2015 Risk Culture and Conduct Benchmarking Report/September 2015

Risk Culture: Where to from here?

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Thank you

We appreciate the support and input of the survey respondents. Your participation and openness was essential to the survey's relevance.

We hope you find the information in the 2015 PwC Risk Culture and Conduct Benchmarking Report insightful and valuable.

Contents

Foreword

The challenge of building a corporate culture that prioritises risk management, ethical behaviour and smart decision-making continues to weigh on financial services organisations.

Culture and conduct have never been more important in the financial services sector: board and executive accountability for defining and driving risk culture and good conduct is at the forefront of market attention, with new risk management and governance prudential standards from APRA, and increasing ASIC monitoring and enforcement of regulations designed to protect investor and consumer interests. With such a clear line of accountability you'd expect that both directors and management would be well advanced in meeting the requirements.

Despite this, the industry continues to be plagued by scandals which erode customer trust and shareholder returns.

With such industry concern, we initiated our first Risk Culture and Conduct Survey to specifically ask our clients their views on the level of maturity of risk culture and conduct risk in the Australian context. We sought participation from non-executive directors (NEDs) and representatives from Risk, Internal Audit and Legal (ie risk professionals) across the industry to understand two main things:

- what companies are doing to positively influence culture
- the differences between perception and reality when it comes to the effectiveness of organisational systems, policies and procedures in driving cultural change.

Using the results of the survey, this report compares NEDs' and risk professionals' (RPs) perspectives on risk culture across the four key dimensions of the PwC Risk Culture Model which we use to measure and assess risk culture:

1. Leadership and strategy
2. Risk management and infrastructure
3. People and communications
4. Accountability and reinforcement

This is described in Figure 1.

Although our survey focused mainly on risk culture, conduct could not be ignored. Risk culture and conduct are interrelated, but are not interchangeable. As such, we also sought respondents' views on conduct and the initiatives being implemented by organisations to understand the impact of conduct. Conduct is a multi-dimensional concept but is generally defined to include behaviour that:

- mitigates the risk that a firm's products and services, processes or behaviours do not deliver fair outcomes for past, present and future customers
- safeguards the integrity of markets.

"APRA is significantly increasing the attention it gives to risk culture – which I sometimes refer to as the 'soft stuff', because it is so different to other aspects of prudential management and rather contrarily is actually quite hard to manage."

Ian Laughlin, Deputy Chairman APRA, Macquarie University Financial Risk Day, Sydney, 13 March 2015

"Frankly, it is a very sad fact that bad culture often leads to bad conduct. This inevitably can lead to poor outcomes for consumers."

Greg Medcraft, June, 2015 - Senate estimates committee briefing

"In a global financial services sector in the midst of transformation, culture is a crucial source of competitive advantage and is set to play an even more important role in the ability of financial services firms, globally, driving growth."

PwC, Conduct: When sorry isn't enough...

Overall, our survey found that there are some disconnects between an organisation's commitment to and desire for a robust risk management culture, and its understanding of conduct risk and operational reality. Given this point, cultural change and conduct initiatives are likely to fail if their primary focus is a compliance requirement, or if they are simply a response to regulator pressures. Organisations need to look beyond the regulatory requirements and think about how culture and their conduct agenda will have a lasting impact on their reputation and future competitiveness.

Those organisations that plan well and embed a focus on a healthy risk culture and conduct agenda in the heart of their businesses will set the new benchmark for effective risk management, the delivery of sustainable business outcomes, and will position themselves to gain a real competitive advantage.

Figure 1: PwC Risk Culture Model

Established processes and controls

Business processes are effectively controlled and controls keep pace with change and complexity in the business.

Identify and assess risk

There are clear processes to identify and assess risk. There is a clear framework with which risks are evaluated and controls are managed.

Integrity and ethical values

Behaviours in practice reflect espoused values and ethics, and these are actively reinforced by management.

Communicate mission and objectives

Strategy is clearly defined and communicated. Staff understand how their objectives link to the business unit and the organisation's strategy.

Commitment to competence

Staff are appropriately qualified, skilled and experienced to effectively perform their role. There is a focus on continuous improvement.

Information and communication

Communication and symbols reinforce the organisation's values, ethics and behavioural expectations. 'Zero Tolerance' behaviours are understood. Communication between functions is effective.

Assignment of authority and responsibility

Roles and accountabilities are clearly defined and communicated to all staff. Staff are clear about what decisions they can make and what they need to escalate.

Human Resource policies and practices, and performance measurement

Leaders and staff have clear performance expectations and targets. Leaders effectively supervise and coach staff and appropriate behaviour is reinforced.

Maturity levels

Environment Organisations have appropriate support infrastructure in place such as policies, processes and systems that guide how to respond to risks.

Knowledge, skills and abilities People have a comprehensive understanding of what risk management policies and procedures mean to them. They can accurately identify risks and have the skill and ability to respond to risks.

Beliefs People value and truly believe in risk management and have internalised knowledge, processes and practices so that doing the right thing in terms of risk management is part of how they naturally operate.

Highlights of the survey

Interestingly, NEDs have a more positive view of their organisations' risk culture and conduct management practices. The differences could indicate a disconnect between NEDs and RPs, or could be attributed to factors such as:

- differences in perspective – NEDs focus on the overall strategic direction and strategic risks, while RPs focus on the day-to-day management of risks and the adequacy of the related frameworks and processes
- the nature and extent of information and reporting received by NEDs in their role versus RPs, and their level of access to management below the executive level
- the individual circumstances of the organisation the RPs or NEDs represent.

Other key highlights

Leadership and strategy

67% of RPs and **88%** of NEDs surveyed consider that their organisations have a clear and defined desired state for risk culture.

Risk management and infrastructure

22% of RPs agree that their organisation is measuring and monitoring the right lead and lag indicators to provide an accurate picture of their risk culture.

People and communications

14% of RPs believe their organisation has processes to evaluate the depth, quality and scalability of their people's risk management capability.

Accountability and reinforcement

21% of respondents agree that their organisation's reward structure is designed to avoid excessive focus on short-term incentives at the expense of adequate risk management.

Conduct

38% of RPs feel that management regularly challenges the performance of existing products, even those which are more highly profitable than anticipated.

Leadership and strategy

A clearly defined and communicated risk culture strategy is core to success rather than a means to redress.

The ability of leadership to communicate the organisation's mission, objectives and strategy in a way that all employees believe in them is critical to business success. Leaders need to define and focus on the values, behaviours and principles they consider important and embed them into organisational standards, policies and procedures. This is necessary if those values, behaviours and principles are to be a key driver for the way people work and how they are measured.

Participants said ...

Our survey responses reveal that many organisations are embracing this message, with 67% of RPs and 88% of NEDs agreeing that their organisations have a clear and defined 'desired state' for risk culture. But to counter this, only 50% of RPs and 40% of NEDs believe that the behavioural expectations required to support the achievement of this state have been clearly defined.

Generally NEDs are also positive about the board's contribution to risk culture with more than 60 per cent confirming they regularly engage in meaningful risk culture discussions.

Bringing about change

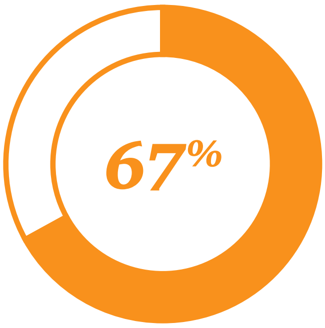
The key to effective change is being able to identify and adjust the specific critical behaviours that need reinforcing. This requires executives, who are role models for the organisation, to demonstrate the right behaviours and hold themselves accountable for monitoring and enforcement. Their attitudes and actions about risk shape the business environment and culture. Their behaviour must exemplify the ethical behaviour which they want to permeate the corporate culture. This will help set the right tone and direction and build momentum for broader change.

The survey results reflect this view, as the majority of NEDs and RPs (88% and 80% respectively) feel the tone from the top is important and believe the board and executive management team should be responsible for fostering this.

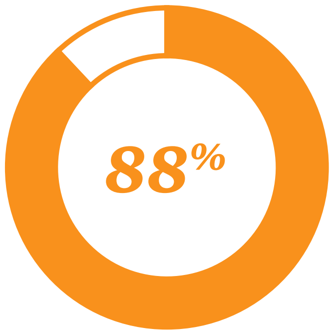
So what does effective 'tone at the top' look like?

A successful risk culture 'tone at the top' has these characteristics:

- the CEO and the leadership team consistently talk about the desired state, norms and values
- decision-making processes employ open and frank communication and encourage people to challenge ideas as a means of encouraging a range of views
- performance and skills management encourages and reinforces the desired risk management behaviour
- leaders value ethics and integrity over short-term business goals, and respond appropriately if they become aware of misconduct.



RPs indicated that their organisation has a clear and defined desired state for risk culture



NEDs indicated that their organisation has a clear and defined desired state for risk culture

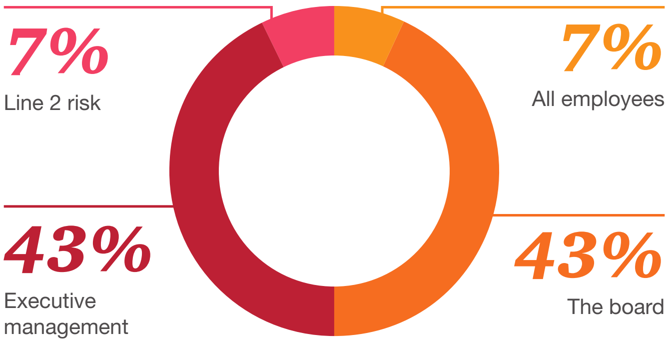
The role of the board …

Boards and other governance committees can only effectively challenge, direct and oversee risk culture when they are given dedicated time for reviewing both the culture and regular feedback from customers, staff and external parties. In this regard, 75% of NEDs report that their board and committee agendas promote the integration of risk issues with other agenda items, such as strategy and finance. On the other hand, only 43% of RPs believe board and committees agendas consider and promote integrated risk, risk culture and conduct discussions.

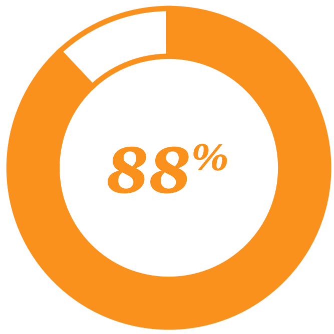
Our view

Critical to such integrated discussions is the ability to interpret a broad range of organisational information to identify potential risks to achieving conduct cultural outcomes. Based on our survey most are doing this through assessing and challenging information received from management. Management reporting can be a great litmus test for a healthy risk culture, as a lot can be gleaned from individual manager responses to issues, control breakdowns or persistent value issues/breaches.

Figure 2: Risk professionals' view of responsibility for driving risk culture



RPs 86% feel that the board and executive management team is responsible for driving a healthy risk culture, with only 7% indicating that all employees should be responsible for driving this change.

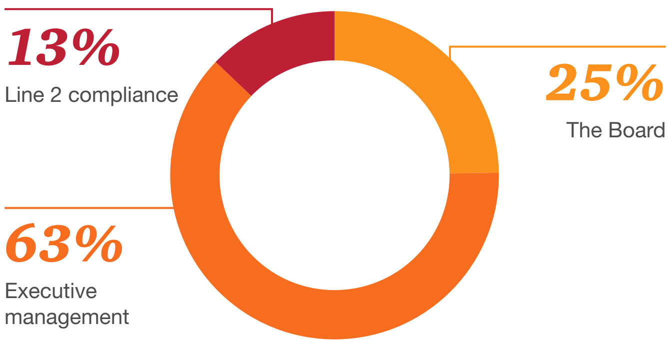


88% of NEDs surveyed believe that management take every precaution to ensure the conduct and behaviour of employees is aligned to the organisation's values, while only 50% of RPs surveyed share the same opinion.

Although we agree that a lot can be qualitatively determined from management reporting, our survey highlighted that over 52% of NEDs would like to be receiving tangible and quantitative data to track current versus future risk culture state. Interestingly, less than half of RPs said that quantitative measurement and tracking would be an initiative in the next 12 months.

This poses the interesting question: given that most participants have a desired state but few have plans for how they will implement change to achieve that state, and most have only limited ongoing measurement and monitoring – how will you know when you have arrived, or at least that you are travelling in the right direction? Food for thought!

Figure 3: NEDs view of responsibility for driving risk culture



88% of NEDs feel that the board and executive management team are responsible for fostering a healthy risk culture. None of the NEDs surveyed indicated that all employees should be responsible for driving this change.

More than 80% of NEDs surveyed believe that management use risk information to inform strategy and annual plans, whereas 53% of CROs surveyed share the same sentiment. However, CROs and NEDs share similar views about management's use of risk information to inform product design and process optimisation.

Risk management and infrastructure

Most organisations have a documented structure and approach for identifying, assessing and managing risk; however, there is still a disconnect between theory and practice.

Establishing and maintaining a healthy risk culture requires effective risk management tools, systems and controls. These need to be user friendly, supported by sound advice and responsive to changes in the business and risk environment.

The current environment

The industry is facing change at a pace not previously experienced. Historically, organisations have emphasised the elements and documents of their risk management framework as the key controls for effectively managing risk. But while these frameworks are often based on International Standards of Risk Management AS/NZS ISO 31000:2009 and tick the requirements of regulators, this alone has proven insufficient to shape and influence the attitudes and behaviours of employees.

With the rate of change, complexity and ambiguity in the industry, people are being asked to consider how they and their teams are acting and thinking about risk on a daily basis. This requires a mindset shift in the way people think about, price and monitor risk. From an industry perspective, it has led to a renewed focus on controls and the 3 Lines of Defence model. But while in the past many focused on the existence of controls with third line oversight, recent failures reveal shortcomings in the design and effectiveness of controls and the lack of clarity regarding risk ownership due to blurred accountabilities across the 3 lines.

Participants said …

64% of RPs and 75% of NEDs reported that their risk management systems and processes are designed to enable risk to be managed holistically across the business rather than in silos.

75% of NEDs feel that management have adequate and timely mechanisms in place to identify and respond to unnecessary risk-taking, but only 43% of RPs share that belief.

Bringing about the change

Regulators are increasingly expecting organisations to demonstrate that they have an appropriate risk culture. For organisations this means ensuring 'Risk' has a strong voice and a true seat at the table.

Although it is common to read 'Risk is everyone's responsibility', in reality it is often the role of the Risk and Compliance group to embed the meaning of this statement. This can create the perception that Risk is an obstacle to doing business rather than an enabler. To position themselves as an enabler, the Risk function must move beyond the role of 'gate-keeper' to become a true business partner, operating at the heart of the business.

Our view

As highlighted by recent UK and US research on this topic, this challenge requires organisations to have specific skills and competencies, and an approach to risk management that:

- embeds risk into business decisions – including identifying risk triggers and seeking risk counsel as part of key

"Risk appetite and risk culture underpin risk management; and strong risk management and governance are crucial for the prudent management of an institution."

Ian Laughlin, Deputy Chairman APRA,Macquarie University Financial, Risk Day, Sydney, 13 March 2015 business decisions (eg new products, acquisitions, cultural initiatives etc) – not as an afterthought

- ensures they have a 'fit-for-purpose' risk model and infrastructure where the whole business understands who owns the process, the risk and the control and then who oversees and monitors these
- gets the right information at the right time to make the right decisions – investing in more consolidated, real-time risk reporting and developing an organisation-wide view of risk.

This means that risk and compliance functions need to look at their environment (both internally and externally) and ask whether they are equipped to manage the demands of the business now and into a rapidly changing future. Leading organisations are looking beyond how they can elevate the status and authority of the risk function to how they can increase the relevance and value contributed by the risk function as a means of achieving the desired state.

"Financial services businesses rise, fall or run on the spot by their ability to price and manage risk. Unlike almost any other sector, their business is risk. Manage that risk well, and they take their opportunities and grow, confidently and responsibly. Do it badly and they boom and bust, stagnate, or cause more pronounced shocks to the real economy.

But now, just as firms need risk management to deliver, they find it battered, bruised and defensive. Risk management needs to change. But for that to happen, the risk managers need to come out from their silos and reinvent themselves as partners of the rest of the business. Only then will risk management become a discipline that everyone builds into their work."

PwC UK, Stand out for the right reasons – Facing the future of risk, July 2015

People and communication

Organisations can do more to set the cultural benchmark for risk awareness than the current focus on hiring, on-boarding and training processes.

The 2015 PwC CEO Survey highlighted that financial services organisations are expecting to significantly increase headcount over the next 12 months. To attract and retain staff with the right values and ensure behavioural and cultural alignment, organisations need to become more focused on recruitment, professional development and communication.

Participants said …

When compared to RPs, NEDs have a more optimistic outlook regarding management's People and Communication practices. NEDs are more likely to believe that management uses processes to evaluate their people's risk management capability, effectively communicate expectations about key risk behaviours, and ensure that employee behaviour is aligned to company values.

63% of NEDs feel that management does a good job of communicating expectations about key risk behaviours to employees at all levels of the organisation. However, only 21% of Risk Professionals believe their organisations relay the same information to all individuals across the business.

Achieving the desired risk culture also requires staff to be appropriately qualified, skilled and experienced to understand and effectively perform their risk management role. Interestingly, only 14% of RPs agreed that their organisation has processes for evaluating the depth, quality and scalability of their people's risk management capability. This is echoed by NEDs. This gap has been recognised by 80% of NEDs and RPs, with staff training nominated as the primary initiative to improve risk culture.

Bringing about the change

Organisations should be looking for employees who can demonstrate a combination of traits: risk management expertise, adherence to a set of common values, operational experience, and soft skills. To do this, leading organisations are turning to different assessment and recruitment tools (eg psychometric testing, customised case studies) to support traditional approaches of assessing risk attitudes and capability allowing companies to recruit talent that is more closely aligned to the target risk culture.

As a follow-on to recruitment, leading organisations are refining on-boarding processes so that new employee orientation programs address the organisation's expectations with regard to employee accountability for identifying and communicating risks.

***63%** of NEDs surveyed feel that management do a good job of communicating expectations about key risk behaviours to employees at all levels of the organisation.*

*Only **21%** of RPs believe their organisations relay the same information to all individuals across the business.*

Developing the skills of staff to provide the capability to effectively manage risk is considered by many organisations as key to driving accountability, Approaches being employed by organisations include:

- defining required risk management competencies at various levels of the organisation across the 3 lines of defence, and developing training programs aligned to building these competencies
- circulating periodic newsletters to highlight new policies/processes and remind employees of their personal responsibilities
- introducing rotational programs to move high-performers with operational experience into Risk roles.

A majority of RPs replied that their organisation does not have communication protocols in place to inform employees about adverse events, so they can learn from them.

Our view

To get people to act according to the spirit of the rules rather than just the letter, they need to be paying attention to the good things they're meant to be doing, and the benefits of achieving them. Emphasising the positive outcomes of a situation is the key to this. PwC UK's recent paper (Stand out for the right reasons. Why you can't scare people into doing the right thing: PwC and London Business School research June 2015) has found that if companies emphasise negative outcomes (eg by focusing on penalties), employees are more than twice as likely to behave unethically than if positive outcomes are emphasised.

To be able to do this, organisations need to identify 'what good looks like', adapt their risk and management information systems to recognise the signs, and finally to communicate them to staff and reward accordingly.

Accountability and reinforcement

As the financial services industry and regulators place increasing emphasis on culture and conduct, accountability and reinforcement take on an important role in managing risk.

Positive risk culture is supported by clearly defined roles and responsibilities and reinforced with appropriate remuneration and performance structures. In such cultures, leaders and staff have a clear understanding of their roles, performance expectations and targets, as well as of transparent consequences for undesirable behaviours (including unnecessary risk-taking).

Participants said …

Again in comparison to RPs, NEDs have a more positive outlook as to how accountabilities are communicated and enforced. More specifically:

- 50% of RPs (but only 40% of NEDs) indicated that the board has clearly defined its behavioural expectations in relation to organisational risk culture
- 75% of NEDs agree that the pressure to meet performance targets is balanced with the need to manage risk effectively, while only 36% of RPs share the same view of the balance between managing performance and mitigating risk
- 88% of NEDs reported that management regularly reviews performance targets to ensure they are relevant, reasonable and drive acceptable risk-taking behaviour; only 36% of RPs share this view
- 75% of NEDs, but only 29% of RPs, said that management has clear and well-communicated consequences for unnecessary risk-taking and undesirable behaviours.

The importance of defining accountability

Defined accountability is integral to a sound risk culture. But role definition, structures and capability can be a stumbling block. It is still common for many in the first line of defence to believe risk management is not a core responsibility. For those in the second (and in some instances the third) line of defence, many see their role, and are rewarded for, being the 'police officer' of the business – instead of challenging the first line's assessment of risk and offering insights through in-depth reviews and trend analysis. This dynamic affects the level of trust between the lines of defence.

The role of incentives

Incentives can also play a significant role. Only 21% of respondents agree that their organisation's reward structure is designed to avoid focus on short-term incentives at the expense of risk management. Based on this, there is some work to do yet to achieve:

- reducing conflicts of interest for sales managers and team leaders whose performance is often rewarded on the same financial results as their team
- reducing the focus on financial measures and establishing appropriate non-financial measures, such as customer, risk and value-based measures

"It is difficult to get a man to understand something, when his salary depends upon his not understanding it!"

Upton Sinclair – I, Candidate for Governor: And How I Got Licked (1935), ISBN 0-520-08198-6; repr. University of California Press, 1994, p. 109.

"We remain concerned about the culture of financial services businesses, and the incentive structures they use. A financial services business should have policies, processes and procedures in place to comply with their legal obligations. The welfare of their customers should be at the heart of their business."

ASIC Strategic Outlook, 2014-15.

- eliminating high-risk incentive features such as 'accelerators' for incremental sales, and highly leveraged pay mixes with a significant proportion of variable pay
- aligning broader recognition with non-cash-related awards. For example, leader boards send a strong message about the type of contribution the organisation values, which is often in contrast with positive risk conduct outcomes.

Our view

By aligning employee incentives and consequences with risk accountabilities, organisations can encourage employees to adopt a well-balanced view about risk-taking. Performance and reward can therefore support the desired risk culture when incentives and consequences are shaped by clearly established behavioural expectations.

The key to effective change lies in being able to identify and adjust the specific critical behaviours that need reinforcing. This will help set the right tone and direction and build momentum for broader change.

As highlighted earlier in 'People and communication' , respondents are focusing on training and education; however, many are not addressing the underlying incentives and performance structures that sit at the heart of many risk culture and conduct issues. Finding the balance between motivating staff and managing potential conflicts is vital in sending the right messages to staff and reinforcing the desired behaviour.

Monitoring behaviour is then critical. Governance bodies or roles should have access to information that integrates data across financial, risk, customer and incentives areas. Some companies are investing in systems that provide this as real-time information, which allows them to quickly detect – and manage – areas of risk, as well as providing a mechanism for more effective coaching of their employees.

The rise of 'conduct'

Over the past year, conduct has been increasingly emerging as a board and executive focus area. 'Conduct' is a multi-dimensional concept but generally encompasses the principles that:

- an organisation's products and services, processes and behaviours must deliver fair outcomes for past, present and future customers
- the integrity of markets must be safeguarded.

Market sentiment and regulation in relation to conduct and mis-selling risk are quickly evolving and have the potential to be profound. Australian institutions are facing an increasingly intense public interest and media scrutiny in their treatment of customers. Following approaches adopted by global banks, particularly those in the UK, to meet specific regulatory requirements, we are seeing Australian banks begin to implement organisational processes and practice to support good conduct.

Examples of emerging practice are:

- product lifecycle management frameworks which consider the suitability and risks of new products, product change, product retirement and product governance
- increased monitoring to identify misconduct, such as quality of advice reviews, reviews of sales practices, evidence to support 'needs-based selling', and trader surveillance
- revisions to performance assessment and remuneration and incentive frameworks, including moving away from incentivised sales remuneration and a greater use of customer-focused measures
- the use of behavioural economics to focus on the right customer outcomes
- reviewing existing services and products to identify those that are not currently delivering the right customer outcomes.

So we also asked participants what key initiatives were in place to manage conduct.

"ASIC is concerned about culture because it is a big driver of conduct in the financial industry. It is a sad fact that bad culture leads to bad conduct and this inevitably leads to poor outcomes for consumers."

Greg Medcraft, ASIC Chairman, quoted in Financial Review, 3 June 2015

Survey responses and our views

Awareness of conduct risk

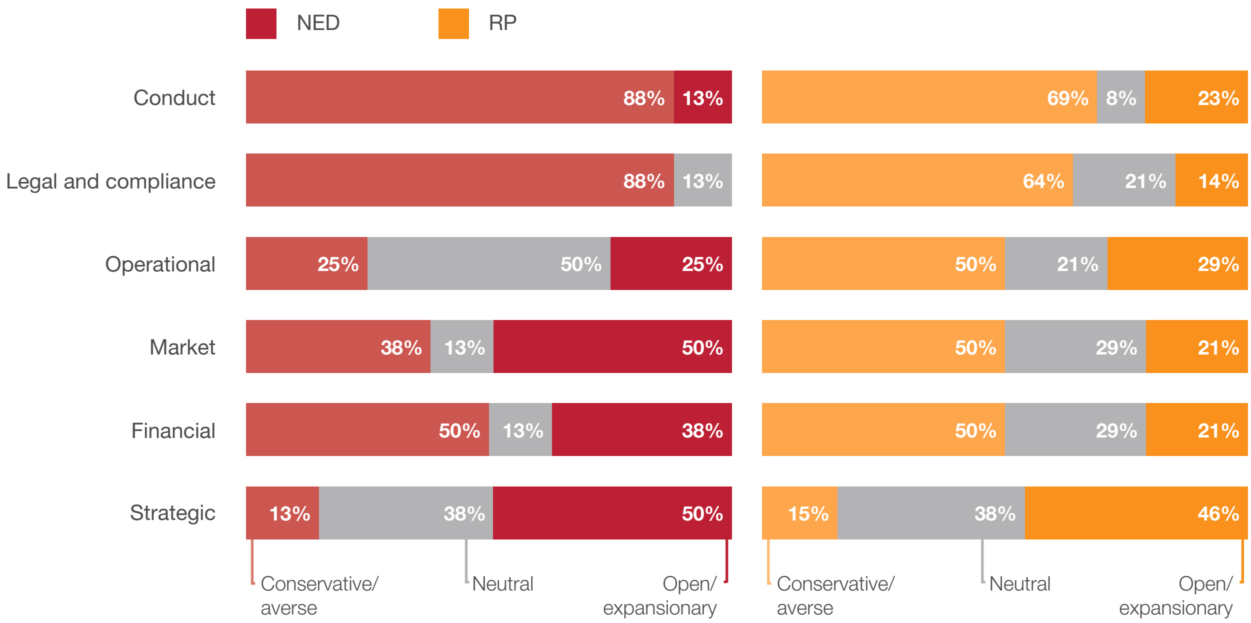
All NEDs who participated in the survey universally agreed that conduct is on management's organisational agenda, whereas only 64% of RPs held the same belief.

Our survey indicated almost 70% of RPs and 90% of NEDs had a conservative appetite for conduct risk.

Given this appetite stance, it should follow that the organisation will invest heavily in conduct mitigation and controls and in the measurement and supervision of conduct.

The majority of both RP and NED respondents reported that initiatives such as staff training and awareness, enhancing tone from the top, enhancing leadership and communication, and risk and control monitoring and oversight are the primary focus.

RP vs NED – Organisational risk appetite in relation to conduct



This is consistent with the general focus on culture and corporate governance as two of the key mechanisms for managing conduct risk.

Both RP and NED participants reported that culture is the top focus area for managing conduct risk in the coming year. Staff training was nominated as the most popular initiative by both RPs and NEDs.

FY2015-2016 focus areas to manage conduct risk – NED vs RP

The role of customer feedback

67% of RPs said they use risk information to improve processes, while less than half said use customer insights. This may be indicative of the reported infrequency of customer assessments within organisations, with only 36% of RPs suggesting that their organisations conduct regular assessments to understand where they are failing their customers.

According to both RPs and NEDs, customer feedback is mostly used to drive product design and development: 80% of RPs and 88% of NEDs use customer insights to inform the design and development of products. Given this, it is surprising that only 50% of RPs agree that services and products are designed and regularly assessed to meet the needs of customers. This may suggest a disconnect between using data to inform design and product development and using practical strategies to actually improve the design of these products to meet customer needs.

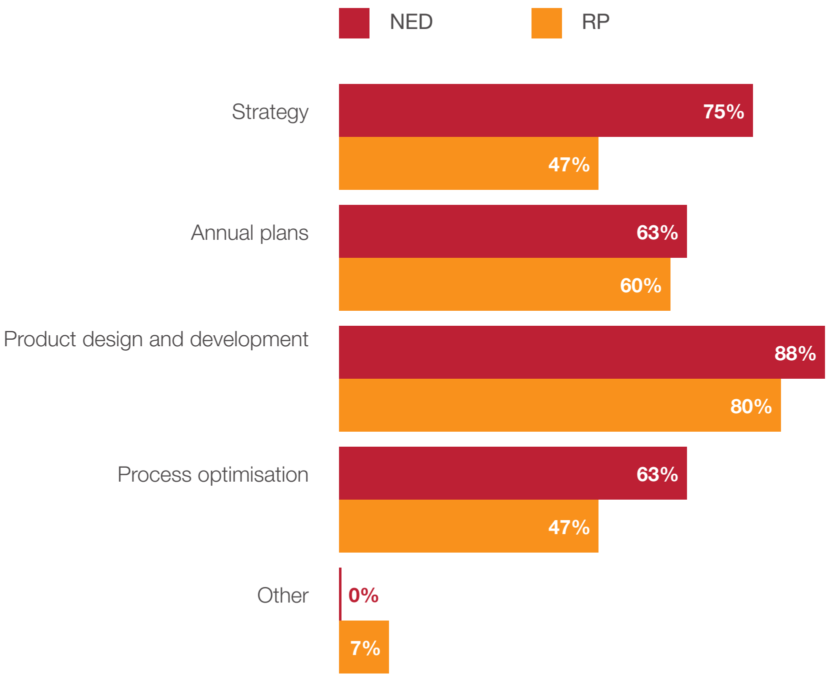
NEDs remain optimistic about their organisation's customer-centricity and use of data to gain important customer feedback, with 65% reporting services and products are designed and regularly assessed to meet the needs of customers. Similarly, the majority of NEDs reported that their organisations undertake regular assessments to understand where they are failing to meet customer needs.

A word of warning in relation to customer insights and feedback here: often the focus is the sales experience of the customer and the actual experience with the sales staff, rather than also including whether the product is actually designed and performs in a way which meets the customer's goals or needs.

Analysis by PwC, within the 'Forging a winning culture' report shows a strong culture has a greater correlation with sustainable high performance than strategy, operating model or product coverage.

The key to effective change is in being able to hone in on, and adjust, the specific critical behaviours that need reinforcing. This will help set the right tone and direction and build momentum for broader change.

Our organisation uses customer insights and feedback to drive – NED vs RP



This is a positive indication in relation to the design of future products, but suggests further work is to be done in relation to existing and legacy products.

Measurement and tracking

While formal and annual product reviews make sense, we are starting to see leading organisations move to a combination of predictive and detective indicators (eg sales, complaints, claims, service levels, churn, mystery shopping) as a means of assessing product, performance and suitability on an ongoing basis. As well as providing feedback on product design, this information may also be incorporated into remuneration governance processes, avoiding situations where incentives are paid in spite of risk or customer outcomes being poorly managed.

According to the survey, this is quite different to local experience, where less than half of RPs and only 63% of NEDs said their organisations were measuring and tracking conduct risk. Of those organisations doing so, RPs reported the most prevalent assessment methods as compliance monitoring followed by claims/incident analysis, while NEDs stated that management teams are playing an active role in measuring and tracking conduct risk making use of a broad range of initiatives.

The ability to leverage existing organisational activities to support the monitoring and measurement of conduct risk is important in enabling efficient and effective assessment of an organisation's exposure, and also in minimising the burden.

Customers and conduct risk

Conduct risk will continue to evolve and its definition is likely to expand, particularly as companies' approaches to it mature. Whereas Australian banks tend to focus on customers' stated needs, UK banks are focusing on customers' unstated needs. This requires a more comprehensive understanding of the customer, including their behavioural biases.

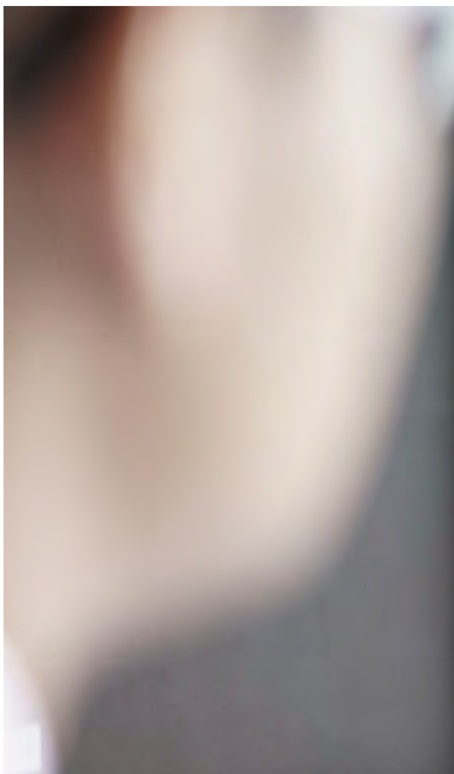
Customers are biased: they have limited attention, self-control and cognitive ability. Rather than engaging in exhaustive search and deliberate decision-making, they apply decision shortcuts. These shortcuts conserve limited energy and time by relying more on readily available decision inputs such as emotions, social context and the most salient information.

Companies are increasingly using behavioural economics to identify those elements of the decision environment that can cause humans to err in predictable directions. This can help them understand when and why incentives, disclosure and training might not be adequate.

Initiatives to identify and understand conduct – NED vs CRO

63% of NEDs and 47% of CROs believe that their organisation measures and tracks conduct risk.

The financial services industry continues to be beset by scandal and foul play, whilst the emphasis of measures taken by firms and regulators, globally, in deterring employee bad behaviour, has, to date, largely centred on admonishing, penalising and punishing.



The future of risk culture and conduct risk

"We intend to: first, incorporate culture into our risk-based surveillance reviews; second, use the surveillance findings to better understand how culture is driving conduct among those we regulate; and third, communicate to industry and firms where we have a problem with their culture and conduct."

Financial review, 3 June 2015), (Greg Medcraft, ASIC Chairman), quoted in Financial Review, 3 June 2015.

While organisations can establish processes and practices that minimise the opportunity for and risk of misconduct, it is the organisational culture that will influence whether these processes and practices are adhered to and their desired outcomes achieved.

Increased regulatory oversight and monitoring of culture and conduct is the new norm. The industry is continually questioning expectations in relation to conduct. The Financial Systems Inquiry consumer recommendations in relation to the fair treatment of customers to ensure better customer outcomes are conduct-risk driven. It is underpinned by a cultural and behavioural desire to treat and address the needs of consumers at every point of the product lifecycle – not just at the point of sale.

We believe Australian financial institutions need to respond quickly to optimise this opportunity to address conduct risk strategically. And it can be done – by applying experiences and learnings from the UK and aligning them to regulator expectations, behavioural economics, remuneration and incentives and broader customer-centricity objectives. Australian financial institutions can realise business benefits and simultaneously achieve both compliance and improved customer outcomes, to create the right product for the right customer at the right price and right time.

Organisations need to focus on outcomes. This involves addressing both the process and practice aspects of conduct in order to support staff to do the right thing by customers and to ensure the integrity of markets. But this must be balanced with ensuring that staff understand the 'why' of what they are doing and that the desired organisational behaviours and values are seen to be practised and championed by leaders and managers.

Based on responses to the survey, it appears that much work remains to be done by financial services institutions in building the infrastructure to support good conduct outcomes.

Key questions to consider

Given the results of our survey – some of which conflict, some of which are strongly positive – we offer you the following self-diagnosis tool as a starting point for thinking about the increasingly prominent issue of risk culture and conduct.

1. Do our leaders set a strong and influential 'tone from the top'?
2. Do we have robust management information systems to provide insights and indicators on risk culture?
3. Do we have the capability to proactively identify emerging risks?
4. Do remuneration structures help or hinder the creation of a risk culture that is consistent with our organisational values?
5. Are all employees encouraged to speak up, question and challenge business initiatives?
6. How well do we understand the risk culture of the business?
7. Have our controls kept pace with heightened regulatory expectations?
8. How have we built behavioural economics into our practices?
9. Are we focused on customer outcomes rather than product performance?
10. Do we believe our existing customers have the right products right now?
11. Do our staff see a conflict between customer outcomes and financial incentives?
12. How well do our products align to customer needs?

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Benchmark data was collected during May 2015. PwC clients within all the Australian majors, regional banks, a number of credit unions and building societies, insurers and superannuation funds were invited to anonymously participate in the online survey.

The size and sector of the participating organisations was collected, but the names of the institutions were not.

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