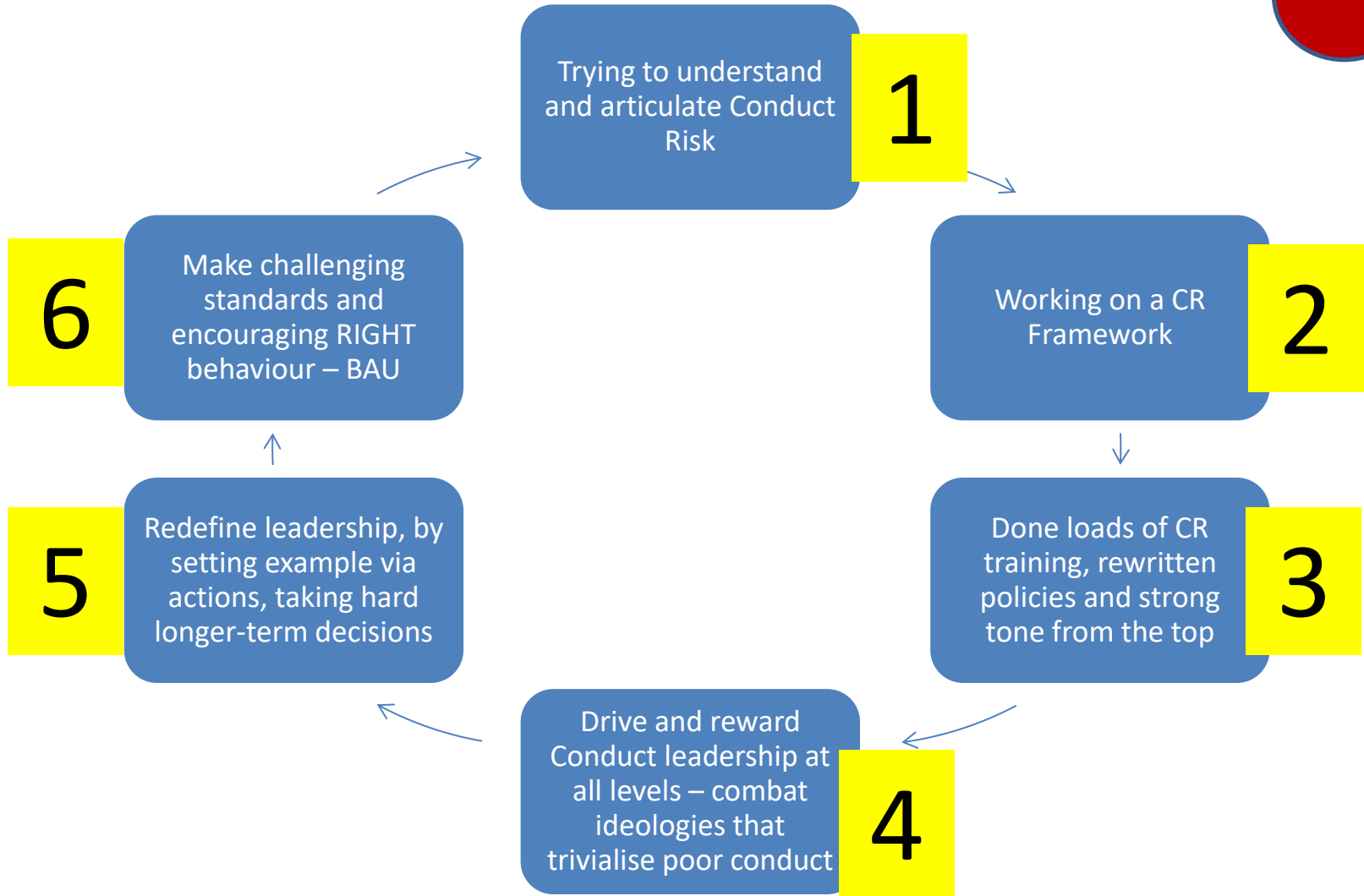
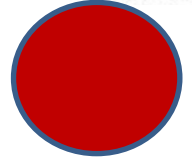
# Introduction

## Conduct Risk Maturity: a cycle of change



# How 'embedded' is CR at my bank now?

**Vote from 1 – 6 now...**



# The change in regulatory approach

- Post-crash
  - Political embarrassment, recovering face
  - Need for a cheap, high-profile enforcement tool
  - Reliance on control frameworks inadequate in complex, globally integrated markets
- Behavioural Economics helps with that
  - Quicker wins: Individual misconduct vs nebulous corporate entities/products / markets
- BE also brings a genuinely fresh outlook:
  - Overcomes ‘failed’ (neoclassical) economics-based controls
  - Embraces **rational rules** AND **intuitive perceptions**
  - **Biases** and other behavioural effects = new “**patterns of irrationality**”
  - Feels familiar to us: “human nature”; anti-“expert”
- But is this really science...?
  - ...or just a new tool for politically expedient ‘banker-bashing’?



# What underpins misconduct?

## Regulators' *language* is revealing:

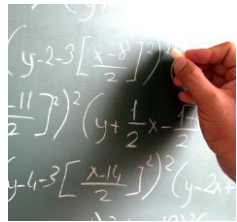
- **Misaligned incentives** = rewards for mis-selling, etc
- **Negative ideologies** = misplaced loyalty to team / brand
- **Moral evasion** = “reasoning away” and harm as remote, irrelevant
- **Selective attention** = attachment to poor compliance processes
- **Lack of challenge** = “governance groupthink”, denial
- **Contagious rule-breaking** = socially condoned misbehaviour
- **Overconfidence** = won't be detected, fines feel trivial



## Research drivers of Conduct Risk (1):

# 'Thinking Fast + Slow'

- Our brains handle risk-taking in two ways:
  - **Intuition** – “what feels ok” (brain System 1)
  - **Reasoning** – “what the logic says” (brain System 2)
- We often fool ourselves:
  - We think we are acting rationally...  
...when in fact it's our intuition guiding us – based on limited experience and flawed memory
- Our brains are more powerful than we know
  - Human animals have highly-evolved 'risk-sensing' (*heuristics*)
  - BUT organised Risk Management (accidentally) squashes this
  - “Box-ticking makes people switch off their common sense”





# Research drivers of Conduct Risk (2):

## Bias risks

- Biases = animal brain short-cuts; *may* help survival
  - *good* for avoiding sabre-tooth tigers
  - *not so good* at grasping complex derivatives
- Recently far better researched and understood
  - know *how* biases create bad decision-making
  - banking environment “makes people dishonest”
  - Growth vs fixed mind-set, resilience and attitude to failure
- Many real-world examples found:
  - A **hungry judge** tends to refuse parole to a prisoner
  - **Drivers** of ‘safety’ branded cars are less careful
  - Many **professionals** overrate their skills at risk-assessment (academic expert witnesses, fund managers, civil servants, surgeons, auditors, lawyers, police)

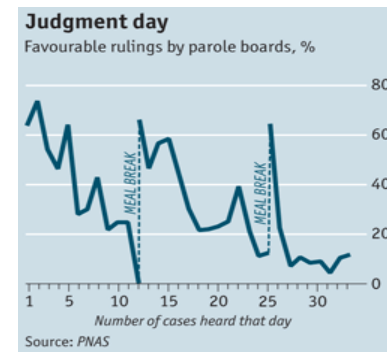
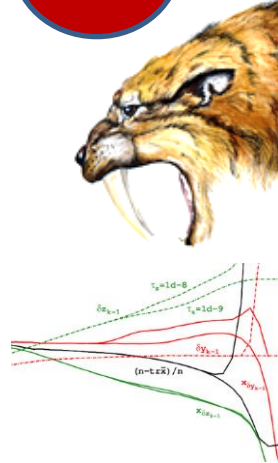
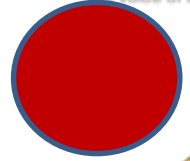
Ariely, *Predictably Irrational*; Thaler, *Misbehaving*;

Kahan, *Cultural Cognition* ;

Cohn, Fehr, and Maréchal. *Business culture and dishonesty in the banking industry*

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# ‘Rational’ management - *induced* misconduct

- Command-and-control
  - “Don’t question it, do it”
- Pulling forward a deadline based
- “Competitive pressures”
  - while ignoring changes in market and client dynamics
- Binary control questions
  - “yes / no” boxes, without context or discussion
- Forewarned audits
- Provider-side biases:
  - **implicit**: condoning “high value producers” – however they do it
  - **systemic**: forced optimism; punishing “failure”; sales target “stretch goals”



# Other drivers of misconduct

## “Too big to care”:

- Big-brand industries may ‘capture’ their regulators  
e.g. sectors with: deep pockets, long histories, easy to relocate, virtual products, high complexity, no easy focus for public challenge
- Lack of challenge or diverse thinking

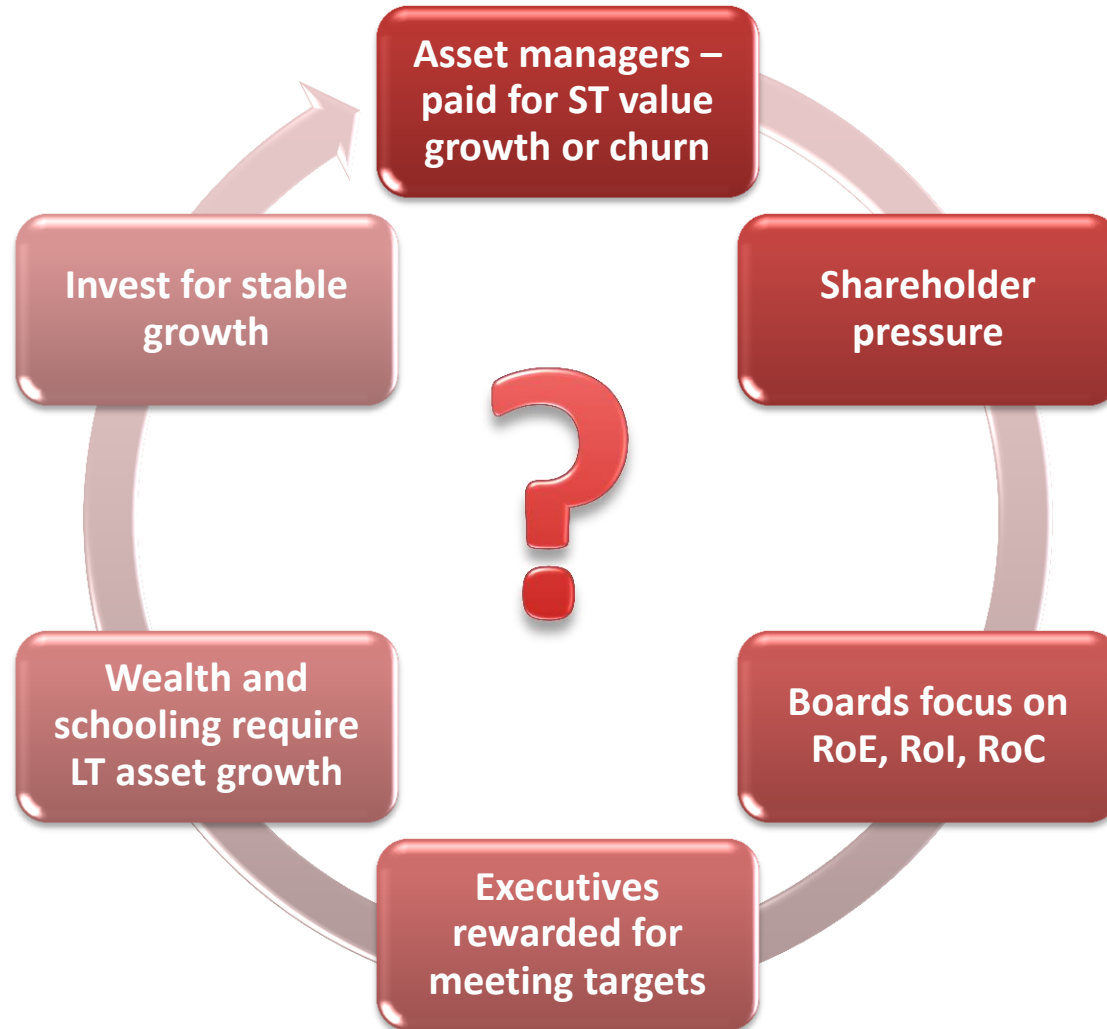
## Sector’s social and psych. profile:

- Big money - attracts sociopaths + ‘gamers’
- Informal ‘tribes’ - subverting formal structures
- Weak culture of learning from mistakes - blame-shifting and cognitive dissonance; problem avoidance, not problem-solving, closed-loop thinking (Aviation vs Healthcare)

## Risk governance was skewed:

- Short-termism...

# Short term vs Long term interests



# From Conduct Risk to good conduct

- FCA (and other regulators) demand a ‘**culture of good conduct**’
  - at **every level** in all firms, incl Board
  - with **personal** responsibility + accountability (SM&CR etc)
  - strong CR framework > culture > **good outcomes** (customers, markets)
- CR management is *not*:
  - an OpRisk ‘add-on’; compliance-driven; one-off training
- Some better approaches:
  - CR colleges; corp. values programmes; personal development



**Conduct Risk – what does it mean to you?**

# Pitfalls and successful approaches (1)

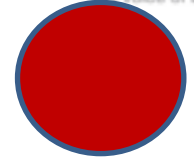
- **Pitfall: Driving Conduct embedding from the centre for too long**
- **Better to:** Get businesses to 'own' it, fast
- **Pitfall: Compliance-driven MI + reporting**
- **Better to:** Drive for businesses to own both – it keeps it alive!
- **Pitfall: Confusing complexity across Frameworks, Policies, Risk categorisation**
- **Better to:** Keep it simple and efficient across all
- **Pitfall: Quantity of firm-wide MI**
- **Better to:** Have one simple firm-wide MI requirement that's forward-looking and focused on business flexibility

# Pitfalls and successful approaches (2)

## What works:

- Ensure **clear 3LOD model** is operating
  - Supports SMCR and drives Conduct into BAU ownership
- Start Conduct Management cycle at **strategy setting** stage
- Make RCSAs **live documents**
  - Complementing assessment of strategic risks
  - Not simply annual refresh cycle, ‘put back in a drawer’.
- Next-generation view:
  - Remove Conduct as a separate risk and make it a **theme**
  - Move focus to **culture/ethics** and **behavioural economics**
  - Challenge: **Who owns Culture?**
- Global firms / diverse business areas:
  - Spend time **‘translating’** conduct; find out what approach each business needs

# But what does good conduct look like?



- Unlike other risk standards
    - Asks: **“What’s acceptable / expected behaviour?”**
    - Depends on “appropriate” decision making
  - A **moving target**:
    - each person’s tolerance changes continuously
      - with age, experience of life / work, influence of social- /work-group
    - Has to look towards and adapt to new standards - innovation
  - Sees firms as having **two forms of “licence”**:
    - Conventional (trading) licence
      - from a regulator
    - Social licence
      - how far stakeholders\* will *continue to withhold criticism*
- \* e.g. customers, regulators, government, public, watchdogs, forums





# Cost-benefit: identifying value

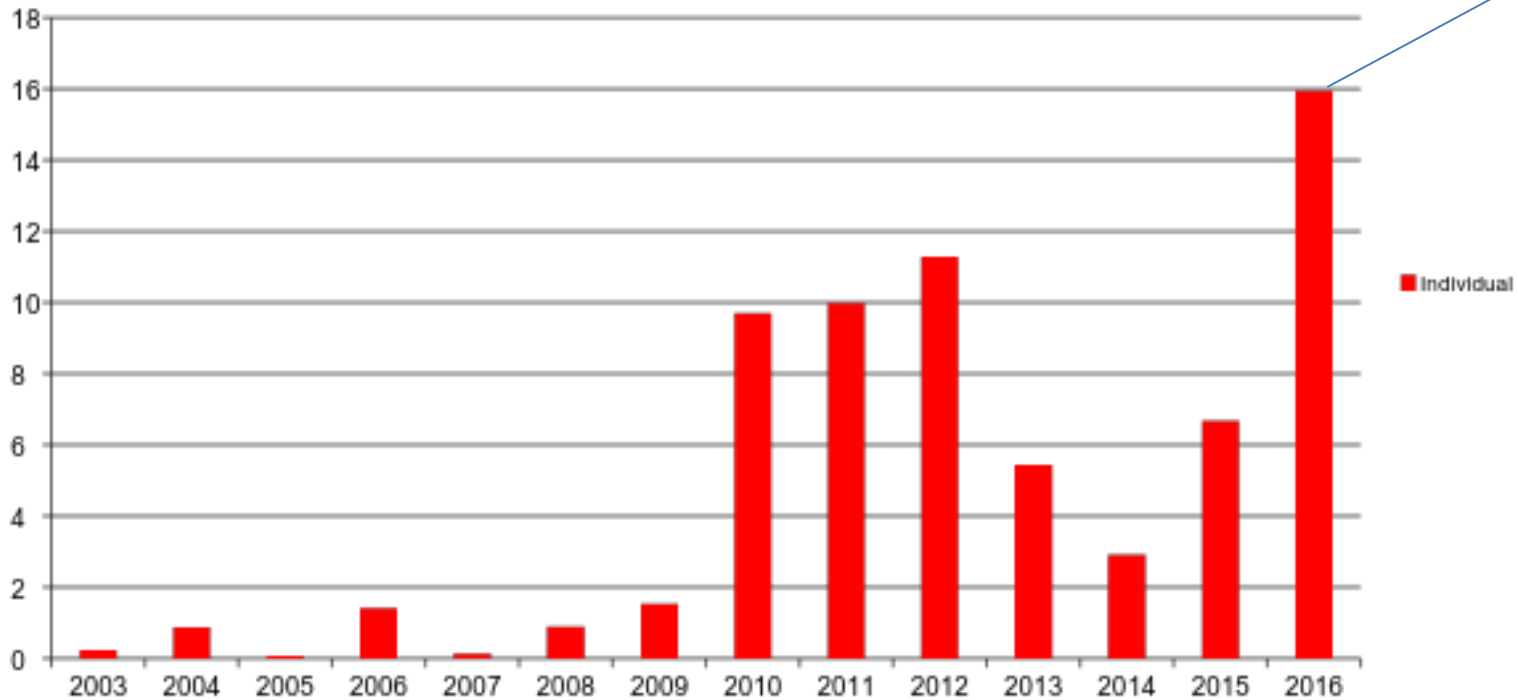


- Black Swan paradox
  - if it works the result is...nothing!
- Overhaul **value models**: link to
  - cap. adequacy, customer + staff retention, regulatory ratings
  - new metrics: trust, collaboration, problem-solving, culture
- Shareholder returns: **long-term**
  - balance v short-term imperatives
  - social licence: banking system's social purpose + economic role
- Invest real time and effort to enhance **conduct and culture...**
  - **earn goodwill** from regulators...
  - so **reduce costs** (scrutiny, legal, enforcement, remediation, op loss)
- Will SMCR personal accountability act to drive this?
  - authenticity is difficult to fake – costly, time-consuming and risky

# The *personal* cost of getting it wrong

- Recent decline in *corporate* fines does not mean threat has subsided
- Rather, it has changed to *individual* focus

FCA fines (£m)



# How do we *embed good conduct*?

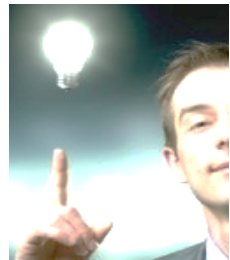
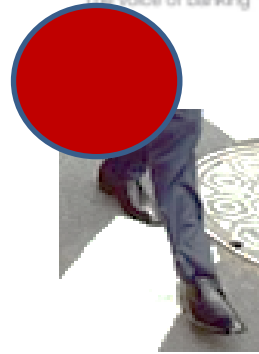
## – a few ideas

- Look **beyond ‘paper processes’** (SMCR, frameworks + dashboards): *are you **actually doing it**?*
- **Challenge** status quo: change + ‘disruption’ = scope for new competitive advantage?
- Articulate, measure + **reward good behaviour** - not just punish bad
- Distinguish **mistakes** from **deliberate misconduct - case** studies
- Understand **bias**: embedded, complex conflicts; at every level
- **Manage by example**: self-awareness; Conduct leadership as KPI
- Link Conduct **dashboards** to SMCR (EXCo, Boards); publish firm-wide
- Assess **internal culture**: mentoring to address embedded conflicts
- **Retool Compliance** functions as agents of **behavioural change**
  - “trusted advisors”, coaches facilitating challenge, + error-based learning

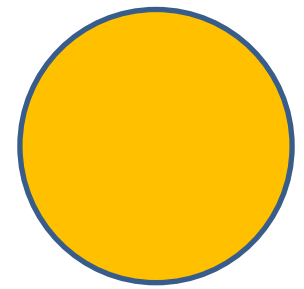


# To sum up

- Conduct (and enforcement) is about *outcomes*
  - “what actually happens”
- Get ahead not just with ‘framework’, but *change in mindset*:
  - *in the past*: we have carelessly *driven misconduct* by using ‘behaviour-blind’ control designs
  - *now*: will factor in + report MI for: problem-solving; customer-centric; biases; incentives; personal accountability; sensing
- Some ‘wins’ *easier than you think*:
  - *staff instincts* are sound; use tools and reward to get them “working risk-aware”; leverage the enlightened as coaches
  - *leaders* must find *moral courage*: challenge short-termism; think long-term, constructively critique status quo
- Our journey continues: workshops with
  - CR Club, Culture Audit teams, NEDs, Risk people, front-line staff



# Next steps



1 day BBA/UKFA workshop by Dr Roger Miles and Patrick Butler

Please indicate preferred content in descending order (1-4)

- Analysis of members' progress to build and embed an effective Conduct Risk management culture, identifying potential framework weaknesses
- Initial design and outline of Conduct Risk management tools, valuation models and metrics, based on members' priorities
- Coaching for individuals with Risk management responsibilities to identify and address Conduct Risk issues
- Design of development programme to enhance Conduct and Culture understanding and practice

Preferred dates:

July

August

September

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