

**Stocktake of efforts to strengthen governance frameworks to  
mitigate misconduct risks**

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# Stocktake of efforts to strengthen governance frameworks to mitigate misconduct risks

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## Foreword

The Financial Stability Board (FSB) Chair's letter<sup>1</sup> to the February 2015 G20 Finance Ministers and Central Bank Governors meeting stated that the FSB will coordinate efforts to address emerging vulnerabilities from misconduct, noting that the scale in some financial institutions has risen to a level that has the potential to create systemic risks and undermine trust in financial institutions and markets. The implications of such misconduct can be far-reaching, contributing to financial exclusion, and limiting the potential of finance to serve real economies and foster global economic growth. The use of fines and sanctions acts as a deterrent to misconduct, but other preventative approaches are also needed to help mitigate the risk of misconduct through improved governance at individual firms. Addressing the misconduct risk issue calls for a multifaceted approach.

The FSB agreed in early 2015 a workplan on measures to reduce misconduct risk, which was sent to the June 2015 G20 Deputies meeting. The workplan proposed to examine, among other things, whether the reforms to incentives, for instance to risk governance and compensation structures,<sup>2</sup> are having sufficient effect on reducing misconduct and whether additional measures are needed to strengthen disincentives to misconduct.<sup>3</sup>

In May 2016 the FSB established a Working Group on Governance Frameworks (WGGF), chaired by Jeremy Rudin, Superintendent of Financial Institutions (Canada), to explore the use of governance frameworks to mitigate misconduct risk with a view to potentially developing a supervisory toolkit or guidelines, taking into account the work of the standard setting bodies (SSBs). To launch this effort, the WGGF held a two-day meeting in June 2016. The first day provided an opportunity for national authorities to exchange information about supervisory practices in assessing governance frameworks, strengthening individual accountability and non-financial incentives, and enforcement powers. On the second day, the WGGF engaged with industry participants (e.g. directors, chief risk officers, business line leaders, compliance) to explore efforts underway at banks and bank holding companies, insurers and asset managers to address conduct and culture issues.

In August 2016, the FSB agreed that it would be useful for the WGGF to conduct a stocktake of efforts underway by international bodies, national authorities, industry associations, and firms on the use of governance frameworks to mitigate misconduct risk. This report largely draws on responses to a questionnaire sent in October 2016. Complementing the stocktake, the WGGF also conducted a literature and scientific review of root causes of misconduct in the financial and non-financial sectors.

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<sup>1</sup> See FSB, the Chairman's letter to G20 Finance Ministries and Central Bank Governors, February 2015 (<http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf>).

<sup>2</sup> Work on compensation structures and financial incentives is being undertaken by the FSB Compensation Monitoring Contact Group.

<sup>3</sup> See FSB, *Measures to reduce misconduct risk: progress report*, November 2015 (<http://www.fsb.org/wp-content/uploads/Misconduct-risk-progress-report.pdf>).

## Introduction

Effective corporate governance by financial institutions is critical to financial stability and is therefore important to the FSB and its work. In the aftermath of the financial crisis, authorities and firms sought to strengthen financial institutions' governance. More recently, a series of high profile misconduct cases in major financial institutions has come to light, focusing attention on the governance of conduct.

Instances of misconduct have ranged from conspiracies to manipulate markets to widespread retail mis-selling. Penalties for some instances of misconduct have been extensive, including fines totalling hundreds of billions of dollars across jurisdictions. Analysing the cause of this misconduct is an important issue for firms as well as all authorities, whether in organisations that are charged with regulating and supervising these areas of conduct, in organisations that are responsible for micro and macro prudential regulation and supervision, or in organisations that integrate those functions.

Addressing misconduct risk is, of course, inherent to the core mission of conduct regulators. For prudential regulators, misconduct of the magnitude mentioned above can become a prudential issue for three reasons. First, fines and redress payments are losses that deplete the loss-absorbing capacity of a financial institution. Second, misconduct cases can be a reflection of underlying weaknesses of the governance framework. Third, misconduct of this magnitude suggests that some financial institutions may be unwilling or unable to get their employees to adhere to proper standards of conduct. This may further indicate that they are also unable to get their employees to adhere to other standards, including those for sound risk management.

Repeated and severe misconduct has implications for the financial system and has potential linkage to financial stability issues. Misconduct undermines public confidence in the financial system. Severe patterns of misconduct may also raise prudential concerns about broader risk management, governance and compensation practices within financial institutions. Of note, the US Financial Crisis Inquiry Commission's report concluded that "an erosion of standards of responsibility and ethics exacerbated the financial crisis."<sup>4</sup>

Given the potential impact of misconduct on financial stability, the FSB tasked the WGGF to consider how progress could be made in using governance frameworks to address misconduct risk. Using governance is attractive for two reasons. First, it has an *ex ante* or preventative focus, although it is often more effective when paired with *ex post* sanctions that can serve as a deterrent. Second, governance enlists the knowledge and efforts of the firm in prevention, which may be necessary to address certain instances of misconduct.

To date, the WGGF has conducted a stock taking exercise that covers international bodies, national authorities, industry associations and a broad sample of major firms to find out what work they have done on using governance frameworks to address misconduct risk and what work they have underway. The WGGF has also conducted a literature and scientific review of specific case studies of high profile misconduct in the financial services industry and in other industries to see what lessons can be drawn. One goal of this phase of the work was to help

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<sup>4</sup> See <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

inform a recommendation to the Plenary as to whether further international work in this area was warranted in a second phase.

## **1. Conclusions and recommendations**

The WGGF's stocktake has provided important insights into the current methodologies and strategies that respondents are taking with respect to these issues. Of particular value are the responses of firms, showing the range of practice that risk management and other professionals are employing to address misconduct risk. The WGGF's work highlights the importance of sharing that range of practices, given the great interest that firms expressed in learning from the approaches and experiences of other firms across sectors and jurisdictions. While there is a variety of ongoing policy and supervisory work by national authorities and international bodies related to governance, much of this work does not focus specifically on mitigating misconduct risk.

High-level summaries of responses to the surveys are annexed to this report, and readers interested in learning more about specific approaches are encouraged to review them. Although the information in the annexes is not exhaustive, it does provide insight into approaches that firms are taking to better manage misconduct risk and that national authorities are using to more effectively supervise this area.

Drawing from the findings of the stocktake and literature and scientific reviews, ten themes surfaced as areas that could garner further attention (see Section 2). The WGGF discussed these themes, exploring how each topic relates to governance frameworks; the extent to which reform could lead to mitigation of misconduct risk; and if further international work were to be conducted, who would undertake the work and what would be the desired outcomes of that effort.

With the aforementioned discussion in mind, the WGGF considered possible areas of focus for a potential Phase 2 of its work. It first identified three criteria for any future work: (i) the topic should be important for addressing misconduct risk from a financial stability perspective; (ii) an international effort should be well positioned to do the work; and (iii) the work should not overlap with that of other international bodies. Based on these criteria, the WGGF agreed to recommend three topics for Phase 2 work and identified the questions that each effort would aim to answer.

At the February Plenary meeting, members agreed three topics for Phase 2 work (see below), which will focus on fully understanding the range of practices, with a view towards preparing a toolkit for supervisors and firms. As Phase 2 work progresses, the WGGF will determine whether any further steps (such as guidance) would be beneficial and if so, such recommendations would be presented to the FSB Plenary at that time. The WGGF will finalise its work by March 2018.

**Topic 1: Information gaps and due diligence in employment of individuals with a history of misconduct**

- What is the nature and scope of the problem?
- How can governance frameworks be used to make due diligence more effective?
- What systemic cross-border and cross-sectoral issues are raised and how can they be addressed?

The “rolling bad apples” problem arises when employees are dismissed due to misconduct at one firm (or leave under suspicion of misconduct) and then are employed by another firm, where they repeat their misconduct. This can be seen as a collective action problem: firms have an incentive to conduct strong due diligence on prospective employees but may face constraints in providing useful information about their current or former employees to other firms. Many employers limit what they disclose to third parties about former employees out of general privacy and litigation risk-related concerns (e.g., claims of defamation, negligent misrepresentation). Data privacy and employment law concerns may also pose challenges. While some authorities have the ability to ban “bad actors” or have powers to remove management, these tools are often sparingly used. Further, “fit and proper regimes”, where they exist, tend to cover a limited population and are frequently not applied beyond the hiring date by firms and authorities. At the same time, work done by the FSB’s Compensation Monitoring Contact Group (CMCG) and various national authorities indicates that firms are becoming increasingly sophisticated in their ability to track disciplinary events and have more information in this area than in the past.

This work would try to define and dimension the problem: How prevalent are “rolling bad apples” in financial services and how much harm do they cause? Work on this topic would also explore the current and potential uses of governance frameworks to make employee screening and due diligence more effective and to what extent the problem is systematic and cross-border or cross-sectoral in nature and whether international, rather than domestic, solutions may be preferable.

While important, the “rolling bad apples” problem is only one element of a broader discussion on misconduct that the WGGF has undertaken. In particular, the WGGF has considered a range of causes and forms of misconduct risk (see, for example, section 3 and Annex E). Input from the industry on “rolling bad apples” and root causes of misconduct more generally would be useful.

**Topic 2:** The potential for responsibility mapping to strengthen the governance of conduct risk in significant financial institutions

- How could responsibility mapping mitigate misconduct risk?
- For those authorities interested in this topic:
  - what approaches could authorities take to implement this for significant financial institutions given jurisdictional differences?
  - what approaches could authorities use to hold individuals accountable for potential and observed misconduct in their area of responsibility?
  - what are the issues that may arise in applying this technique to a financial services provider that forms part of a wider group?

The FSB and the standard setting bodies have issued policy documents that outline supervisory expectations for the role and responsibilities of the board(s) and senior management. Most of these expectations are aimed at the board and/or senior management as a collective. Some authorities have extended this concept to require institutions to identify defined responsibilities of specific senior individuals. The broader goal of these authorities is to make specific senior individuals responsible and accountable for taking reasonable steps to govern the conduct of others.

This effort would examine the ways in which responsibility mapping and related tools could be used to mitigate misconduct risk, including through supervisory examination or enforcement practices focused on the legal and regulatory requirements applicable to those who hold a supervisory position at financial firms. It would also consider any legal challenges that exist that might limit the application of this solution on an international basis.

This effort would include work examining the issues involved in operationalising such a requirement in an international environment. This work would also examine supervisors' experiences in implementing more targeted responsibility frameworks and responsibility mapping. It could also consider related issues that may arise in group structures, such as the relationship between a financial services provider and any holding company arrangements within the group. Finally, it would consider what tools are available for addressing such issues.

**Topic 3: Practical applications from a cultural perspective of governance frameworks addressing misconduct risks**

- What cultural (risk) factors can undermine the effectiveness of governance frameworks and drive misconduct?
- How can governance frameworks be used to monitor, prevent and mitigate those factors?
- What role could supervisors play?

In many instances of misconduct, there is evidence that the norms and expectations that most strongly influence behaviour within financial institutions can be very different from the institutions' stated values and policies. Practice does not always follow principle. Word and

deed can diverge. The culture<sup>5</sup> of an institution can defeat its formal governance. Indeed, over time the culture of a firm can be a major influence on its governance framework. On this basis, the project would seek to provide examples on the practical application of a cultural perspective of governance frameworks to address misconduct risks. In particular, the group would explore how a firm's culture can support proper identification, application and monitoring of governance mechanisms to deliver good conduct, as well as how governance mechanisms may mitigate misconduct risks posed by the culture of a firm.

For example, how can firms encourage employees to speak up and escalate information about possible misconduct before it takes root and grows? What role could whistleblower programs play in this regard? How can ongoing training and non-financial incentives reinforce desired behaviours and promote a culture of effective communication and challenge?

Boards<sup>6</sup> and senior management typically have access to a wide range of quantitative and qualitative indicators to assess their governance and risk management processes, which could include indicators of misconduct risk. This work would also look at these potential indicators of misconduct risk from a culture perspective, including examples of how boards and senior management use and respond to these misconduct risk indicators.

While firms are responsible for their culture and its consequences, supervisors are in a unique position to gain insights on culture at firms given their access to information and individuals across the firm, as well as the results of supervisory work. National authorities could learn from each other's experiences.

In 2014, the FSB published *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture*.<sup>7</sup> This guidance identifies some foundational elements that contribute to the promotion of a sound risk culture within a financial institution, and states that these will evolve as more experience is gained and additional insights are garnered. Topic 3 will take into account the content of the risk culture paper. If appropriate, the completion of Phase 2 may result in recommendations to update or supplement the said guidance, particularly in relation to conduct issues.

## **1.1 Definitions and taxonomy**

There is neither a homogeneous definition nor a pre-determined taxonomy for misconduct risk. It is likely that the wide array of events that could result from misconduct, and the necessity to appropriately calibrate a firm's response depending on the specific facts and circumstances of the event under review, is contributing to this outcome.

Responses to the survey suggest a general trend among financial institutions to link misconduct risk to day-to-day risk decisions of the different businesses as a first line of defence, or breaches related to codes of conduct, whereas compliance risk is seen as abiding by laws, regulations and rules. Further, firms differ as to whether misconduct risk should be managed as a distinct

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<sup>5</sup> See section 2.3.1 of Annex E (page 78) for various definitions of culture found in the literature review.

<sup>6</sup> The structure and numbers of boards differ among countries. The use of "board" throughout this paper encompasses the different national models that exist (for example one and two tier) and should be interpreted in accordance with applicable law within each jurisdiction.

<sup>7</sup> See <http://www.fsb.org/wp-content/uploads/140407.pdf>.

risk category, often subsuming it under operational or compliance risk. These differences can have a major impact in terms of the risk management employed by firms.

For purposes of the stocktake, the WGGF defined misconduct as:

*Conduct that falls short of expected standards, including legal, professional and ethical standards.*

The definition is necessarily broad given the wide range of misconduct events and captures the major hallmarks underlining such events.

Figure 1 illustrates a high-level taxonomy of activities and risk types that may be useful to address the apparent lack of definition/taxonomy surrounding misconduct risk.

**Figure 1**



## 2. Main themes identified in the stocktakes

In August 2016, the WGGF launched its stocktake by first surveying international bodies. Doing so enabled the WGGF to leverage off of the work already underway by international bodies and to avoid any overlap with their efforts. The results of this stocktake helped to shape the remaining stocktakes and assist the WGGF in ensuring that its work complements existing (or planned) work by international bodies. A stocktake of efforts by national authorities, industry associations and firms was launched in October 2016. At the same time, the WGGF conducted the literature review of root causes of misconduct in the financial and non-financial sectors and the scientific review of approaches to prevent misconduct or to mitigate its risk.

The stocktake highlighted certain issues, many of which were also identified in the literature review. While not exhaustive, the most prominent governance framework themes are enumerated below:

1. *Culture*: The importance of culture was evident throughout the responses, particularly in the leadership role of the board and senior management in setting the “tone at the top” and communicating ethical values. Interplay can be seen between culture and governance frameworks. While an effective governance framework can improve a firm’s culture, culture can also defeat measures taken through governance frameworks when individuals continue to act in accordance with a culture that tolerates or rewards misconduct. While firms are responsible for shaping their culture, supervisors and regulators could play a role in promoting culture as a mitigant to misconduct risk.
2. *Individual accountability*. Employees should be held accountable for their conduct. The assessment of fitness and propriety by institutions and, in some jurisdictions national authorities, can be one important way of gaining assurance around competence and integrity. Approaches to accountability (and the related topic of allocation of responsibility for governance functions) often focus on the role of the board. There is a lesser focus on clearly articulating responsibilities for certain roles beyond the collective responsibilities of the board. Increasing individual accountability and responsibility can facilitate both ex ante prevention and remediation and more effective enforcement actions on individuals as well as firms.
3. *“Rolling bad apples”*. The primary responsibility in nominating and hiring persons filling key roles lies on the firm. Both firms and supervisors, however, expressed concerns regarding “rolling bad apples” – employees who leave one firm following misconduct or allegations of misconduct and are later hired by another firm. While national and international approaches may differ, a process for addressing the problem of “rolling bad apples” was generally noted as important, taking into account personal privacy and national labour laws.
4. *People management and incentives*. Incentives (financial and non-financial) were identified as a key driver of behaviour, and hence of misconduct risk. How a firm rewards and manages its people sends a clear signal about the corporate culture and the “tone from the top”.
5. *Escalation policies*. While most firms have policies and processes for escalating misconduct issues, employees must feel safe to speak up and effectively challenge decisions. A culture of openness fosters an expectation that the escalation of concerns

around misconduct will be handled fairly and without reprisals against those raising the concerns.

6. *Definitions and taxonomy.* There is neither a homogeneous definition nor a pre-determined taxonomy for misconduct risk provided by international bodies, industry associations or firms. This lack of standardised definitions was raised by firms and national authorities in the stocktake and highlighted as one of the issues where international work would be welcomed.<sup>8</sup>
7. *Monitoring tools.* Monitoring tools can help supervisors and firms more effectively identify and prevent misconduct risk. A number of firms are embedding misconduct risk within their risk appetite frameworks. Some other tools used by firms include risk dashboards and to a lesser extent, stress testing that incorporates misconduct risk stress scenarios. Many firms monitor broader activity including through electronic and other communications surveillance. However, the development of backward- and forward-looking metrics to identify and measure misconduct risk remains a challenge.
8. *Comprehensive and ad hoc approaches to misconduct risk.* Some national authorities embed misconduct risk analysis in stress testing and operational or compliance risk management while others target misconduct risk as a stand-alone area of supervisory focus. Some firms have designed a strategic approach to prevent misconduct, including policies, processes and incentives (both financial and non-financial). These comprehensive approaches are sometimes complemented by ad hoc measures to address specific cases of misconduct.
9. *Consistent international framework / harmonisation of general principles around misconduct risk.* International bodies, national authorities and industry associations have policies aimed at enhancing governance frameworks but not necessarily to mitigate misconduct risk.
10. *Enhanced coordination and communication amongst regulators and supervisors.* Another topic of interest that has been mentioned is the potential benefits of greater exchange of information and coordination at both at the international level and at the national level amongst prudential and conduct authorities to mitigate misconduct risk.

### **3. Abstracts of the stocktakes and literature review**

The stocktake provided a useful understanding of the breadth of work focused on strengthening governance frameworks to mitigate misconduct risk. For instance, responses from national authorities highlighted a broad range of activities, practices and approaches in supervising and regulating misconduct risk. Firms take a variety of approaches to prevent misconduct, and many have integrated misconduct risk into their risk management and control schemes. A number of firms have also integrated conduct-related metrics into their performance and compensation plans, and their risk appetite frameworks.

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<sup>8</sup> The WGGF notes, however, that in a separate stocktake conducted by the CMCG, firms preferred not to have a standardised definition of misconduct, but at the same time recognised that a firm-specific taxonomy of misconduct helped to ensure a consistent treatment of individuals across the firm and reinforced expectations for appropriate conduct.

At the same time, most international bodies included in the stocktake have issued policy documents relating to the use of governance frameworks to reduce misconduct risk; assessment of implementation of guidance or recommendations contained in these policy documents is only conducted in some instances. Finally, responses to the stocktake received from industry associations indicated that they are not particularly active on this issue. Of those industry associations that have been active in this area, the survey responses suggest that their work may have been a reaction to policies issued by the official sector rather than self-initiated efforts. A summary of the findings from each of the stocktakes is provided below and more details can be found in the Annexes.

National authorities provided a wide range of responses to the stocktake survey (see Annex A). Although most national authorities supervise governance frameworks and see them as important to managing misconduct risks, a range of approaches exists among regulators within the FSB membership on how to address misconduct risk through governance frameworks. Supervisory and regulatory approaches and tools (laws, regulations, codes etc.) vary across the financial sector (i.e. banks, insurers, investment firms and other financial institutions). The policy initiatives used by some jurisdictions include (i) conduct rules applicable to market professionals, (ii) training and qualification requirements for market professionals, (iii) fiduciary or other obligations, (iv) compliance controls, and (v) improved policies, procedures and other approaches to identify and manage conflicts of interest. There are some approaches that appear to apply to all financial institutions in some jurisdictions. For example, corporate governance rules take various forms, such as codes, official guidance and sometimes laws, and generally apply to all listed companies, not just financial institutions. These are often implemented on a “comply or explain” basis. Some jurisdictions state that it is the board’s responsibility to deter misconduct by fostering an appropriate culture.

Firms have made some progress since the last financial crisis, in terms of how misconduct risk is monitored and integrated into their risk and control schemes. This is true for all types of institutions within the scope of the analysis; there was little variance across banks, insurers and investment firms. The causes of misconduct are not substantially different across types of institutions either, with many institutions indicating weaknesses in governance systems as a contributing factor. The interplay between governance frameworks and the management of misconduct risk is complex and firms have adopted a number of approaches to dealing with it, as illustrated in these areas (see Annex B for further details):

- *Risk appetite framework*: While firms have devoted more attention to how they manage misconduct risk as an element of their Risk Appetite Framework (RAF), in some cases adopting both qualitative and quantitative metrics, the thoroughness of this practice varies widely. These metrics usually refer to adherence to laws and regulations as well as follow-up actions after compliance breaches.
- *Comprehensive and targeted approaches to misconduct*: Some firms have designed comprehensive approaches to prevent misconduct, including policies, processes and incentives (both financial and non-financial). These approaches are sometimes complemented by ad-hoc measures to address specific cases. Some firms lack an integrated system of financial and non-financial incentives and tools to prevent, identify and deal with cases of misconduct, instead applying ad-hoc approaches to specific cases.

Since the global financial crisis, most international bodies have undertaken a variety of work related to governance, including issuing policy documents. This work has sought to develop supervisory and regulatory expectations for financial institutions to strengthen their governance frameworks. Although not all of this work is specifically focused on mitigating misconduct risk, improving the effectiveness of governance frameworks at financial institutions may, by extension, support the development of an environment that promotes good behaviour and enables the identification of poor conduct.

Overall, international bodies' work on governance frameworks is thorough and, importantly, some of the forthcoming policy documents (see Annex C) may be highly relevant to the connection between governance frameworks and misconduct risk. International bodies are starting to assess implementation of their policy documents related to governance and take different approaches. For example, the FSB has a programme of peer reviews across its membership, the IAIS develops application papers, the OECD conducts thematic reviews on certain aspects of their principles for a subset of OECD members, and the IMF-World Bank FSAP assesses implementation of the BCPs, ICPs, and IOSCO Principles. In some cases, however, an implementation assessment does not occur.

Finally, although 30 industry associations responded to the survey, nine said that they are not conducting any relevant work on strengthening governance frameworks to mitigate misconduct risk and among those that are undertaking work in this area, many chose not to answer all of the questions. Given the relatively small amount of information, it is therefore difficult to determine to what extent industry associations contribute to the strengthening of governance frameworks to mitigate misconduct risk (see Annex D). What work that is being conducted, is frequently in the form of codes, guidelines, recommendations related to ethics, conduct or sound practices.

In order to help better understand some of the root causes of misconduct in governance frameworks, a literature review of root causes of misconduct at both financial sector and non-financial sector firms was undertaken (see Annex E). The literature review identified a number of behavioural and structural factors that contributed or potentially contributed to misconduct and/or failures in the financial and non-financial sector.

The literature review identified the following as important structural and behavioural factors, or root causes of misconduct in the cases studied:

- Some form of pressure, caused by external forces (market) or internal forces, such as deteriorating capital/liquidity positions or an (overly) ambitious growth strategy.
- Business challenges resulting from these pressures affected decisions by the board and senior management, whose responses influenced the cultures of their organisation. The challenges influenced leadership styles and tone from the top (the messages conveyed and the behaviour displayed), as well as the strategy set by and the (quality of the) decisions taken by the board and senior management. For example, boards and senior management faced with balance sheet shortfalls tended to give priority to profit and growth at the expense of risk management and ethics. Boards and senior management also tended to display dominant leadership styles, which weakened group dynamics and constructive challenge. In turn, an erosion of deliberative checks tended to erode the quality of decisions. Finally, inappropriate behaviour was condoned and came to be seen as normal (normalisation of deviance).

- Leadership, board behaviour and decision-making in turn influenced the organisational culture, and hence the behaviour of employees within the firm. The workstream members identified organisational mindsets that were determined by an eagerness for growth and profit, yet undervalued safety and/or ethical values. Finally, employees perceived few opportunities to freely speak up.
- Within the organisational cultures studied, the governance frameworks also played an important role. For example, enhancement of the mindset of growth and profit by (financial) incentives, diffused division of roles and responsibilities, poor escalation channels and insufficiently strong or independent control functions all contributed to an environment ripe for misconduct. Finally, in some cases adequate risk management and control functions were overruled by senior management.

## **Annex A: Efforts by National Authorities to strengthen governance frameworks to mitigate misconduct risk**

### **Executive summary**

National authorities provided a variety of responses to each of the questions in the survey, highlighting a broad range of activities, practices and approaches in supervising and regulating misconduct risk. While authorities take different approaches to governance frameworks to mitigate misconduct risk, there seems to be general agreement that governance frameworks influence the risk of misconduct. Other themes that emerged from the responses include:

- **Culture.** The importance of culture was evident in many responses, particularly in the leadership role of the board and senior management in setting the “tone from the top” and communicating ethical values.
- **Board membership and effectiveness.** Effective oversight by the board is widely seen as critical. Directors need to be competent and have integrity and must be able to provide independent challenge to senior management. Responsibilities of directors and senior managers should be clearly defined.
- **Risk management and internal controls.** Great importance is placed by some authorities on oversight of risk management frameworks and effective internal controls, including risk, compliance and internal audit functions. Escalation policies (e.g. whistleblower and risk escalation policies) and increased accountability were also noted as important.
- **People management and incentives.** Incentives (financial and non-financial) were identified as a key driver of behaviour, and hence of misconduct risk, as well as the need for training, competence and performance management.<sup>9</sup>

### **Key observations**

Most FSB member jurisdictions completed the survey, with the European Union also completing the survey to include the work by the European authorities (e.g. European Commission and European Central Bank).<sup>10</sup> Some key observations from the stocktake include:

1. **Definitions:** Many jurisdictions lack formal and explicit definitions of “governance framework”, “conduct” and “misconduct”. Some jurisdictions noted that they do not have a single definition for “misconduct” as events that characterise “misconduct” span a large and diverse spectrum of behaviour ranging from minor policy violations to egregious actions.
2. **Top three features of the governance framework:** While no national authority’s response formally ranked the top three features of its governance framework that are effective in addressing misconduct risk, there are a few themes that emerge from the

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<sup>9</sup> To the extent responses touched upon the role of compensation practices, the responses will be provided to the CMCG Working Group for further consideration.

<sup>10</sup> Responses were not received from Indonesia and Russia.

responses. At a high level, these themes include: (1) clearly defined corporate strategy and risk appetite with relevant controls; (2) appropriate expertise, stature, responsibility, independence, prudence, transparency, and oversight on the part of board members and control functions; (3) corporate culture; (4) effective control environment; and (5) and appropriate people management and incentives.

3. **Policy documents:** Most jurisdictions have issued policy documents related to governance generally but not specific to misconduct. Some jurisdictions issue policies applicable to all financial institutions, and others are directed at a particular sub-set (e.g. listed companies) or sector (e.g. banks, insurance, or securities firms).
4. **Approach / strategy:** National authorities' approaches and tools to discourage misconduct at firms through governance frameworks generally vary by type of financial institution (e.g. bank, insurer, or investment firm); however, where jurisdictions have a corporate governance code, that code generally applies to all listed companies. Some authorities state that it is the board's responsibility to deter misconduct or mitigate misconduct risk, including fostering appropriate culture, and the role of authorities is to support their efforts.
5. **Information gathering:** Most jurisdictions have gathered information relating to how firms are addressing misconduct risks through governance frameworks. Their work has identified areas for improvement, including the need to strengthen the effectiveness of internal controls, encourage constructive challenge by board members, focus on the roles played by independent board members; "tone from the top" and effective communication of culture throughout the organisation; defining risk limits consistent with the overall risk appetite framework; and increasing transparency towards clients through effective disclosure of information (e.g. to mitigate risks of mis-selling).
6. **Top three issues that could benefit from additional work:** Not all jurisdictions responded that additional work was needed and among those that did, there was a very limited degree of commonality among the issues identified. It is possible, however, to identify a few themes that help to categorise some, but not all, of the responses. At a high level, these themes include: (i) the need for definitions and taxonomy; (ii) metrics to assess misconduct risk; (iii) board and management procedures; (iv) risk management and internal controls; (v) "rolling bad apples;" (vi) international coordination and cooperation; (vii) financial and non-financial incentives; and (viii) whistleblower protections.
7. **Impact assessments.** No common approach to measuring the impact of misconduct has been adopted by national authorities yet; evaluations conducted to date have generally been done either at individual firms, within the general framework of supervisory assessment or on a horizontal basis using a mixture of qualitative and quantitative tools.
8. **Root causes.** Only a few jurisdictions have conducted root cause analysis of recent misconduct events. Some common root causes identified in national authorities' submissions include external pressure (i.e. market conditions or a growth strategy to remain competitive); poor or ineffective oversight by senior management; and lack of

challenge in the decision-making process, including instances where internal controls were overridden.

## **Definitions and top three features**

### **Definitions**

Many jurisdictions' responses indicated that they lack formal and explicit definitions of "governance framework", "conduct" and "misconduct". Most jurisdictions defined these terms only contextually, i.e. by referencing governance and other frameworks that are further defined in guidance, regulations and other supervisory approaches. Overall, jurisdictions mentioned principles or regulations relevant to corporate governance generally, where the principle of an effective "governance framework" could be inferred. Two jurisdictions noted that their rules on governance frameworks are consistent with standards issued by the Basel Committee on Banking Supervision (BCBS) and the Organisation for Economic Co-operation and Development (OECD).

Some jurisdictions addressed "conduct" by referencing general institutional objectives, standards, and values that are codified in firm-specific Codes of Conduct, which guide the conduct of board and staff members. At a high level, principles apparent in such codes include but are not limited to: (i) acting in good faith; (ii) preventing corruption and other illegal activities; and (iii) avoiding conflicts of interest. One jurisdiction noted a code of conduct that was defined as an agreement or set of rules not imposed by law, regulation, or administrative provision but limiting the behaviour of traders who undertake to be bound by the code in relation to one or more particular commercial practices or business sectors.

Almost all jurisdictions noted that they lack a single definition for "misconduct" and that events that characterise "misconduct" span a diverse spectrum of behaviour ranging from minor policy violations to egregious actions. As a general approach, one jurisdiction noted that "misconduct" could be considered any action or inaction that falls short of standards. Some jurisdictions noted that the financial institutions themselves rather than supervisors have definitions of "misconduct" as well as deterrent mechanisms that span the same range of behaviour. These definitions are structured in the firms' own Codes of Ethics or Codes of Conducts.

A few jurisdictions noted the potential overlapping definitions between regulatory compliance risk, conduct risk, and "misconduct". One jurisdiction noted that regulatory compliance risk, which it defined as the risk of a regulated institution's potential for non-conformance with laws, rules, regulations, and prescribed practices in any jurisdiction in which it operates, is akin to "misconduct". Another jurisdiction noted that supervisory guidance defines "conduct risk" as the current or prospective risk to an institution arising from inappropriate supply of financial services including cases of wilful or negligent conduct. More broadly, several jurisdictions noted that "misconduct" is addressed through regulatory frameworks for operational risk such as internal fraud and internal governance and risk management policies, procedures, and practices.

In banking, several jurisdictions noted the adoption of a twin peaks approach to supervision by separating conduct supervision from macro- and micro-prudential supervision. In those jurisdictions, conduct supervision aims to assess compliance with rules and regulation and risks

to expected outcomes such as the fair treatment of customers and the prevention of money laundering and terrorism financing. Almost all jurisdictions noted that securities market regulations prescribe professional and ethical standards of conduct for regulated entities (brokers, dealers, fund managers, investment advisors, custodians, registrars, etc.) and their representatives when performing activities as capital market intermediaries.

Generally, there is a high degree of commonality among the jurisdictions' responses in identifying a lack of a common definition for "governance frameworks", "conduct", and "misconduct". However, one jurisdiction's response noted that the survey's definition of "misconduct" appears sufficient providing that standards are defined broadly to include not just standards of conduct but standards that apply to the outcome of conduct.

### **Top three features of the governance framework**

While no jurisdiction explicitly ranked the top three features of its governance framework, the features identified in the responses varied widely from one jurisdiction to another. Some jurisdictions focused on existing expectations outlined in regulations and supervisory guidance. Other jurisdictions noted principles-based approaches and/or proportionality principles.

It is possible to identify a few themes that emerged from the responses. At a high level, these themes include: (i) clearly defined expectations; (ii) appropriate expertise, stature responsibility, independence, prudence, transparency, and oversight on the part of board members and control functions; (iii) corporate culture; (iv) effective control environment; (v) and appropriate people management and incentives. Each theme is described in more detail below.

- (i) ***Clearly defined expectations.*** Many jurisdictions noted that they have general governance expectations that firms define a clearly articulated corporate strategy and institutional risk appetite. These expectations are outlined in either regulations or supervisory guidance. For instance, one jurisdiction noted that its expectations include effective and independent internal audit, corporate compliance, and internal control functions. In the securities sector, one jurisdiction noted that detailed legal prescriptions on frameworks exist that set forth very detailed rules.
- (ii) ***Expertise, stature, responsibility, independence, prudence, transparency, and oversight.*** Several jurisdictions noted that board members and control functions should have the appropriate expertise, stature, responsibility, independence, and prudence to understand their responsibilities and functions within the framework of corporate governance and should behave with integrity while conducting business for the financial institution. Some jurisdictions have codified board composition in regulations and several jurisdictions noted prescriptive requirements for board committees. Other jurisdictions noted sector-specific guidance. Several jurisdictions noted that effective oversight by the board and senior management was critical to an effective governance framework.
- (iii) ***Corporate culture.*** Several jurisdictions noted that culture is a significant factor in an effective governance framework. Some jurisdictions noted that firms should maintain a corporate culture that emphasises the importance of compliance with laws,

regulations, and consumer protections as well as the avoidance of conflicts of interest and the management of reputational and legal risks.

- (iv) ***Effective control environment.*** Several jurisdictions noted that an effective and efficient internal control system and environment is of paramount importance in setting an appropriate risk appetite framework, risk tolerance, and risk limits. One jurisdiction noted that an independent compliance function was a critical component of an effective second line of defence.
- (v) ***People management and incentives.*** One jurisdiction noted that the way in which a firm rewards and manages its people sends very clear signals about the corporate culture and the “tone from the top”. In addition to structural and behavioural elements of a governance framework, many jurisdictions noted that an effective framework needs to be supported by appropriate financial and non-financial incentives and people management policies and procedures that align with and support the risk appetite and firm values.

## **Surveys/information gathering**

National authorities were asked whether they had conducted surveys related to measures taken to reduce misconduct risk in their jurisdiction. Respondents were invited to share the findings of any such survey. Jurisdictions indicated that information is generally gathered through:

- specific surveys sent to individual firms or supervisory reporting requirements.
- information gathered as part of routine day-to-day supervision of individual firms during inspections or self-assessment exercises.

When assessing the effectiveness of governance frameworks, many supervisors regularly engage with the firm’s board of directors. Their work might result in the publication of public benchmarks, guidance or recommendations.

National authorities indicated that their information gathering efforts focus on several matters: past incidents and existing policies. Such actions are motivated by the fact that the information gathered tends to improve surveillance through a better knowledge of industry practices. Some national authorities also report that their actions are motivated by the number and scale of misconduct cases recently observed and the cost such misconduct cases impose on society.

The multifaceted nature of conduct risk in the findings they shared is reflected in the diversity of types of misconduct and business areas affected. National authorities consider misconduct risks to be linked to non-compliance risk and reputational risk. Conduct risks are also considered a financial risk as their costs could be significant. Examples of issues addressed in the surveys include to:

- determine firms’ attitude, appetite and approach to managing misconduct risk;
- identify detrimental business practices and their implications for consumer confidence;
- analyse how firms identify and manage conflicts of interest;
- monitor the implications of legal, reputational and misconduct cases on banks’ governance, culture, compliance, and financial risk profile;

- analyse the impact of compensation packages and incentives;
- monitor the application of codes of conducts.

Several responses indicate that while there has been an increased focus on culture, values and behaviour in recent years (through the three lines of defence framework for instance), some improvements remain to be done in order to foster procedures that are conducive to mitigating and limiting misconduct risk.

Some observations in the responses include:

- national authorities are at various stages of supervising for misconduct, depending on size, complexity and the prevalence of sub-cultures within the organisation (business units, geography);
- institutions should reinforce internal constructive challenge by involving control functions such as compliance or risk management desks more closely, at an earlier stage of the decision-making process and by reinforcing the roles played by independent board members;
- leaders of firms have a central role in shaping and driving both organisational and risk culture (“tone from the top”) as well as addressing severe conflicts;
- governance frameworks to address misconduct risks need to be clearly communicated and cascaded throughout the organisation to be understood by staff members;
- a lack of risk limits or risk appetite statements may impede deployment of the full range of operational risk management tools; and
- greater transparency is needed through effective disclosure of information for clients (risks of mis-selling of banking products to consumers for instance).

## **Policy documents**

Most jurisdictions have issued policy documents related to governance frameworks but not specific to mitigating misconduct risk. Jurisdictions have taken different approaches, with some policies applicable to all financial institutions, others directed at listed companies or specific sectors (e.g. banks, insurance, or securities firms). Some of the policies aim to (i) strengthen accountability, internal controls and risk management; (ii) establish whistleblowing policies and an (ethical) code of conduct; (iii) align compensation with risk-taking, and (iv) promote a sound risk culture. A few jurisdictions have not issued any policy documents but have national laws or corporate governance codes. Where policy documents have been issued, many are in the form of guidelines or guidance, or best or recommended practice for implementing rules and laws. There is a plethora of policy documents issued across the FSB membership, such as booklets, circulars, communiques, guidance, instructions, manuals, measures, notices, official positions, policy statements, risk alerts, and trial provisions. Of note, the Dutch central bank published a book dealing with supervision of behaviour and culture.

Many policy documents address the board of directors, supervisory or management board, as well as to senior management. Some documents also address non-executives or boardroom conduct.

In many jurisdictions, policy documents are subject to a regular review.

## **Approaches, strategies and interaction with national and firms' initiatives**

Many jurisdictions provided an extensive response regarding their approaches and strategies for discouraging misconduct at firms through the use of governance frameworks. In the responses, jurisdictions highlighted their use of a combination of rulemaking, comprehensive supervision and enforcement in order to discourage misconduct. The breadth of responses highlights how national authorities have increased their efforts to promote strong governance practices at firms.

### ***Policy initiatives / monitoring***

Supervisory and regulatory approaches and tools (laws, regulations, codes etc.) vary across the financial sector (i.e. banks, insurers, investment firms and other financial institutions). The policy initiatives used by some jurisdictions include (i) conduct rules applicable to market professionals, (ii) training and qualification requirements for market professionals, (iii) fiduciary or other obligations, (iv) compliance controls, and (v) improved policies, procedures and other approaches to identify and manage conflicts of interest. There are some approaches that appear to apply to all financial institutions in some jurisdictions. For example, corporate governance rules take various forms, such as codes, official guidance and sometimes laws, and generally apply to all listed companies, not just financial institutions. These are often implemented on a “comply or explain” basis. Some jurisdictions state that it is the board’s responsibility to deter misconduct by fostering an appropriate culture.

Some examples of jurisdictional specific policies include:

- The UK introduced the Senior Managers and Certification Regime (SMCR), which forms the basis of their individual accountability regime through a clear and comprehensive allocation of responsibilities to the most senior executive managers and key non-executive directors.
- The Netherlands introduced in 2015, a so-called “bankers’ oath”. In taking the oath, staff members at financial institutions pledge that they will perform their duties in good faith, to the best of their knowledge and by putting the interest of the customer first. If staff members do not take the oath or fail to live up to it, financial institutions may impose sanctions on their employees. They also introduced a 20% bonus cap which is only applied to financial enterprises and established a specific department called “Governance, behaviour and culture”.
- In Australia, ASIC has developed an internal document entitled Culture Indicators for Surveillance, which is a tool to incorporate consideration of a firm’s culture into their surveillance work. ASIC has also established an Office of the Whistleblower which oversees the handling of whistle blowers across ASIC teams, including ensuring that the whistle blower is kept informed, to the extent possible, about what actions ASIC is taking in response to their information. The unique example is the “Two Strikes Rule”, which requires an advisory vote on the remuneration report at the annual general meeting. This has attracted much criticism by companies since its introduction in 2012, who say that the rule is causing a distraction for directors. This debate,

however, triggered an increased tendency for companies to more actively engage with their shareholders on matters of remuneration and other matters.

### ***Enforcement***

In most jurisdictions, a combination of binding laws and regulations and soft laws is used to take enforcement actions; supervisory guidelines, and other types of guidance, as well as the corporate governance code are non-binding. The types of enforcement sanctions that can result from misconduct cases include financial penalties, suspension of business, or cancellation of licenses. Most jurisdictions can take such action against firms with some jurisdictions also able to take enforcement action against individuals. Some jurisdictions consider whistleblower mechanisms as an enforcement tool.

### **Top three issues**

Most jurisdictions suggested areas that they thought would benefit from improved international standards or guidance. Some jurisdictions addressed this topic by discussing matters of general applicability to the financial market while others specified potential areas for particular financial sectors (i.e., the banking, insurance and securities sectors). Relatively few jurisdictions, however, provided narratives explaining why they had chosen particular topics as potential areas for improved international guidance. One jurisdiction advised taking a cautious approach to the development of additional international standards or guidance, noting that: (i) because international standards and guidance do not have the force of law, jurisdictions may not be inclined to adopt them; and (ii) the level of complexity in mitigating misconduct risks differs from jurisdiction to jurisdiction.

A few general themes emerged from the responses, such as: (i) definitions and taxonomy; (ii) metrics to assess misconduct; (iii) board and management procedures; (iv) risk management and internal controls; (v) “rolling bad apples;” (vi) international coordination and cooperation; (vii) financial and non-financial incentives; and (viii) whistleblower protections. Each theme is described in more detail below.

- (i) ***Definitions and taxonomy.*** Some jurisdictions proposed the development of standardised definitions for a variety of terms, such as “misconduct.” Responses on this topic included:
  - A standardised definition for “misconduct” and “governance frameworks,” particularly for internationally active banks with more than one supervisor.
  - Developing consistent vocabulary and understanding the relationships between the overlapping concepts of governance effectiveness, behaviour, culture, conduct and misconduct.
  - Clarifying the taxonomy of conduct risk in general.
- (ii) ***Metrics to assess misconduct.*** Some jurisdictions stated that the development of approaches and metrics to measure the impact of misconduct would be helpful. Responses noted that this is a relatively new area and that, accordingly, firms and supervisors may benefit from international guidance.

- (iii) ***Board and management procedures.*** Some responses suggested that criteria or guidance could be developed relating to strengthening the oversight role of boards of directors or senior management personnel. The scope of the responses in this area varied but included discussion of the following issues:
- Developing criteria or guidelines allowing for the standardisation of parameters for directors to be considered to have independent judgment and to be “fit and proper” for their roles.
  - Strengthening and improving monitoring by the board on management team performance to ensure that its functions are developed in accordance with an institution’s strategy, risk appetite and institutional values.
  - Strengthening approaches to the “tone from the top” in the context of the role of board and senior management.
- (iv) ***Risk management and internal controls.*** Some jurisdictions suggested work to clarify *expectations* for risk management and internal controls, including, but not limited to, clarity around the three lines of defence approach. Illustrative examples of suggested work include:
- Expectations for risk conduct from the board, senior management and the three lines of defence is an area that would benefit from improved guidance.
  - The development of guidance or implementation documents focusing on conduct of business and misconduct from the perspective of internal controls, risk management, and internal audit.
  - Guidance on risk management frameworks for mutual funds, including the use of liquidity management tools.
- (v) ***Rolling bad apples.*** Some jurisdictions suggested additional work to address the problem of “rolling bad apples” (the movement of people with poor conduct records). Some responses noted that the creation of a central registry could be helpful, although privacy laws could present a hurdle to the development of such a registry.
- (vi) ***International coordination and cooperation.*** Some jurisdictions suggested that increased coordination between authorities may be helpful in connection with sharing information about potential misconduct risk such that risk could be mitigated through a cross-jurisdictional approach. One response acknowledged that enforcement-related information is effectively shared through the IOSCO MMoU but noted that sharing of supervisory information would also be beneficial.
- (vii) ***Incentives.*** Some jurisdictions suggested the development of criteria or guidance pertaining to financial and non-financial incentives. Responses on this issue addressed the following:
- Further guidance on both financial<sup>11</sup> and non-financial incentives related to mitigating misconduct risk. People are motivated by a broad range of organisational incentives and these can be strong influences on behaviour.

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<sup>11</sup> The CMCG is currently developing guidance on compensation and conduct.

Additional work could capture the range of “people systems” that can influence and motivate behaviour, including recruitment, training and development, and promotion.

- (viii) **Whistleblower protections.** Some of the responses said that the adoption of enhanced protection for whistleblowers and related firm-level policies would be desirable and a potential area for international coordination.

## Quantitative or qualitative assessment

Only a few jurisdictions have conducted impact assessments of misconduct on the *vulnerability of the financial system*, while a number of jurisdictions have analysed the impact of misconduct risk on the *financial performance of firms*. These impact assessments have mainly been qualitative and largely addressed at banks and financial institutions. Such assessments are often conducted as part of on-site and off-site supervisory activity. Several jurisdictions include misconduct risk within their prudential supervisory assessment for banks; one jurisdiction noted that it assesses misconduct as part of compliance supervision as its impact could potentially affect the overall rating of the bank. Another jurisdiction noted that some banks and insurance companies have voluntarily included the impact of misconduct, or other events that could affect reputation, as part of their scenario stress tests. Other examples of impact assessments include:

- In 2015 Mexico developed a supervisory tool aimed at having preventive and results-oriented supervision including timely analysis of root problems and vulnerabilities at financial institutions. The aim of this tool, called Risk Rating Matrix CEFER, is to assign each institution a rating. It provides a systematic and structured mechanism to assess the different types of risk that banking institutions face and it incorporates a robust quantitative and qualitative assessment of inherent risks, mitigating factors, such as corporate governance, and complementary elements that impact the risk profiling and bank soundness.
- In Europe, intense activity has been undertaken in assessing misconduct risk through qualitative and quantitative analysis, focusing on the banking system. In 2015, ECB Banking Supervision performed a survey of conduct risk which analysed past and open legal cases that have led, or could lead, to costs for a sample of significant institutions. In 2015, the EBA performed a qualitative survey on conduct risk, whose results have been published together with the EBA risk assessment. In 2016, the EBA performed a stress-test, including the impact of operational losses related to misconduct. The EBA EU-Wide Stress Test is a quantitative analysis having explicitly required banking institutions to include operational risks – split between conduct risks and other operational risks – among the factors impacting the CET1 ratio. Banks had to report aggregate historical information on the frequency and severity of losses and elaborate stress test projections, both on the profit and loss financial statements and the RWAs, during the three-year time interval 2016-2018.
- In the US, one approach used by the Securities and Exchange Commission (SEC) staff is to conduct qualitative and quantitative assessments of the impact of potential regulatory fines and/or litigation expenses (many of which are the consequence of misconduct) related to broker-dealers. The SEC staff has also conducted qualitative

and quantitative assessments of misconduct risk and its impact on firms and the financial sector in connection with various rulemakings by the SEC.

### ***Gaps or areas where more work may be needed, and proposed recommendations***

The responses from the survey highlight that there is no common approach to measuring the impact of misconduct on firms or on the financial system; this evaluation has been largely conducted by the different jurisdictions either individually, within the general framework of supervisory assessment or horizontally, on the basis of a mixture of qualitative and quantitative tools.

### **Root cause analysis**

The responses to questions about jurisdictions' analysis of the root cause of significant financial sector misconduct in the last eight years have been categorised in four patterns that were extracted from the literature review of root cause analyses in Annex E. These include external pressure, tone from the top, communication and effective challenge, culture, and structure of the organisation and system.

Drawing from the results of the survey, some noticeable common themes from the responses are:

- Some kind of external pressure, or a growth strategy (the latter usually as a response to perceived outside pressures).
- Poor and ineffective oversight by the senior management, profit-driven motives, and a lack of compliance and risk awareness. Furthermore, in terms of decision-making, the results reveal that in most cases the board had made decisions without having all the relevant information. In some cases, the board was well informed but the results show signs of overriding internal controls and a lack of challenge in the decision-making process.
- Flaws in the organisational culture, which showed up as disregard for compliance and control requirements and a lack of professional ethics. In a number of cases, incentives also apparently drove inappropriate behaviour.
- Failures of the internal control system, which seem to have reflected a lack of knowledge and inadequate management of conflict of interest.

### ***Board and senior management behaviour***

In cases reported by some jurisdictions, the mind set of senior management is sometimes unduly influenced by profit maximization accompanied by a lack of compliance awareness; the directors and the president compelling front-line staff to prioritise business promotion and not fostering a sense of ownership or a compliance-oriented mind-set with regard to the initiatives against the anti-social forces; and/or the company became more aggressive in its management and collateral investment practices in order to generate additional revenue.

Other jurisdictions have witnessed, senior management that was either unaware of the risks, did not understand the risks, or had overridden internal controls. For instance, the root cause analysis of one jurisdiction indicates that excessive pressure was applied by the entity's

managers on staff to originate loans and override internal controls in order to meet high credit placement goals. Other examples are: ineffective governance by senior management, leading to a poor risk culture which prioritised questionable customer demands ahead of compliance with anti-money laundering regulations and the bank's own internal controls; the inability of the board and investment committee to independently confirm what the affected fund was investing in, or even whether the investments actually existed; and management failing to recognise the importance of problems in captive loans and not thoroughly investigating the fundamental problems.

### ***Communication and challenges***

In some of the cases, the board was not able to make informed decisions because they did not have all relevant and timely information for a thorough decision-making process.

### ***Organisational culture***

With respect to culture, the analyses demonstrate that corporate culture is an important determinant for the occurrence of misconduct. Important expressions of a culture are the perception of the balance between reward and risk, the relevance of risk management and ethical considerations, the importance of remuneration/bonuses and the opportunities of employees to freely speak up. In general, the results indicate that the absence of a sound risk culture and a risk-centric tone-from-the-top are critical factors.

### ***Incentives***

In some of the cases, bad behaviour was further incentivised by the incentive structure in place. For example, several jurisdictions noted that financial and non-financial incentive frameworks and policies and compensation/remuneration structures failed to align with desired behaviour. Other weaknesses in incentives include: variable component based on short-term performance; improper balance between fixed and variable components; uncertainty in the enforceability of claw-back clauses and treatment of golden parachutes; and deficiencies in compensation policies.

### ***Organisational structure and system***

A majority of the root cause analyses show internal control system failures. For instance, wide spread deficiencies in governance, risk management, surveillance systems, and audit have led to major compliance failures, which have resulted in financial loss and /or reputational risk.

## **Conclusions**

A wide range of approaches exist among national authorities on how misconduct risk should be addressed through governance frameworks, while taking into account differences in board structures (e.g. one tier and two tier).

Most national authorities supervise governance frameworks and see them as important to managing conduct risks. However, a great deal of variation in approaches and emphasis is apparent. Some key areas where this variability is evident include the following:

- Culture and the “tone from the top” were seen as important by a number of jurisdictions. In some cases, they were seen as central. Some authorities do not supervise culture in their approach.
- Several jurisdictions noted that an effective and efficient internal control system and environment is of paramount importance in setting an appropriate risk appetite framework, including the “three lines of defence” model. Risk appetite frameworks were seen as important to supporting strong governance frameworks by central banks and other prudential bank regulators.
- Policy approaches range widely among respondents, with some authorities relying solely on basic law and general corporate codes of conduct. Many authorities did not specifically try to address misconduct through policy on governance frameworks.
- Clear articulation of responsibilities is central to the approach of one jurisdiction and is a theme echoed in many other authorities’ responses.

There is a general lack of formal definitions for the terms “governance framework”, “conduct” and “misconduct” among responding jurisdictions. Some jurisdictions noted that they do not have a single definition for “misconduct” as events that characterise “misconduct” span a large and diverse spectrum of behaviour ranging from minor policy violations to egregious actions. Definitions were also identified by some authorities as a potential area for further international work, being aware that with regard to the variety of misconduct cases a comprehensive definition is difficult to achieve.

Little work has been performed in most jurisdictions on the impact of misconduct on firms’ financial positions or the financial system as a whole. Such work that has been performed does not allow a consistent set of conclusions.

There appears to be a significant degree of agreement that governance frameworks influence the risk of misconduct. Key themes include board membership, oversight, and effectiveness. Other important aspects of an effective framework for misconduct are oversight of risk management and internal controls, culture and people management and incentives.

Most authorities – but not all – identified areas where further international work could be helpful. As with other responses, these were very diverse but key themes identified include: definitions and taxonomy, metrics to assess misconduct, board and management, risk management and internal controls, “rolling bad apples”, international cooperation, incentives and whistleblowers.

## **Annex B: Stock take of efforts by firms to strengthen governance frameworks to mitigate misconduct risk**

### **Key observations**

A total of 53 firms completed the survey: 33 banks, 14 insurers and 6 investment firms (see Table 1 for a list of the firms that responded to the survey). While more banks were surveyed than insurers and investment firms, three key trends emerge from the responses to the survey:

- **Heterogeneity in terms of taxonomy:** There are differences across firms regarding the way they define and classify misconduct risk, but individuals are generally expected to adhere to ethical standards, and to abide by Codes of Conduct as well as other policies, laws and regulations. Many firms refer to ethical behaviour towards both customers and stakeholders. The most common values identified to guide individual actions are honesty, fairness and integrity.
- **Holistic approach:** Many of the firms explained they have developed or are beginning to develop a set of integrated policies and practices including financial and non-financial incentives, training, and codes of conduct in order to raise awareness of sound governance practices and prevent misconduct at the firm-wide level.
- **Improvements in misconduct risk monitoring:** Stocktake responses indicate that the majority of firms subsume misconduct risk under compliance and occasionally operational risk. Some firms monitor conduct risk as a stand-alone element of the RAF expressed through both quantitative and qualitative statements.

Other common themes from firms' responses are set out below, with selected examples that describe current practice, as excerpted from the surveys, provided in Table 2:

- **Definitions:** There is no common definition for terms such as “governance framework”, “conduct” and “misconduct”. However, many firms' definitions for “governance framework” and “misconduct” align with the working definitions provided by the WGGF. A number of firms add in their definitions of “conduct” dimensions like ethical behaviour of individuals.
- **Interplay between compliance risk and misconduct risk:** Firms generally see a close link between compliance risk and misconduct risk. Compliance is seen as abiding by laws, regulation and rules, while misconduct risk management is related to embedding culture, values and ethics in day-to-day behaviours of the businesses as a first line of defence. The surveys revealed some differences in the classification of misconduct risk across firms: several firms refer to a formal inclusion of misconduct risk in the non-financial risk mapping, usually as a sub-category of operational risk and/or compliance. In other firms, there is a convergence between the frameworks for compliance and conduct.
- **Top three features of a governance framework:** Firms responded that they generally see the management of misconduct risk as the Board's responsibility and that there are a variety of features that they consider important in order to mitigate it. Some of the most common features referenced by firms include Board composition; “tone from the top” and promulgation of corporate culture and values; employment practices, such as

compensation, incentives and people management; policies, standards, guidance and procedures, with senior management oversight; and a three lines of defence model to ensure that there is an independent system of checks and balances in place and to provide assurance that risks are managed properly. Other features mentioned include appropriate internal controls, the role of the compliance function and its interplay with the Board, escalation processes, timely reporting, individual accountability of senior management, transparency (providing clear insight into risks and their mitigants) to inform decision-making and independent decision-making processes.

- ***Top three issues that would most benefit from improved guidance:*** Firms described a range of issues that would benefit from further guidance. Some of the more common areas mentioned include greater harmonisation of supervisory approaches and practices in setting expectations around a misconduct risk framework; greater consistency in definitions and taxonomies for misconduct risk, conduct and misconduct; enhanced processes for reporting of misconduct and whistleblower policies; financial and non-financial incentives; a regulatory process for tracking “rolling bad apples”; clarity on regulatory expectations regarding overlaps between the first and second lines of defence; transparency of policies to prevent mis-selling; and increasing Board accountability in respect of market conduct matters.
- ***Misconduct risk monitoring:*** Many firms have conduct-related quantitative metrics embedded in their RAF Metrics commonly referenced by firms include: (i) operational losses, including actual and expected losses due to misconduct, the market value of investment products sold to high-risk clients, and reputation risk on the franchise value or brand; (ii) number of cases of market abuse or customer complaints, such as number of monthly trade surveillance escalations, percent of favourable versus unfavourable volume of comments, and number of serious incidents or significant conduct investigations underway, and regulator fines as a percentage of prior year pre-tax income; and (iii) performance/training indicators, such as number of employees who receive code of conduct training, or alternatively those who miss mandatory training sessions, embedding conduct metrics or objectives into variable compensation, and a number of involuntary employee terminations and disciplinary actions due to misconduct. Qualitative statements on conduct included in the RAF referenced by firms include adherence to laws and regulations, meeting compliance obligations and acting on compliance breaches.

A few firms refer to dashboards used throughout the firm to capture metrics related to late completion of tasks, travel and expense-related matters, exception-based trades, delinquent compliance training reports, employee registrations, gifts and entertainment policy exceptions, cancel and correct/error tickets, policy breaches, personal account and trading reviews, and policy exceptions, among others. These dashboards are usually discussed with supervisors on a regular basis (semi-annually or quarterly).

- ***Policy initiatives:*** Firms described many policy initiatives that articulate expected behaviours and aim to deter misconduct. These policies are set out in mission statements; codes of conduct; policies governing financial and non-financial incentives; and new product approval processes. Respondents also emphasized the

importance of firm-wide escalation policies that define the types of issues that should be escalated, establish individual responsibilities for such escalation, and describe the appropriate channels through which escalation should take place. Some firms reported that their policies are designed to encourage client-oriented business conduct. Whistleblower mechanisms were also referenced as an important part of a program to deter misconduct as part of a firm's risk management strategy. Whistleblower programs are usually overseen by the Board Audit Committee, or an independent third party, while day-to-day operations of such programs are managed by the Internal Audit division.

- ***Financial and non-financial incentives:*** Most firms indicate they have developed clear guidelines on compensation adjustments for misconduct. A number of firms also highlight the importance of aligning staff incentives with the firm's long term interests, including the firm's reputation. Many firms also have appraisal processes / promotions related to conduct.
- ***Impact assessments on the firm and financial system:*** Conducting assessments of the financial impact of misconduct on the firm or the financial system is not a common practice, however, in some cases it is assessed through operational risk management procedures and other tools, such as assessment of risk from mis-selling scenarios; risk assessments of fraud to evaluate the firms' fraud risk management efforts; anti-corruption assessments; and reviews of customer complaints. Some banks refer to the regulatory stress tests (e.g. US CCAR, EU EBA, UK PRA) or to the calculation of operational losses as assessing the impact of misconduct on the firm. Almost all firms are silent on how misconduct specifically impacts their financial performance.
- ***Root cause analysis:*** Some of the most common cases of misconduct cited were cases of individual fraud (e.g. "rogue" trader), market manipulation, and mis-selling. The root causes for such misconduct were largely attributed to inadequate systems and internal controls; weaknesses in governance, including tone from the top and insufficient senior management/board involvement; a weak culture; lack of judgement; insufficient policies and procedures; inadequate supervision/monitoring; inappropriate compensation schemes and inconsistencies in complaints management.

Firms stated that most of the misconduct cases were detected through governance arrangements, such as internal audit and supervision. However, some firms indicate some of the cases were detected by regulators and/or through lawsuits by customers or client complaints. Some of the lessons learned include defining clear responsibilities and accountabilities for local business units and group functions, enhancing guidelines for potential conflicts of interests, strengthening escalation processes and increasing employee understanding and awareness (for instance through trainings).

- ***Individual responsibility and accountability:*** Firm responses pointed to the importance of robust employee screening and job descriptions as important to ensuring appropriate responsibility and accountability, and emphasized the need to communicate the importance of accountability from the employee's start date at the firm. To help ensure continued understanding, firms monitor and embed adherence to codes of conduct and other related policies in annual performance plans and reviews. These efforts are supported in various ways, including dedicated training sessions;

annual certifications that require employees to acknowledge that they have read, understood, and will comply with the firm's code of conduct; and compensation frameworks and related performance management mechanisms that ensure appropriate consequences for poor behaviour. Some firms mentioned that strengthened codes of conduct and training are applied to employees engaged in client relations.

- ***Role and involvement of the Board:*** Approximately half of the firms indicated that the Board has the ultimate ownership of the business strategy as well as conduct issues. Almost a quarter indicated that the board is responsible for approval of group-wide conduct policies. In many firms, the Board and its supporting committees have a common objective of ensuring compliance and determining an appropriate level of risk-taking by staff, as defined by the company's risk appetite. In some firms there are dedicated committees responsible for oversight of conduct, reputation or culture.
- ***Group versus subsidiaries:*** Most firms implement group-wide governance frameworks, taking into account the national legislation where the organisation operates. Most firms identify a role for subsidiary Boards; several firms indicated that subsidiaries and their local Boards are expected to adapt the global framework to comply with local requirements as needed. Several firms have developed specific mechanisms to ensure a consistent control framework across the group, including cascading group governance, policies, risk management and escalation processes from the group to the local level.

## Conclusions

Since the global financial crisis, firms responding to the survey state that they have made some progress in terms of how misconduct risk is monitored and integrated into their risk and control schemes. This is true for all sectors within the scope of the analysis, i.e. banks, insurers and investment firms. Root causes for misconduct at responding firms are not substantially different across sectors, with many institutions indicating inadequate governance systems as a contributing factor.

The interplay between governance frameworks and the management of misconduct risk is complex and firms have adopted a number of approaches to dealing with it, as illustrated in these areas:

- ***Risk appetite framework.*** While firms have devoted more attention to how they manage misconduct risk as an element of their RAF, in some cases adopting both qualitative and quantitative metrics, the thoroughness of this practice varies widely. These metrics usually refer to adherence to laws and regulations as well as follow-up actions after compliance breaches occur.
- ***Definitions and Taxonomy:*** There is neither a homogeneous definition nor a pre-determined taxonomy for misconduct risk. There is a general trend to link misconduct risk to day-to-day risk decisions of the different businesses as a first line of defence, whereas compliance risk is seen as abiding by laws, regulations and rules. Further, firms differ as to whether misconduct risk should be managed as a distinct risk category, often subsuming it under operational or compliance risk. These differences

can have a major impact in terms of the risk management architecture employed by firms.

- *Holistic and ad-hoc approaches to misconduct:* Some firms have designed holistic approach to prevent misconduct, including policies, process and incentives (both financial and non-financial). These holistic approaches are sometimes complemented by ad-hoc measures to address specific cases. Some firms lack an integrated system of financial and non-financial incentives and tools to prevent, identify and deal with cases of misconduct while others apply ad-hoc approaches to specific cases instead. In addition, the assessment of the financial impact of misconduct on the institutions and on the financial system as a whole is very often vague (and sometimes not assessed).

**Table 1: Firms surveyed**

***Banks***

- |                                    |   |
|------------------------------------|---|
| 1. Banco do Brasil                 | 19. HSBC  |
| 2. Banco Inbursa                   | 20. ING   |
| 3. Banco Santander                 | 21. Itaú Unibanco                               |
| 4. Bank of Nova Scotia             | 22. Lloyds Banking Group                        |
| 5. Banorte                         | 23. Morgan Stanley                              |
| 6. BBVA                            | 24. National Australia Bank                     |
| 7. BNP Paribas                     | 25. Sberbank                                    |
| 8. Branco Bradesco                 | 26. Societe Generale                            |
| 9. China Construction Bank         | 27. Standard Bank                               |
| 10. Citigroup                      | 28. Standard Chartered Bank (Hong Kong) Limited |
| 11. Commonwealth Bank of Australia | 29. Sumitomo Mitsui Banking Corporation         |
| 12. Credit Agricole                | 30. The National Commercial Bank                |
| 13. Credit Suisse                  | 31. UBS   |
| 14. Deutsche Bank                  | 32. Unicredit                                   |
| 15. Garanti Bankası T.A.Ş          | 33. Zürcher Kantonalbank                        |
| 16. Gazprom Bank                   |   |
| 17. Goldman Sachs                  |   |
| 18. Group BPCE                     |   |

***Insurers***

- |  |                                     |
|--|-------------------------------------|
| 1. AIA Group Hong Kong                 | 8. Manulife Financial Corp          |
| 2. AIG                                 | 9. Ping An Insurance Group          |
| 3. Allianz Sigorta A.Ş.                | 10. Prudential                      |
| 4. Anadolu Anonim Türk Sigorta Şirketi | 11. Prudential plc                  |
| 5. Aserta Seguros                      | 12. Qualitas                        |
| 6. Axa                                 | 13. Sberbank Life Insurance Company |
| 7. Liberty Group                       | 14. Sogaz                           |

***Investment Firms***

- |   |                  |
|---|------------------|
| 1. Aberdeen Asset Management plc        | 4. Interacciones |
| 2. Franklin Templeton India Mutual Fund | 5. JSC Finam     |
| 3. Grupo Bursátil Mexicano (GBM)        | 6. Sberbank CIB  |

## **Table 2: Examples and excerpts from survey responses**

Presented below is a more detailed sample of specific policies/practices described by the firms in their responses.

### **A. Definitions**

#### **Banks**

The banks surveyed provided heterogeneous definitions of conduct/misconduct. The definitions are generally consistent with the FSB ones, with the added dimension that firms tend to add ethical behaviour of individuals and positive outcomes for the stakeholders (customers, competitors, colleagues, etc.).

Nearly all banks included in their definition of misconduct a failure to obey the law and the firm's own code of conduct. Many made reference to ethical standards or community norms and a few to the specifics of an employment contract. Some mentioned a concern that individuals act with integrity and treat all with whom they interact fairly. Generally, the definition of misconduct includes the concept of intentionality, i.e., when the individual violates expected standards of behaviour (e.g., the law, the code of conduct, or ethical norms), he or she does so either deliberately or through gross negligence. Many firms make reference to the relationships to which standards of behaviour apply. Customers, the markets, and the firm itself are typically mentioned; suppliers, the community, and the broader group of stakeholders less frequently so.

In at least one other case, conduct is characterised in terms of outcomes. The firm noted that appropriate conduct will benefit the firm through greater transparency of the business model, effective governance, appropriate compensations schemes, robust infrastructure, and clearer procedures. It also indicated that employees will benefit from appropriate incentives backed up by ethical and supportive leadership, clients will be treated fairly and view transactions as beneficial, and external stakeholders will have trust in the institution.

#### **Insurers**

In the insurance sector, definitions of conduct and misconduct generally pointed to actions that are non-compliant with laws, rules and regulations (e.g., behaviour not in accordance with codes, laws, or regulations), internal directives and policies (e.g., values and drivers such as honesty, fairness, and integrity), and/or behaviour that is not acceptable (e.g., outcomes that result in good or bad behaviour).

Some responses from the insurers highlighted the importance of:

- Acting ethically and being fair to customers, shareholders, employees, and other stakeholders.
- Identifying the drivers of poor conduct, such as incentives structure, product design, conflicts of interest, culture, and tone from the top.

- Holding employees accountable for misconduct so that any employee who fails to comply with or neglects laws and regulations is responsible for his/her own act.

### **Investment firms**

The surveyed investment firms provided broadly similar definitions of conduct and misconduct, mainly focusing on ethical and lawful behaviours. One respondent made reference also to the reputational dimension of misconduct (“actions involving significant risks of losing business reputation”). Another firm noted that conduct implies appropriately taking into account customer interests and market integrity while carrying out business.

In half of the responses, definitions of governance frameworks employed by the respondents did not encompass all of the dimensions included in the WGGF definition, which was defined as:

*“The range of methods and techniques by which a firm is directed and overseen by those who have ultimate responsibility for the affairs of the firm (e.g. directors, executive management). These could include, but are not limited to: corporate governance structures (i.e. boards and board-level committees and management committees); risk governance framework; individual accountability; strategy setting, business planning and budgeting; internal reporting and management information; system of internal controls (risk management, compliance, and audit); financial and non-financial incentives; people management (including recruitment, training and competence, performance management and staff promotions); and promulgation of corporate culture and values (e.g. “tone from the top”, risk culture, escalation and whistleblowing mechanisms).”*

## **B. Categorisation of misconduct risk within the risk management framework**

### **Banks**

Though there are instances of banks that treat conduct risk as its own risk type, most banks appear to choose one of two main approaches to incorporate misconduct risk in their broader risk management framework, focusing either on compliance risk or operational risk. The majority of respondents classified misconduct risk as a type of compliance risk, and focus on failure to comply with law and regulation. However one firm indicated that it takes the reverse view and sees compliance risk as a subset of conduct risk, noting that inappropriate behaviour that complies with the law can still be considered misconduct. Another firm distinguished compliance risk from misconduct risk by noting that the latter is a more severe form of the former and only occurs when the failure to comply rises to a level that threatens faith in the financial system. Misconduct was also characterised dealing with the moral and behavioural aspects of compliance risk. Some firms also noted that appropriate conduct is associated with acting in accordance with not only the letter of the law but its spirit and the values of the company. There were some cases where firms have combined compliance and conduct, rather

than described one as a subset of the other. As an illustration, one firm has changed the responsible function's name to reference not only compliance, but also conduct risk.

Some firms treat misconduct risk as a type of operational risk, grouping misconduct together with errors and other breakdowns that disrupt operations. This linkage is most often made because fraud is classified as a type of operational risk.

Other firms take a hybrid view, or manage conduct risk under multiple frameworks. One firm indicated that conduct risk is a component of not only operational risk, but also compliance risk and franchise risk. Another firm responded that it did not view conduct risk as an individual risk type within its taxonomy. Instead, it identifies which risk types within its taxonomy have conduct risk aspects, and manages the risks that way. There was also a respondent that indicated that conduct risk makes up a significant part (80%) of its non-financial risk category. Some firms mentioned that misconduct has implications for reputational risk management, while others referenced fair outcomes for customers and misconduct's potential to disrupt orderly and transparent financial markets.

### **Insurers**

Insurance firms provided a range of response regarding the categorisation of conduct risk:

- One insurance firm viewed conduct risk as a behavioural issue in that it classified fraud, corruption, money laundering, mis-selling, any breach of economic sanctions, conflict of interest, and data privacy as a compliance risk, and deemed conduct risk to cover not only compliance risk but also risks with respect to the reliability of financial statements.
- At another insurer, the compliance officer manages issues related to compliance with local regulations, and manages conduct risk in tandem with human resources.
- One insurance firm thought conduct risk should be determined principally from the perspective of customer expectations and experience, maintaining high ethical standards, and ensuring compliance with laws and regulations.

### **Investment firms**

Investment firms generally tend to see the compliance and conduct risks as separate risks. At the same time, they acknowledge the close link between both, especially in a high-regulated environment where misconduct generates compliance risk events.

It was mentioned that compliance risk largely focuses on achieving compliance with applicable laws and regulations (which include conduct requirements) and conduct risk focuses on achieving the best outcomes for clients and ensuring consistency with the fair, orderly and transparent operation of the markets (which also include compliance requirements).

## **C. Role of boards**

### **Banks**

Survey responses indicate that the responsibilities that a bank board assumes vis-à-vis misconduct and the types of actions that it may take differs across institutions. Approximately half of the surveyed institutions reported that the board has the ultimate ownership of conduct issues. Many institutions also indicated that the board is responsible for approval of group policies related to conduct, such as the Code of Conduct. The type of board committees involved differs across banks: the risk committee (in most of the cases) or the HR / remuneration committee have primary responsibility at many of the surveyed firms, though some have established separate committees dedicated to considering issues of ethics, conduct, values, or culture, and there are instances where reputational risk committees play a central role. Banks indicated involvement of one or more of the following Board Committees in order of frequency: Risk Committee (also split into risk-specific sub-committees in one bank), Audit, Compensation, Governance / Ethics and Culture / Public Responsibilities, Compliance, HR, Conduct, Strategy, Operational Risk Committee.

In terms of specific practices, one bank mentioned that each of the board committees is responsible for conduct, with the Risk Committee having an oversight function. A few firms have committees dedicated to matters related to misconduct (and related topics such as ethics, culture and values). One firm has a committee responsible for reviewing and assessing the firm's culture to determine what concrete steps can be taken to foster ethical decision making. Another has a management level “commission” in charge of proposing approaches to mitigating misconduct risk based upon its reviews of misconduct events, including its analysis of root causes, and its assessment of the effectiveness of controls. A third has an executive level committee that reports to the board every six months on “management of corporate ethics”. One institution explained that each of its board committees has responsibility for some aspect of misconduct while also having a specific committee for conduct review. For instance, the board’s risk committee considers conduct matters through the lens of the firm’s risk appetite and risk management frameworks, while the committee focused on conduct considers conduct issues more directly. There were also firms that described their reputational risk committees as central to oversight of misconduct risk management.

### **Insurers**

The insurance firms’ responses described both the board’s responsibility and the responsibilities of the various committees that report to it. For example, one firm noted that the board is responsible for providing leadership within a framework of effective risk management and control, for approving the group strategy and monitoring progress against it, and for ensuring that the group is suitably resourced to achieve its chosen strategy. The firm set out the board’s responsibilities with respect to misconduct as:

- Ensuring an effective system of internal control and risk management;
- Approving the group’s overall risk appetite and tolerance and governance policy;
- Authorising any actual or potential conflict of interest situation applying to any director; and
- Approval of remuneration policy

Several other firms listed the principal committees that report to the board and noted that the responsibilities of the:

- Audit committees typically include internal control and risk management, internal audit, compliance, financial crime, and whistleblowing.
- Risk committees involve the risk framework and its approval policies, standards and limits within the overall appetite, and tolerance approved by the board. Risk committees also review material risk exposures such as customer and conduct risks against the group's risk methodologies and management's actions to monitor and control such exposures.
- Remuneration committees' responsibilities entail determining and recommending the remuneration framework and policies, monitoring the remuneration of group leadership teams and other selected individuals as well as senior staff in the risk, control, and governance functions, and those with an opportunity to earn \$1 million or more annually. For personnel, risk behaviour and adherence to risk appetite are considered in assessing performance and determining remuneration and incentives.

### **Investment firms**

All surveyed investment firms mentioned the role of the Board in approving the various internal policies, including codes of ethics, measures for the prevention and management of conflicts of interests and compliance policies.

Five out of six responding investment firms highlighted the Board's responsibilities in establishing the corporate strategies or in taking decisions on strategic issues.

Another frequently identified Board responsibility is carrying out the necessary oversight over the firm's operation, including by regularly reviewing the risk exposure based on information received through appropriate risk reporting lines.

As an example, a firm noted that the Board is responsible for the long-term success of the Group and sets the appropriate "tone from the top" by guiding /overseeing the embedding of strong conduct within the business through the governance structure and the information flows in place. The Board has delegated operational responsibilities to the Chief Executive and other committees, which in turn avail themselves of sub-committees. The Conduct Committee is a subcommittee of the Risk Management Committee. In addition, there are four independent committees: the Audit Committee, the Risk Committee, the Remuneration Committee and the Nominations Committee, particularly:

- the Risk Committee is responsible for assessing the effectiveness of the risk management framework, defining the risk appetite, ensure appropriate mechanisms for the risk identification, reviewing and approving the internal capital adequacy assessment process and reviewing and assessing compliance plans and reports;
- the Remuneration Committee approves the design of incentive plans and performance-related pay schemes.

## **D. Main features of a governance framework**

### **Banks**

When asked to name the top three features of a sound approach to preventing misconduct, a majority of the banks cited the three lines of defence model and internal governance frameworks. Around half of the institutions identified the tone from the top and promulgation of corporate culture and values. WGGF surveys and work in the CMCG indicate that many firms also emphasize incentives as playing an important role. Having a clear organisational or governance structure with clearly articulated responsibilities was also referenced as important by several banks. One example mentioned by a firm is a policy framework (deviation from which can constitute grounds for disciplinary actions, including termination) and audit sections that review such policies.

A sample of select responses follows:

- Clear organisational structure, clear responsibilities and accountabilities, “robust” decision making (adequate challenge)
- Tone from the top, standards and policies, compensation and other relevant employment practices
- Accountability and senior management oversight, three lines of defence
- Operational risk management, internal controls, compliance guidelines
- Separation of functions in decision making, collegial decision making, three lines of defence
- Code of conduct, discipline committee, three lines of defence
- Embedding values in recruitment, training, performance management; three lines of defence; and clear responsibilities defined for committees, with some overlap so conduct is not neglected.

### **Insurers**

The responses from the insurance sector identifying the top features of a well-functioning governance framework that aid in preventing misconduct, firms indicated a broad spectrum of elements:

- Board composition to reflect diversity in nationality, ethnicity, education, expertise, gender, age, and experience.
- The three lines of defence model, which represents a coordinated identification and assessment of controls, quality assurance in the first and second lines of defence, non-duplicative targeted second line of defence testing, and an independent internal audit function are central to effective risk management and compliance assurance.
- Transparency to support informed decision-making that reflects clear insight into risks and their mitigants.
- Fostering long-term relationships with shareholders and other stakeholders and promoting trust help the board and management gain useful feedback on a variety of topics, including

corporate governance, corporate social responsibility, strategy, performance, and related matters.

- Policies, standards, guidance, and procedures that outline the roles and responsibilities within the company, and ensure consistent performance across the firm
- Committee structure and tone from the top
- Information management (data to identify, measure, and report on market conduct risks), timely escalation processes, and reporting lines that encourage escalation to decision makers in a manner that rewards and does not inhibit reporting of issues and compliance with a code of conduct.
- A path for quick resolution including communication and assignment of authority for execution and closure.
- Set of corporate values.

### **Investment firms**

All surveyed investment firms mentioned the essential role of internal policies to ensure effective and efficient performance of business activities, avoidance / management of conflicts of interests and good conduct by employees.

Some investment firms pointed out the importance of:

- Defining operational mechanisms consistent with the strategies and purposes of the firms;
- Developing appropriate escalation processes in order to ensure that all internal anonymous reporting is investigated and escalated at an appropriate level of the firm's governance structure;
- Ensuring an appropriate level of business automation, to minimise opportunities for misconduct;
- Employing incentive systems that take into account the employee's level of compliance with internal rules and appropriate reputational risk management systems.

Other top features commonly mentioned by the investment firms are: (i) the tone from the top and promulgation of corporate culture and values, including the implementation of codes of ethics and training initiatives and the development of risk culture; (ii) the internal controls and timely information flows as a means to detect misconduct and apply corrective measures; and (iii) a clear organisational and governance structure, setting a clear definition of internal bodies' and personnel's functions and responsibilities, including clear reporting lines.

One firm noted that its mechanism to efficiently cascade information is the Chief Executive Officer's monthly cascade, which reinforces key messages, such as customer focus and corporate values.

## **E. Non-financial incentives**

### **Banks**

Most of the banks claim they have developed clear guidelines on the impact that negative behaviour should have on the compensation of an employee. Appraisal and promotion processes are referenced to by around two-thirds of the institutions, and the impacts of sanctions / disciplinary processes are mentioned by a few institutions. For example, one firm provides a list of the situations in which clawbacks will be triggered.

Many banks consider conduct in making performance evaluations. At many banks, employees' performance is increasingly evaluated on the basis of "what" the employee achieved as well as "how" the employee achieved it, including, in some cases, through explicit ratings of behaviour. At one bank, this is achieved through a matrix, one axis of which shows the "what" and the other the "how." The how is the governance mechanism by which the firm assesses whether objectives are achieved in a manner consistent with the firm's conduct standards and/or might harm the firm's customers or the firm itself. It specifically considers 10 standard behaviours such as whether an employee takes on an attitude of ownership and responsibility. Another firm focuses specifically on the conduct of managers and considers conduct a key element in determining promotion for managerial roles. Similarly, one bank described how managing director candidates are assessed for their contributions to culture and adherence to expectations of conduct, as well as the ability of control functions to review candidates and raise concerns about candidates' behaviours with respect to conduct. One bank indicated that it looks at customer satisfaction, workforce diversity, and stakeholder engagement as some of the conduct-related factors used in performance evaluation.

In terms of responding to negative behaviours, one respondent described its global "consequences management policy," which is designed to ensure that conduct issues and violations of conduct standards are handled consistently across the firm,

### **Insurers**

In terms of non-financial incentives, the insurance sector observed that the use of disciplinary actions could help deter misconduct and incentives could encourage good conduct. In terms of incentives, insurance firms have implemented:

- Recognition programs;
- Appraisal processes or promotions;
- Motivation policies (official recognition of merits by awarding diplomas, badges); and
- Programs to involve employees in management (staff opportunities to make proposals for the solution of various problems and delegations of authority).

One firm described an accountability performance plan aimed at competence, incentives, and elimination. The accountability performance plan includes four parts: goal setting, performance review and coach, performance evaluation and feedback, and application of evaluation results. The programme entails each employee with his/her direct supervisor setting his/her own performance goal with periodic targets, expectations and actions; a performance evaluation on a regular basis with each

supervisor evaluating and giving guidance for improvement with the result that good performance provides more access to resources and the contrary leading to elimination.

### **Investment firms**

The most cited incentive by the surveyed investment firms is the conducting of performance assessments (including against qualitative factors such as competences, customer satisfaction, and adherence to corporate values) and application of penalties in cases of misconduct.

One investment firm mentioned “public recognition” as a non-financial incentive adopted to reward employees with client-oriented behaviours.

Another firm mentioned that the remuneration policy applied to certain staff is governed by stringent regulatory regimes with defined remuneration provisions.

## **F. Quantitative metrics**

### **Banks**

Around half of the banking institutions confirmed their use of conduct-related quantitative metrics, While a number of firms reported that they have already begun to use “dashboards” to track a series of conduct-related indicators, a few banks stated they were still in the process of developing quantitative conduct risk metrics. Firms also described qualitative monitoring practices such as transaction surveillance and surveillance of electronic and voice communications.

Metrics identified by respondents include: operational loss-related metrics; the number of cases of market abuse; customer or client complaints; control breaches; missed training; late completion of tasks; travel and expense-related matters; exception-based trades; delinquent compliance training reports; internal frauds; number of regulatory actions against the firm; number of civil or labour claims against the firm; number of reimbursements and cancellations due to complaints about sales practices; costs and expenses derived from litigations in civil actions; gift and entertainment policy exceptions; cancelled and correct/error tickets; policy breaches; personal account and trading reviews; number of ombudsman cases; the number of employees who have completed ethics; and other external statistics (such as external-party rankings on employee satisfaction), and statistics generated by employee surveys, including surveys focused specifically on culture and organisational climate.

Several types of ratios are also used by respondents, including: fraud-related losses / net income; operational losses / gross margin; complaints / number of accounts; percent of complaints decided in favour of customer; high risk customers / total number of accounts; value of investment products sold / high risk customers; and fines as percentage of income.

Banks may trigger reviews and responses based on tolerance levels set for the various metrics.

### **Insurers**

While insurance firms did not provide responses with common quantitative metrics regarding conduct risk, a few firms do have policies that address conduct risk with a quantitative factor. For example, one firm noted that all losses above a certain threshold are reported to a board risk committee and all

significant employee terminations for misconduct are reported to an audit committee on a quarterly basis. Another firm framed its treatment of misconduct risk as having zero tolerance for:

- Exploitation of policyholders in terms of price and policy charges,
- Exploitation of policyholders in terms of policy wordings, exclusions and policy terms and conditions,
- Investment practices that will result in guaranteed returns not being met,
- Poor and negligent advice,
- Unregistered agents and agents not fit and proper to sell financial products, and
- Deliberately misleading marketing material.

Most insurers noted that the risk appetite statement of firms typically includes regulatory and compliance requirements. While these insurers provided no specific metrics to address conduct risk, they used their operational metrics to monitor breaches, reputation damage, or financial loss and limits. Some examples of qualitative statements are as follows:

- One firm relies on five principles to support its risk appetite statement involving (i) regulatory capital (no appetite for regulatory non-compliance and thus holds sufficient capital); (ii) financial strength (ensure the ability to meet future commitments to customers); (iii) liquidity (sufficient to meet expected financial commitments); (iv) earnings volatility (deliver reported operating earnings consistent with expectations and implement policies, limits and controls risks within reasonable tolerances); and (v) business practice (uphold high ethical standards).
- Another firm's policy provides that officers and employees are expected to act with integrity and in the best interest of customers, shareholders and other stakeholders, and to demonstrate the highest ethical standards of conduct at all times. The firm aims for full compliance with legal, regulatory and compliance requirements but accepts that the risk of non-compliance with these requirements cannot be completely eliminated; the firm seeks to avoid business practices, products, and activities which present unacceptable reputational risk.
- At another insurer, conduct risk does not constitute an individual risk of the insurer's policies and standards but is incorporated into a high level operational risk appetite statement through diverse categories (*e.g.*, financial crime, people management, social and environmental responsibility, external communications, third party management, business continuity, operations processes, *etc.*)

### **Investment firms**

Most of the surveyed firms that provided details on their risk appetite statement seemed to employ more qualitative than quantitative metrics in their RAS, such as compliance with regulation, acting with prudence and understanding the reputation risk inherent in the conduct.

An example of conduct qualitative statements employed by an investment firm covers a range of outcomes, such as: (i) complaints resolved fairly, promptly and appropriately; (ii) managing transactions in the best interest of customers; and (iii) a product behaving and performing as expected.

One firm uses a range of quarterly indicators as quantitative metrics related to conduct risk, such as average value of compensation paid on events to investment funds/clients and number of complaints received. Additional quantitative measures are: (i) “fair hearing”, timely handling, restitution and remediation and theme investigation; (ii) best execution and timely execution metrics for transactions; and (iii) performance, fund size and ability to meet flows.

## **G. Misconduct Events**

### **Banks**

#### *Nature of events*

- Most firms indicated that the majority of incidents have been cases of individual fraud, "rogue" misconduct or non-compliant behaviours by staff in bank branches. Some firms refer also to sanctions from regulatory authorities. Market manipulation and mis-selling and events related to the adequacy of disclosure, conflicts of interest, confidential information, and adequacy of due diligence were also referenced by several firms

#### *Root causes*

- All the banks indicate they have identified the root causes of the misconduct events. It was not clear from the discussions, however, that this analysis went beyond identifying what happened and why, particularly in terms of structural factors, the misconduct occurred.
- Almost all the institutions refer to inadequate systems, supervision and controls (with different patterns) and/or weaknesses in the governance of the institution (e.g. lack of tone from the top) or in its risk culture.

#### *Detection through the governance frameworks*

- Most of the cases were identified through the governance framework. However, some firms indicate some of the cases were detected by regulators and through clients or counterparties, including through lawsuits by customers.
- The firms provided the following ways that incidents were detected internally:
  - On-going surveillance, for instance through legal and compliance programs, risk and compliance investigations, performed by the Risk, Compliance, Audit and/or HR functions;
  - Escalation by employees (including whistleblowers).

#### *Lessons learnt*

- A majority of institutions indicate that the misconduct case triggered the need for strengthening their governance (including tone from the top) and controls.
- The importance of training and awareness surrounding escalation and the need to raise awareness of compliance and compliance issues.

- The need for clear guidelines on potential conflicts of interests together with adequate escalation processes.
- A few firms indicate that complex IT architecture and data systems are a significant challenge for establishing effective controls to monitor conduct.

### ***Remedial actions***

- Enhancement of the governance of the institution and strengthening of the control and policy framework are mentioned by a majority of institutions.
- Adjustments in the incentive framework have also been introduced.
- Firms have also examined their relationships with and responsibilities towards clients, reviewed training and professional development programs, and looked at conflicts of interest practices, among other remedial actions taken.

### **Insurers**

In the insurance sector, firms observed that the major root causes of misconduct are primarily related to dishonesty, poor judgement, personal gain (e.g. enhanced stature or finances), gaps or inefficiencies in controls, bad faith behaviour, inadequate policies and procedures, operational burden, process design, insufficient supervision monitoring, inefficiencies of compensation payments, lack of knowledge, and inconsistencies in complaints management. In most cases, a firm's governance framework (internal audit or supervision) and clients' complaints were important to detecting misconduct. In addition, it was highlighted that sometimes a root cause for misconduct could relate to the industry and not to a particular company.

### ***Lessons Learnt***

Reflecting upon the global financial crisis, insurance firms summarised lessons learnt as follows:

- To have a clear scope of responsibility and accountability among the local business units and Group's functions.
- An effective software support platform should not provide opportunity for data manipulation.
- It is impossible to stop all dishonest conduct. From there, firms stressed the importance of periodic reviews and reinforcing the duty to act ethically.
- The most effective way to avoid these offences is fines, exceeding the benefits from misconduct.
- Lack of training leads to unintentional misconduct.
- Increasing the level of financial literacy of the customer.
- Constant enhancement of internal control and management mechanisms.
- The need of a centralised uniform approach to aspects relating to market conduct.
- Training simplification to instil employee understanding and enhance employee awareness.

### ***Remedial actions***

While remedial actions were taken to prevent reoccurrence of such events. The nature of these actions have to do with review of policies and strengthening of controls, risk prevention systems and quality processes, training and disciplinary actions.

### **Investment firms**

One investment firm reported deficiencies in its internal controls system and lack of supervision (mostly due to operational errors), detected in the course of regulatory audit. The main root cause was that the policies applicable at that time were not effective. The internal controls and reporting systems have been consequently revised to ensure more effective compliance risk management. The senior management and board members' involvement in and awareness of compliance/misconduct risk mitigation have been raised.

Another firm mentioned a case of manipulation of client records within an emerging market jurisdiction. The principle root cause was staff fraud, detected via identification of a non-standard operating process by a new senior hire and a subsequent internal enquiry. The relevant staff left the company and the operating controls have been enhanced. They concluded that staff should be fully aware that oversights would occur from time to time and that zero tolerance is applied for deliberate wrongdoing or unethical behaviour.

## **H. Policies and Procedures to monitor and minimise misconduct**

### **Banks**

The firms note that there are many policy initiatives that articulate expected behaviours. Each firm highlighted a range of policies, usually fewer than 10, designed to actively manage conduct risk issues, either directly or indirectly. All banks refer to their statements of mission / culture / values and a code of conduct. All of the firms refer to their remuneration policies. Two-thirds of them reference new product approval processes. One-third of firms highlighted their specific firm-wide escalation policies, which define the issues that should be escalated, establish individual responsibilities for escalating issues, and describe appropriate escalation channels. Some firms also mention that whistleblower policies are an important part of a program to deter misconduct. Around one-third of firms refer to their Global Conflicts Policies (in one case this is part of a discussion of annual certifications) and training (including of Board members) is mentioned by around two-thirds of the institutions. Many firms indicate that they use video and online training modules to communicate their expectations with respect to employee conduct.

In general, companies have issued policies that largely cover the areas that might be impacted by the conduct of individuals when performing their corresponding activities and these policies determine the rules, limits and scope of action of the staff. In addition to the policies noted above, the most common policies mentioned are: Code of Conduct, Corporate governance best practices / code, Compensation Policy, Anti-Corruption Policy, Anti-Fraud Policy, AML/FT policy, Data Privacy Compliance Policy, Sanctions Policy, Whistleblowing Policy, Customer Complaint Resolution and Management Policy, Conflicts of Interest Policy, Customer Risk Policy, Fit & Proper, Internal

Control Policy, Risk management policy/ Procedure on operational risks, Rules for market manipulation prevention, and Market Abuse / Trading / Insider Information Policy

Examples:

- For the past three years, one firm has implemented a policy to assign responsibility for misconduct risk to the regional business management, providing those businesses with management information on employee conduct, client outcomes, and market integrity to assist them in their monitoring of misconduct risk. The businesses are then expected to monitor common conduct risks across all businesses within the region. Conduct risk has been added to the annual risk assessment process and the firm has decided to undertake thematic reviews in a number of areas (e.g., strategy, performance management, whistleblowing cases) to identify emerging misconduct risks. Performance evaluations and ratings now include reference to the firm's code of ethics and other standards of behaviour, and compensation is linked not only to delivery of business targets but also to demonstrating behaviour consistent with firm standards.
- One firm has established a process by which the compensation committee will review the compensation of any individual who has been involved in a material incident, regardless of whether the individual is a material risk taker.
- One firm reported that it seeks to address misconduct risk by defining expectations, encouraging the right behaviour, and controlling risk. The bank seeks to define expectations through "tone from the top" and a commitment to individual accountability throughout the organization. It pursues the right behaviour through its hiring practices by providing training, and by employing both carrots and sticks to incentivize employees.
- One firm reported that it ensures that a line manager is involved whenever certain financial products are sold to elderly customers, and where appropriate that the customers "legal successor" is aware of the transaction.
- One firm conducts reviews of its compliance risk culture, which looks not only at adherence to the code of conduct, but also considers employees' approaches to the range of relevant policies and principles. It says, too that it looks not only at whether employees comply with the letter of the law, but also its spirit.
- One bank recently developed an accountability review process to be used to review the context that permitted a misconduct event to occur, looking at all individuals "potentially proximate" to the incident and at management oversight of the relevant systems and controls.
- One bank requires twelve mandatory training sessions for all employees, which include Internal Controls and Compliance, Information Security, Prevention of Money Laundering and Financing of Terrorism, Escalation processes, Anti-Corruption and Ethics. One firm has developed case studies with scenarios related to misconduct.
- Some firms mentioned the importance of whistleblower programs. Examples of steps taken to improve whistleblower programs include: engagement of an external consultant to review the program, appointing someone to head the program, ensuring that all employees are aware of a program, outsourcing the initial handling of whistleblower reporting.

## **Insurers**

In the insurance sector, monitoring and review processes are seen as essential to effective risk management. Surveyed firms noted that monitoring and review processes need to take place periodically and that audit and risk committees need to have the proper tools to monitor and enhance policies and take remedial actions. One firm mentioned that monitoring programmes are an important element of building a strong culture of compliance.

Monitoring and review procedures among insurers include:

- Internal controls reporting;
- Assessment of controls against defined risk criteria;
- Internal audit, which performs an annual independent assessment of the overall effectiveness of the governance and risk and control frameworks of the organisation, and of compensation practices.
- Closed-loop management through a compliance review and assessment along with certain operational risk management tools (*e.g.*, a self-assessment of risk control, an indicator of key risks, and collecting loss data.
- Other monitoring tools include:
  - Annual employee certification of compliance with a code, including the obligation to report observed misconduct.
  - Dissemination by top management of lessons that can be learned from the activities of other companies when applicable.
  - A help line provided by an independent third party for employees to report instances of alleged misconduct.
  - Corporate investigation units to root out fraud.

## **Investment firms**

All investment firms referenced the proper setting, implementation and monitoring of internal policies documenting the expected conduct and requirements. All firms also noted the setting of internal policies and codes to set expectations for conduct and avoid/manage conflicts of interest.

Control procedures and compensation schemes fit to deter misconduct have also reported.

One investment firm specified that its approach is to build strategies around the clients' interests and develop risk culture to mitigate conduct risk, also through appropriate staff incentives and risk adjusted remuneration.

Another firm looked to embed oversight / review in their Committee structure (for example, risk culture metrics are presented to the Culture Committee), business processes (for example, Human Resources Exit interviews) and Management Information reporting (for example, through the firm's Risk Management system). In addition, all policies are reviewed at least semi-annually and significant changes are escalated to the Risk Management Committee or Board for approval, as appropriate.

## **I. Ensuring that governance frameworks are effective both at group and subsidiary levels**

### **Banks**

All participating firms operate based upon firm-wide governance frameworks, which need however to take into account the specificities of each national legislation in which the bank operates. Most of the firms identified a role for subsidiary boards in ensuring that global governance frameworks are effective locally. Several firms indicated that subsidiaries and their local boards are expected to adapt the global framework to comply with local requirements as needed, while one firm stated that the board is not “a relevant governance level” when it comes to an affiliate’s activities.

Several firms have developed specific mechanisms to ensure a consistent control framework across the group:

- Cascading-down of the group governance, policies, escalation processes at local level.
- Comply-or-explain approach at entity level with regards to the group corporate governance policy to be implemented in the bank

As an example, one institution, explained that its governance framework also requires all subsidiary control functions to report to the corresponding head office functional office. This ensures independent oversight and integrates those functions globally to relevant parent board level committees. The head office approves the key risk limits and risk policies of material operating subsidiaries; reviews regular risk reporting by each subsidiary, including adherence to their risk appetite metrics; reviews and approves the subsidiaries’ enterprise risk management framework, which details each subsidiary’s risk governance structure; and adjudicates all material risk transactions.

### **Insurers**

Most insurance firms responded that they have established mechanisms to ensure effectiveness of governance frameworks at a group level and their subsidiaries. Some examples from insurers include:

- Group-wide, the risk and compliance functions report directly or indirectly to the chief risk officer of the group, and risk and compliance personnel report up through their respective control function.
- The global compliance chief and the compliance senior leadership team frequently visit the firm in various jurisdictions.
- Corporate governance manuals establish the governance processes to be followed by material subsidiaries. In addition, the compliance group assesses the subsidiary businesses to ensure they comply with the relevant policies, and internal audit provides further assurance that suitable controls are in place.
- The group is responsible for managing and overseeing the headquarters and helps subsidiaries to implement management expectations. However, subsidiaries are responsible for their own management in line with the principles. When reporting management matters to their own senior management, subsidiaries are also expected to report to the group.

- Documented business systems outline decision making authorities and limits. Teams from audit, compliance, and risk functions for each business or corporate centre (with input from legal and ethics functions) complete an annual review of the risk and control environments in each group and report to the group's CEO and global leaders.

### **Investment firms**

Five out of the six responding investment firms belong to a wider group. All firms reported that their governance framework is consistently set at group level and subsidiaries' approaches share common features, although each firm is required to comply with local applicable regulations.

One firm noted that the principle it follows is to apply the more stringent policy when facing different laws or expectations locally versus globally.

Another firm indicated that the same persons are present on the boards of various group companies, to encourage common approaches and strategies.

One firm noted that its Group operates a central governance framework that applies to all of its integrated subsidiaries. Regional or specific subsidiary arrangements complement the group framework where necessary to meet requirements of local regulation or custom. This framework is designed to assist the Boards in discharging their duties by providing a simple structure for the oversight, challenge and delegation of authority and responsibilities across the Group. The key elements of the framework are the central Board, Subsidiary Boards, Committees, Risk appetite, Policies and Delegated Authorities.

## **Annex C: Stocktake of efforts by international bodies to strengthen governance frameworks to mitigate misconduct risk**

### **Background**

The following international bodies were surveyed:

- Financial Stability Board (FSB)
- International standard-setting bodies (SSBs):
  - Basel Committee on Banking Supervision (BCBS)
  - International Association of Insurance Supervisors (IAIS)
  - International Organisation of Securities Commissions (IOSCO)
- International financial institutions
  - International Monetary Fund (IMF)
  - Organisation for Economic Co-operation and Development (OECD)
  - World Bank
- Other international bodies
  - Senior Supervisors Group (SSG)
  - Supervisors Roundtable on Governance Effectiveness

The survey to international bodies covered the following areas:

1. The international body's **general mission/purpose** in exploring how governance frameworks can incentivise good conduct and deter misconduct.
2. The extent to which **policy documents** related to governance frameworks to mitigate misconduct risk have been issued.
3. The **workstreams** that have been established by the various international bodies, with a focus on whether surveys have been issued and papers published.
4. The **governance topics** covered in their various workstreams
5. The **definitions** for 'misconduct', 'governance' or 'governance frameworks' used by international bodies.
6. Any **future plans** related to governance frameworks to mitigate misconduct risk.

### **Key findings from the stocktake**

While all international bodies surveyed have a general mission to promote effective governance, the degree to which they focus explicitly on mitigating misconduct risk (or promoting good conduct) varies. For instance, most international bodies have workstreams devoted, in part, to addressing how governance frameworks can be used to decrease various forms of risk. Some of these workstreams are devoted to analysing misconduct risk, while others explore governance and conduct broadly and address a number of risk factors, including misconduct risk. Of note, the FSB, IAIS, IOSCO, and

OECD have workstreams that focus explicitly on strengthening governance frameworks. A summary of the deliverables for these workstreams is set forth below.

Date	Deliverable
Mar 2017	<ul style="list-style-type: none"> <li>FSB will publish its peer review on corporate governance, which is taking stock of implementation of certain G20/OECD Principles in the financial sector</li> </ul>
May 2017	IOSCO Market Conduct Task Force (MCTF) will publish a final report that will include a regulatory toolkit
Before the 7-8 Jul Summit	FSB will publish: <ul style="list-style-type: none"> <li>a progress report on measures to reduce misconduct risk</li> <li>a consultative document on guidance to supplement the FSB principles and standards on compensation</li> </ul>
Early 2018	IAIS will issue an Application Paper on group corporate governance and control function

Most international bodies have issued policy documents relating to the use of governance frameworks to reduce misconduct risk, but the assessment of their implementation is only conducted in some instances and how such assessments are conducted vary. For example, the FSB has a programme of peer reviews across its membership; the IAIS develops application papers; the OECD conducts thematic reviews on certain aspects of their principles for a subset of OECD members; and the IMF-World Bank Financial Sector Assessment Program (FSAP) assesses implementation of the BCBS Core Principles for Effective Banking Supervision (BCPs),<sup>12</sup> the IAIS Insurance Core Principles (ICPs),<sup>13</sup> and the IOSCO Objectives and Principles of Securities Regulation<sup>14</sup> (IOSCO Principles). As part of the Report on the Observance of Standards and Codes (ROSC) initiative, the World Bank has assessed implementation of the G20/OECD Principles of Corporate Governance (G20/OECD Principles)<sup>15</sup> in a number of emerging market jurisdictions. In some cases, international bodies have held roundtables with national authorities and representatives from financial institutions to assess progress towards implementation of relevant principles and standards.

<sup>12</sup> See BCBS, *Core Principles for Effective Banking Supervision*, September 2012 (<http://www.bis.org/publ/bcbs230.pdf>).

<sup>13</sup> See IAIS, *Insurance Core Principles*, November 2015 (<http://www.iaisweb.org/page/supervisory-material/insurance-core-principles/file/58067/insurance-core-principles-updated-november-2015>).

<sup>14</sup> See IOSCO, *Objectives and Principles of Securities Regulation*, June 2010 (<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>).

<sup>15</sup> See OECD, *G20/OECD Principles of Corporate Governance*, September 2015 (<http://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf>).

The stocktake found that a number of governance topics relevant to the WGGF's work are covered in the various policy documents issued by international bodies. Of the eleven governance topics listed in the survey, three of the most prominently covered areas include:

- *Risk governance in firms*, including themes such as risk appetite and risk culture, has been an area of focus for international bodies since the financial crisis and is a common theme featured in their work. Taking forward the recommendations set out in the FSB thematic review on risk governance,<sup>16</sup> the FSB issued principles for an effective risk appetite framework<sup>17</sup> and guidance for supervisors to assess the risk culture at financial institutions.<sup>18</sup> While these papers are focused on managing risks more generally, the paper on risk appetite highlights that an institution's risk appetite statement should also address more difficult to quantify risks such as reputation and conduct risks as well as money laundering and unethical practices, while the paper on risk culture notes that employees in all parts of the institution should be expected to conduct business in a legal and ethical manner.
- Additionally, one of the primary objectives of the revisions to the BCBS *Guidelines for Corporate Governance Principles for Banks*<sup>19</sup> (BCBS Guidelines) was to explicitly reinforce the collective oversight and risk governance responsibilities of the board. According to the BCBS Guidelines, board members and senior management are expected *inter alia* to define conduct risk based upon the bank's business model, its activities, products and services. Another important objective was to emphasise key components of risk governance such as risk culture, risk appetite and their relationship to a bank's risk capacity. Similarly, the IAIS also strengthened its core principles; ICP 8 notes that an effective risk management system typically includes, among other elements, a clearly defined risk appetite that takes into account the insurer's overall business strategy and its business activities (including any business activities which have been outsourced).
- "*Tone from the top*", which is often covered in the context of the role of the board and senior management as an indicator of a sound risk management practice. It sometimes also features as a stand-alone outcome with specific details on how the board and senior management can deliver the appropriate "tone from the top." The importance of "tone from the top" is highlighted in the FSB guidance on risk culture, the FSB thematic review on risk governance, the BCBS Guidelines for banks, ICP 7, and the G20/OECD Principles.
- *Role of the board of directors*, which is an area covered in detail by the work of international organisations although the link to mitigating misconduct risk is not always explicit. Most notably, the G20/OECD Principles have a dedicated chapter on the responsibilities of the board (Chapter 6). The BCBS Guidelines build on the G20/OECD

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<sup>16</sup> See FSB, *Thematic Review on Risk Governance*, February 2013 ([http://www.fsb.org/2013/02/r\\_130212/](http://www.fsb.org/2013/02/r_130212/)).

<sup>17</sup> See FSB, *Principles for an Effective Risk Appetite Framework*, November 2013 ([http://www.fsb.org/2013/11/r\\_131118/](http://www.fsb.org/2013/11/r_131118/)).

<sup>18</sup> See FSB, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture*, April 2014 (<http://www.fsb.org/2014/04/140407/>).

<sup>19</sup> See BCBS, *Guidelines: Corporate governance principles for banks*, July 2015 (<http://www.bis.org/bcbs/publ/d328.pdf>).

Principles and set out the board’s overall responsibilities for banks, including approving and overseeing management’s implementation of a bank’s strategic objectives, governance framework, corporate culture and values. In the insurance sector, ICP 7 provides supervisory requirements for the board to set and oversee the implementation of an insurer’s corporate culture, business objectives and strategies for achieving those objectives, in line with the insurer’s long-term interests and viability.

While the work of international bodies covers a wide range of governance topics, there are some areas that, to date, have received less coverage. For instance, accountability and responsibility of the most senior individuals in firms for both their own actions and the actions of those that they oversee appear to be areas where there has been less coverage. Likewise, metrics used to track misconduct (or incentivise good conduct) and employee training, and enforcement practices (outside the securities sector) have received less coverage relative to other governance topics.

In addition to better understanding the degree to which the work of international bodies addresses specific governance topics, the survey aimed to understand how the terms “governance,” “governance frameworks” and “misconduct” are defined by international bodies. While international bodies have not adopted common definitions for these terms, some illustrative approaches to exploring how these terms have been used are:

- The FSB Compensation Monitoring Contact Group (CMCG) explored how banks define misconduct. While banks recognise a hierarchy of misconduct events that range from minor to severe, there is no standard broadly adopted definition of misconduct.
- The BCBS Guidelines have no explicit definition of “misconduct,” but look to the board and senior management of a bank to define conduct risk based on the context of the bank’s business and to oversee and manage codes of conduct. Supervisors are expected to evaluate whether the bank has in place effective mechanisms through which the board and senior management execute their respective oversight responsibilities, including misconduct risk.

## **Conclusions**

Since the global financial crisis, international bodies have undertaken a variety of work related to governance, including issuing policy documents. This work has sought to raise supervisory and regulatory expectations for financial institutions to strengthen their governance frameworks. Although not all of this work is specifically focused on mitigating misconduct risk, improving the effectiveness of governance frameworks at financial institutions may, by extension, support the development of an environment that promotes good behaviour and enables the identification of misconduct.

Overall, international bodies’ work on governance frameworks is relatively thorough and, importantly, some of the forthcoming policy documents may be highly relevant to the connection between governance frameworks and misconduct risk. However, there are some areas that, to date, have received less coverage by international bodies. These include:

- International bodies take different approaches to assessing the implementation of their policy documents and, in some cases, an implementation assessment does not occur. For example, the FSB has a programme of peer reviews across its membership, the IAIS develops application papers; the OECD conducts thematic reviews on certain aspects of their principles for jurisdictions that participate in the OECD Corporate Governance Committee, and the IMF-World Bank FSAP assesses implementation of the BCPs, ICPs, and IOSCO Principles. The effectiveness and scope of various approaches to implementation assessments could be analysed.
- Specific governance topics that have received less coverage than other topics include individual accountability and responsibility (including issues relating to group structures, such as the relationship between a financial services provider and any holding company arrangements); whether international frameworks capture groups on a group-wide basis, including unregulated entities; and metrics used to track misconduct (or incentivise good conduct) and employee training. Outside the securities sector, approaches to enforcement have also received relatively less coverage.
- Few definitions for “governance,” “governance frameworks” or “misconduct” have been developed by international bodies; therefore, there may be lack of uniformity in how those foundational concepts are applied across international bodies.

## **Annex D: Stocktake of efforts by industry associations to strengthen governance frameworks to mitigate misconduct risk**

### **1. Key observations**

Forty-two industry associations received the survey, of which 30 completed the survey, including nine associations that indicated they are not conducting any relevant work on strengthening governance frameworks to mitigate misconduct risk.<sup>20</sup> Of the 21 associations that completed the survey and indicated they are undertaking relevant work, most did not answer all questions. Section 10 lists the industry associations surveyed.

Some of the key observations from the responses include:

1. *Efforts to mitigate misconduct risk:* Efforts by industry associations to strengthen governance frameworks to mitigate misconduct risk are largely through the issuance of codes, standards or guidance related to ethics, conduct or sound practices, but assessments of their implementation are not a general practice.
2. *Definitions:* Nine associations provided a definition for at least one of the terms ‘governance framework’, ‘conduct’ and ‘misconduct’. While there was no common view on the definition for ‘governance framework’ or ‘misconduct’, definitions for ‘conduct’ related to behaviour exhibited by personnel within financial services firms that could directly cause problems to consumer protection, market integrity and/or competition.
3. *Information gathering:* Few industry associations have undertaken surveys or information gathering exercises in relation to addressing misconduct risk through governance frameworks.
4. *Approaches and strategies:* Several industry associations promote market efficiency, integrity and professionalism, as well as financial education. Some hold roundtables with industry members on regulatory requirements and are actively involved in staff training. Staff members of industry associations also conduct speaking engagements on conduct and culture that addressing member firms as well as public conferences on these subjects. Many associations interact with regulators through regular meetings as well as by hosting issue-specific roundtables and responding to consultation papers issued by regulators.
5. *Impact assessments:* No industry association that responded to the survey indicated it had undertaken any quantitative or qualitative assessment to ascertain the impact of misconduct. A few submissions noted that the majority of their members would have performed the assessment as part of their risk assessment process.
6. *Top 3 issues that would benefit from international guidance:* Some of the most commonly noted topics include: harmonisation of general principles/ standards around conduct risk; awareness and education about misconduct risk; fit and proper regimes

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<sup>20</sup> The International Council of Securities Associations and Property Casualty Insurers Association voluntarily completed the survey after receiving it from their trade association.

and certification requirements; individual accountability regimes and responsibility matrices; and information and data transparency.

7. *Root cause analysis*: Some of the common root causes identified by industry associations include (i) inappropriate incentives that rewarded the firm and individual at the expense of clients, which is often referred to as mis-selling; (ii) inadequate governance frameworks, including a lack of control of business activity, lack of appropriate procedures and of effective oversight of adherence to those procedures, and ineffective accountability arrangements. (iii) fraudulent and criminal activity; (iv) a lack of training and awareness of conduct policies; (v) inadequate product design to address customer needs; and (vi) external factors such as increased financial performance pressures.

## **2. Efforts to mitigate misconduct risk**

Most of the 21 industry associations that indicated they have conducted or are conducting relevant work on strengthening governance frameworks to mitigate misconduct risk do so through the issuance/adoption of codes, guidelines, recommendations related to ethics, conduct or sound practices. Many of the associations have also established committees to explore governance issues. Three organisations work in order to support the efforts of regulators and the industry to improve culture and conduct (including legislative and regulatory developments). One association also mentioned engagement with members and policy makers in order to promote fiduciary culture and compliance as well as acting in the best interest of fund investors. A few associations mentioned the use of education, the imposition of penalties, roundtables with public and private sectors, and the establishment of ombudsman services. One association mentioned supervision of its members as a key factor.

## **3. Definitions and top three features of a governance framework**

### ***Definitions***

Only nine industry associations provided a definition for at least one of the terms “governance framework”, “conduct” and “misconduct”, with very few definitions provided for “governance framework”.

- *Governance framework*: One association highlighted that the key purpose of the governance framework is to ensure appropriate oversight (including independent challenge where necessary) of the firm’s activities. Another association has issued a governance framework composed of nine elements: Shared Purpose, Honesty, Respect, Openness, Accountability, Competence, Reliability, responsiveness and Resilience.
- *Conduct*: Definitions generally referred to the behaviour exhibited by personnel within financial services firms that could directly cause problems to customer protection, market integrity and/or competition.
- *Misconduct*: Definitions for ‘misconduct’ were commingled with ‘conduct risk’ which was seen as the risk of inappropriate, unethical or unlawful behaviour on the

part of a firm's management or employees. According to responses, such conduct can be caused by deliberate actions or may be inadvertent and caused by inadequacies in an organisation's practices, frameworks or education programs. A few associations associated 'misconduct' with the compliance with laws and regulations.

### ***Top three features of a governance framework***

Twelve industry associations identified features of a governance framework that are most important, which covered a wide range of areas. Several associations underscored the importance of the three lines of defence – highlighting the importance of having a sound risk management process (first line of defence), with clear roles, responsibilities and reporting structures, as well as the need for increasing individual accountability, and ensuring that there are effective second and third lines of oversight and challenge. Compliance with policies, standards, and codes were seen as an important feature of an effective governance framework. Another feature mentioned was people management, including training, financial and non-financial incentives. Other features mentioned were the promulgation of corporate culture and values (e.g. tone from the top, risk culture and whistle blowing mechanisms), restrictions on personal investing activities, and fiduciary responsibilities, including transparency in how firms should deal with their clients and provide them with better solutions in line with their expectations.

## **4. Surveys/information gathering**

Only eight industry associations responded directly to this question. Of those responses, no organisations had specifically conducted a survey or gathered information relating to addressing misconduct risks through governance frameworks although some responses referenced related work. International trade associations (whose members are trade associations) tend to be more active than jurisdictional firm membership organisations.

Two cross-jurisdictional organisations referenced a survey of culture and conduct. A further cross-jurisdictional body has surveyed members on top current and emerging conduct risks. The other respondents referenced more tangential work or general interaction with members. This work includes reviews of initiatives that touch on conduct, including on codes and the implementation of legislation, other related publications, and discussions with members.

However, two associations explained that they have projects underway focused on reviewing instances of misconduct and their causes. These associations are at too early a stage to report findings.

Themes from responses most relevant to conduct and governance frameworks included:

- Responses tend to highlight the importance of management and other internal control functions to ensure good conduct. "Tone from the top" is a recurring phrase in the responses submitted.
- Findings from the UK Fair and Effective Markets Review (FEMR).
- Some responses indicated that work on conduct issues could reduce volumes of new legislation with another specifically taking a position against further regulatory

developments in this area. These responses suggested the preference for further work to be undertaken via trade bodies and not within the formal regulatory space.

## **5. Approaches, strategies and interaction with national and firms' initiatives**

Sixteen industry associations provided a response on their approach and strategy to discouraging misconduct at firms through governance frameworks. Some responses represented the views of its members rather than a consensus or average view from the association itself. Some associations rely on national authorities' rules while others, especially those that encompass regulation in their mandate, issue codes of self-regulation and codes of conduct. The most common approach taken by responding associations to address misconduct is by educating their members and promoting market efficiency, integrity and professionalism. Many of these associations stated that they are actively involved in staff training, financial education, and public speaking on conduct and culture.

Committees and working groups have been established by some associations to monitor and review national and international initiatives and to periodically review and update their own codes of conduct. A few associations review market conventions and processes and establish committees to remedy inappropriate behaviours.

Many associations reported that they regularly interact with regulators, and will have bilateral meetings, hold roundtables on specific issues, and respond to consultation papers issued by regulators. They explained that maintaining close contact with supervisory and regulatory authorities helps to ensure that the association and its members correctly interpret their rules and recommendations aimed at mitigating misconduct risk. Industry associations generally align their initiatives with those of regulators through the establishment of a joint agenda.

## **6. Top three issues**

Only six industry associations provided a response to this question. According to those responses, the most common issues / themes noted that would benefit from improved international standards or guidance include: (i) harmonisation of general principles/standards around conduct risk; (ii) awareness and education about misconduct; (iii) fit and proper regimes and certification requirements; (iv) individual accountability regimes and responsibilities matrices; and (v) information and data transparency.

Three organisations noted the need for greater harmonisation on high level principles around conduct risk. International consensus on general principles as well as understanding the differences between local and global standards was an area cited that would benefit from international guidance. As well, it was indicated that regulators should recognise that the common risks in all financial sectors (insurers, banks and capital markets) cannot be addressed in the same way across sectors.

Improving awareness and education was referenced by a several organisations as another area that would benefit from enhanced guidance. Having clear and explicit industry wide codes of conduct and norms of acceptable practice would, in their view, result in customers having more trust and a more favourable perception of firms.

Fit and proper regimes and certification requirements, as well as individual accountability regimes and responsibility matrices were themes that were raised by several associations. One association indicated that an industry level fit and proper regime and an associated blacklist to prevent “rolling bad apples” would best be run by regulators, as opposed to industry, because regulators have the necessary authority to require disclosure of this information and are typically better resourced to implement and monitor the regime. With respect to accountability regimes, one association noted that while the need for highly prescriptive individual accountability regimes has not been established in every jurisdiction, and may not be appropriate for all countries, clearly articulating responsibilities for certain roles and ensuring these responsibilities are acknowledged and measured, could facilitate appropriate selection, training and competence of staff.

Guidance on information and data transparency, in particular, the qualitative assessment over conduct risk metrics, was an area highlighted by a few associations that would benefit from enhanced international guidance.

## **7. Quantitative and qualitative assessments**

No responding industry association reported having undertaking any quantitative or qualitative assessment to ascertain the impact of misconduct. A few submissions noted that the majority of their members would have performed the assessment as part of their risk assessment process.

## **8. Root cause analysis**

Six industry associations provided views on root causes for recent misconduct events. Although there was a wide range of root causes cited, there are some common themes that can be drawn despite the cross-sectoral and cross-border representation of the industry associations. For instance, associations referenced inappropriate incentives that rewarded the firm and individual at the expense of clients, which is often referred to as mis-selling. They also cited inadequate governance frameworks, including a lack of control of business activity, lack of appropriate procedures and of effective oversight of adherence to those procedures, and ineffective accountability arrangements. Fraudulent and criminal activity was also identified as a root cause due to failure to comply with relevant law and rules governing market behaviour. Associations also noted a lack of training and awareness of conduct policies. Misconduct was also attributed to inadequacy of product design to address customer needs and external factors such as increased financial performance pressures.

At a global level, several associations observed that the consequences of misconduct events have triggered substantial changes to governance frameworks within their member firms. Some of these changes include:

- More attention given to conduct risk and culture by the board and executive management.
- Appointment of individuals to key roles that are directly accountable to regulators.
- Mechanisms to encourage staff to “speak up” including whistleblowing programs.
- Additional training and compliance programs focusing on ethics and conduct.

- Changes to remuneration structures to better align with risk-taking.
- Simplification of products in order to make them more understandable.
- Changes in the reporting and escalation framework such as introduction of different internal awareness schemes for reporting conduct risk; escalation procedures for high risk compensation schemes; and good conduct included within performance measurements.

The most notable root cause analysis has been conducted under the FEMR. The FEMR sets out an analysis of a number of the root causes of recent misconduct in fixed income, currency and commodities markets (FICC), and found that:

- Market structures presented opportunities for abuse;
- Standards of acceptable market practices were poorly understood or adhered to and short on detail;
- Systems of internal governance and control placed greater reliance on second and third lines of defence than on the first and failed to identify emerging vulnerabilities or ensure that conduct lessons learned were universally applied;
- Limited reinforcement of standards through bilateral market discipline; and
- Remuneration and incentive schemes stressed short-term returns over longer-term value enhancement and good conduct.

These findings resulted in the establishment of the FMSB, which is addressing a number of these factors, including standards of practice, market collective understanding and learning and emerging vulnerabilities.

## **9. Conclusions**

Given the relatively small amount of information industry associations provided in their responses to the survey, it is difficult to determine how active they are in strengthening governance frameworks of firms to mitigate misconduct risk. From the information received, it would appear that they are not particularly active on this issue. Of those industry associations that have been active in this area, the survey responses suggest that their work may have been in reaction to policies issued by the official sector rather than self-initiated efforts. Given the brevity of many industry associations' responses, the WGGF's observations regarding industry associations should not be considered conclusive.

## **10. Industry associations that responded to the survey**

- |  |   |
|--|---|
| 1. American Bankers Association                | 16. Geneva Association                          |
| 2. American Counsel of Life Insurers           | 17. German Insurance Association                |
| 3. Association for Financial Markets in Europe | 18. Global Federation of Insurance Associations |
| 4. Association of British Insurers             | 19. Institute of International Finance          |
| 5. Australian Financial Markets Association    | 20. Insurance Bureau of Canada                  |

6. Banking Standards Board
7. Brazilian Association of Financial Markets Institutions
8. Brazilian Federation of Banks
9. British Bankers Association
10. Canadian Banker Association
11. Canadian Life & Health Insurance Association
12. Chief Compliance Officers' Forum
13. Deutsches Aktieninstitut (DAI)
14. European Banking Federation
15. FICC Markets Standards Board
21. Insurance Council of Australia
22. International Capital Market Association
23. International Council of Securities Association
24. Investment Association
25. Investment Company Institute
26. Investment Industry Association of Canada
27. Japanese Bankers Association
28. Property Casualty Insurers Association
29. Spanish Banking Association
30. The Clearing House

## **Annex E: Key observations from the literature and scientific review of root cause analyses**

### **Introduction**

In recent years, misconduct in financial markets has revealed deficiencies in governance frameworks, as evidenced by their failure to identify and prevent emerging vulnerabilities to misconduct. In order to help better understand these weaknesses, the WGGF Workstream 5 (WS5) studied a variety of literature that analysed the root causes of misconduct at both financial and non-financial sector firms (see Section 1). The objective of this research was to gain a better understanding of the underlying factors that led to misconduct in these cases.

The next objective of our stocktake was to explore scientific insights about the effectiveness of various approaches to prevent and/or mitigate the risks of misconduct. Section 2 summarizes and gives an overview of relevant meta-analyses, dominant research streams and well-evidenced constructs evidencing the impact of rules-based approaches, enforcement and culture-based approaches on individual and organizational behaviour (in the context of misconduct). This overview is given from the perspective of various social sciences. These reviews complement the various stocktakes by international bodies, national authorities, industry associations, and firms.

### **1. Literature review**

#### **1.1 Background**

WS5 reviewed 12 public reports, each of which considers a significant case of misconduct or organisational failure and its root causes. The complete list of reports reviewed can be found at the end of this paper. The cases are drawn from some of the most well-known instances of misconduct and organisational failure in recent history, and represent a diverse set of issues at financial and non-financial firms across multiple jurisdictions. They include cases such as the Challenger disaster, the Volkswagen emissions scandal, and the review of Barclays' business practices following its high-profile role in the LIBOR-manipulation scandal. The review identifies common characteristics regarding leadership, decision-making process, and in governance frameworks.

#### **1.2 Key observations drawn from the literature review**

The literature review identified the following structural and behavioural factors associated with misconduct:

- **Pressures:** All of the studied institutions were subject to pressures, generated by either external forces (e.g. market circumstances) or internal forces (e.g. deteriorating capital/liquidity positions, large debts, or an overly ambitious growth strategy).
- **Leadership:** Pressures found their way into the organisation, usually starting with the board and senior management. Such pressures influenced leadership styles and tone from the top (the messages conveyed and the behaviour displayed), as well as the strategy set by and the decisions taken by the board. For example, in many instances

boards and senior management prioritised profit and growth over risk management and ethics. Dominant leadership and group dynamics discouraged dissenting opinions and constructive challenge, both of which are necessary to foster high-quality decisions. Finally, inappropriate behaviour, or behaviour inconsistent with stated policies and values, was condoned or came to be seen as normal.

- Culture: Leadership, board behaviour, and decision-making in turn influenced the organisational culture, and hence the behaviour of employees within the firm. The workstream members identified organisational mind-sets that were determined by an eagerness for growth and profit at the expense of safety, compliance, ethical values, or long-term sustainability. Employees in most cases perceived few opportunities to freely speak up or escalate (ethical) concerns.
- Governance Frameworks: governance frameworks were significant factors as well. For example, in many instances roles and responsibilities were unclear, escalation channels were weak, the mind-set for profit and growth was reinforced through financial incentives, and control functions were insufficiently strong or independent. Finally, in some cases where risk management functions were adequate, they were overruled by senior management.

One of the key observations drawn from the literature was the relationship between structure and culture. While it is usually assumed that organisational structure influences behaviour, the literature provided some evidence that structural design often resulted from the board and senior management's mind-sets. For example, managers focused solely on profit and growth may direct the organisation in a manner that supports that goal, giving risk management a weak or unclear mandate. In short, if the entire organisation is determined to grow above all else, the position of risk management may be weakened or its contributions overruled.

These observations may have implications for the effectiveness of responses by firms aimed at preventing or mitigating the risks of misconduct. The second aspect of WS5's work was to study scientific literature regarding the effectiveness of various approaches and to collect best practices (see Section 2).

### **1.3 Behavioural and structural factors of governance frameworks**

The literature described a number of behavioural and structural factors that contributed to governance deficiencies and raised the probability of misconduct in the organisation. The workstream grouped these factors into several broad categories: internal and external pressure, leadership, decision-making, and governance frameworks. Three of these reflect the underlying theme of culture.<sup>21</sup> These factors are elaborated in the table below. The discussion that follows further explains these factors.

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<sup>21</sup> The behavioural and structural factors that were found, are to a certain extent similar to the elements mentioned in the FSB paper on risk culture. However, the paper does not contain all of the pieces of the puzzle. At this point in time, we focussed on extracting the various root causes and did not link it to any regulatory framework. (See FSB, Guidance on supervisory interaction with a financial institution on risk culture, April 2014 (<http://www.fsb.org/wp-content/uploads/140407.pdf>)).

<b>Circumstances</b>	<b>Categories</b>		
<b>A. Pressure:</b> <ul style="list-style-type: none"> <li>• From outside (market) forces</li> <li>• Self-imposed / internal pressures</li> </ul>	<b>B. Leadership</b>	<b>C. Decision-making</b>	<b>D. Governance frameworks</b>
	<b>Tone from the top:</b> <ul style="list-style-type: none"> <li>• Leadership style</li> <li>• Group dynamics</li> <li>• Reflecting espoused values</li> <li>• Ensuring common understanding and awareness of risk</li> <li>• Learning from past experiences</li> </ul>	<b>Communication and challenges</b> <ul style="list-style-type: none"> <li>• Decision-making process</li> <li>• Biases and thinking failures</li> <li>• Assumptions and normalisation of deviance</li> <li>• Quality of challenge</li> </ul>	<ul style="list-style-type: none"> <li>• Accountability</li> <li>• Organisational structure</li> <li>• Information systems</li> <li>• System of regulation/supervision</li> <li>• Incentives</li> <li>• Escalation procedures</li> </ul>
	<b>E. Culture</b> <ul style="list-style-type: none"> <li>• Mindset and habits (board, senior management, organisation)</li> <li>• Openness to speaking up</li> </ul>		

**A. Pressure**

Analyses of the literature indicate that in almost every case there was some kind of pressure on the organisation. This pressure may have resulted from outside (market) forces, but could also have been the consequence of self-imposed (internal) pressure, such as an ambitious growth strategy. This pattern is evident in both the financial and non-financial sectors. For example, reviewed cases include a governmental organisation that faced external pressure to show results in order to maintain political support for its mission, a for-profit multinational energy company that faced intense market competition, and another case where an organisation was under significant pressure to improve lead times and meet budget requirements. In many cases involving financial institutions, ambitious growth strategies contributed to misconduct.

**B. Leadership (tone from the top)**

As mentioned in the FSB-paper on risk culture<sup>22</sup>, tone from the top is a strong indicator of ethical organisational behaviour. That paper defines it as follows:

*“The board and senior management are the starting point for setting the financial institution's core values and expectations for the risk culture of the institution and their behaviour must reflect the values being espoused. A key value that should be espoused is the expectation that staff act with integrity (doing the right thing) and promptly*

<sup>22</sup> See FSB, *Guidance on supervisory interaction with a financial institution on risk culture*, April 2014.

*escalate observed non-compliance within or outside the organisation (no surprises approach).”*

The literature reviewed illustrates that the mind-set and behaviour of the board and senior management influence the organisational culture and the behaviour of employees within firms. In most of the misconduct cases studied by the workstream, board and senior management gave priority to growth and profit over risk management and ethics, thereby giving a clear message to the employees of what is valued (and what is not). It is striking that in most of the cases, the board was not sufficiently concerned with risk, did not take warnings seriously, and did not learn from past experiences.

The root cause analyses also indicate that dominant leadership style is a common feature of the organisations that suffer from instances of misconduct. This management approach often goes hand in hand with: (i) an attitude of prioritising growth and (short term) financial success over safety or integrity, and (ii) the absence of challenge among the board of directors.

### **C. Decision-making (communication and challenge)**

Poor decision making is also a recurring finding from the analyses; in particular, in many cases the board of directors (and often also the senior management or employees across the organisation) were overconfident and/or failed to accept their own fallibilities. Another theme identified in some of the cases was flawed group dynamics within organisational leadership, such as: (i) an executive team that included strong leaders but was not cohesive, (ii) a group board that was very large and had little relevant experience or (iii) the hierarchical culture where subordinates quietly defer to their immediate supervisors. These patterns discouraged others speaking up and often meant that if they did speak up, they would be ignored, leading to weak decisions unsupported by multiple perspectives.

Many of the root cause analyses indicate a lack of challenge at board level. As mentioned above, this may be caused by CEO-dominance or defective group dynamical patterns within the board (strain for consensus or overconfidence). Significantly, in most of the cases, decision-making was dominated by the business, creating a focus on growth and profit and leaving other perspectives out. This lack of diversity hampered constructive debate.

Furthermore, a lack of challenge may have also been caused by the fact that the board and senior management did not have all the information that was needed for a thorough decision-making process. For example, in many cases risk management and internal audit functions did not (or were not in a position to) provide sufficient checks and balances on (and hence challenge) senior management or the board. In some other cases, important information was available, but was ignored or not taken seriously by the board or senior management. For instance, (i) risk management was overruled by the business; (ii) control functions focused solely on checking whether a proposed action complied by applicable rules, without exploring wider implication; or (iii) information was suppressed and the board claimed plausible deniability<sup>23</sup>.

A final factor that may determine the quality of constructive challenge, as demonstrated by the root cause study, is the normalisation of deviance. This concept may be explained by the following quote:

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<sup>23</sup> Plausible deniability means the willing blindness of top management for wrongdoing within the organisation.

*“Social normalisation of deviance means that people within the organisation become so much accustomed to a deviation that they don’t consider it as deviant, despite the fact that they far exceed their own rules for elementary safety”.*<sup>24</sup>

For instance, in one case, management accepted certain flaws as an unavoidable and acceptable risk. Since those flaws had not resulted in failure in the past, management determined that the flaws did not pose a meaningful risk. The cases illustrated several other signals that an organisation might be affected by a normalisation of deviance, including: (i) a firm’s perception that the way it dealt with issues was similar to the industry, (ii) another firm’s acceptance of near misses as normal (causing them not to learn), and (iii) a board’s failure to challenge management assurances that, for example, the firm’s issues were industry issues or were known to the regulators. While such assurances may have been given in good faith, they did not always turn out to be a reasonable basis for not taking more urgent action. This would seem to be the case with respect to PPI mis-selling, which, although both an industry problem and known to regulators, seems to have taken too long to be fully confronted.

A last finding relates to the interaction between supervisors and regulators on the one hand and entities on the other. In some of the cases, deregulation – which was sometimes made the urgings of industries and/or even individual undertakings – contributed to practices which in the end proved important causes for failure. For instance, Enron succeeded in convincing the SEC to a new ruling allowing Enron to book as current profits the expected stream of future earnings over the life of a contract. Enron’s abuse of this rule necessitated other fraudulent practices which in the end resulted in its collapse.

#### **D. Governance frameworks**

In all but one of the financial institution cases that were reviewed, there was a growth mindset, a focus on cost savings and prioritisation of profits that were reinforced by financial incentives. Short-term success contributed to higher pay, larger bonuses, and long-term incentive plans for senior executives and others who were responsible for generating high returns. Each case involved: (i) inappropriate incentives (rewards based upon revenue), (ii) minimal attention to risk factors in setting compensation, and (iii) a CEO remuneration package focused on revenue, profit, and earnings per share rather than balance sheet risks.

In both financial and non-financial institutions, recurring themes were: (i) poor escalation channels and (ii) insufficient (independent) controls. In most of the cases reviewed, there were weak risk management, compliance, or audit functions. Other red flags included: (i) risk management functions that were unable to measure the risk of complex products that few people understood, (ii) poor oversight of operational risk, (iii) a fragmented approach to operational risks, (iv) insufficiently forward-looking risk management frameworks, information, and reporting systems, and (v) weak safety programs.

Notably, in one case, a bank had sophisticated policies and metrics in place to estimate risk as well as a large, experienced risk management staff with well-organised procedures. Nonetheless, these factors did not prevent risk control functions from being overruled. Instead,

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<sup>24</sup> Vaughan, D. (1996) *The Challenger Launch Decision*. University of Chicago Press, Chicago Illinois.

management relied on its business experience, knowledge of the various markets, and its successful track record when making strategic decisions.

## **E. Culture**

In both the financial and non-financial cases reviewed, a variety of cultural aspects were an important determinant for the occurrence of misconduct or industry hazards. In some cases the culture was limited to the organisation, but in others it was the culture of the industry as a whole.

Culture can be defined as follows: “organisational culture represents the collective values, beliefs and principles of organisational members and is a product of such factors as history, product, market, technology, strategy, type of employees, management style, and national culture: culture includes the organisation’s vision, values, norms, systems, symbols, language, assumptions beliefs and habits”.<sup>25</sup>

According to the literature, important expressions of culture are for example the perception of the balance between reward and risk, the relevance of risk (management) and ethical considerations, the importance of remuneration/bonuses and the opportunities for employees to freely speak up. Mindset and common assumptions at various levels within the organisation influence leadership, decision-making and the design of governance frameworks, which in turn influence the way that employees and management think and behave. In this respect it is important to note that structural and cultural factors mutually influence each other. The literature shows that over time, they tend to blend together into a common culture, which may reinforce or weaken certain behavioural patterns. Changing culture requires changing the underlying mindset, assumptions and convictions of people, which may in turn change behaviour at several levels within the organisation.

Mindset and culture are also reflected in attitudes towards integrity, safety or ethical values. On many occasions the organisations reviewed focused on growth, cost savings, promotion of the business practices or profits and suffered from a lack of transparency and lack of openness. Consequently, employees were typically afraid to speak up, reluctant to pass on bad news and unwilling to raise their hand when they see inappropriate or unsafe behaviour or misconduct.

## **2. Scientific review**

### **2.1 Background**

The above literature review addresses a variety of structural and behavioural factors associated with misconduct. But it does not consider the type of approaches available to prevent or mitigate the risk of misconduct. In order to answer this question, we reviewed over fifty relevant scientific research papers – from both legal and psychological literatures – that contain well-established scientific concepts regarding such approaches. This review summarizes the knowledge contained in these works in order to explore means of preventing misconduct.

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<sup>25</sup> Needle, D., *Business in Context: An introduction to Business and its Environment*, 2004.

## 2.2 Key observations drawn from the scientific review

Drawing from the scientific literature, we identified several approaches to preventing misconduct, which can be broadly grouped into three categories: (i) rules-based approaches, which focus on preventing, detecting, and punishing violations of legal requirements; (ii) deterrence-based approaches, which aim to incentivise compliant behaviour and/or disincentivise illegal activity by enhancing and advertising the adverse consequences of aberrant behaviour for individuals and organizations; and iii) values/culture based approaches, which aim to *encourage* good conduct by fostering shared values and assumptions regarding desirable behaviour.

Our research observes that an effective approach for preventing misconduct combines rules- and deterrence-based approaches with a values/culture-based approach. Further, rules- and deterrence-based approaches face limitations with regard to effectively mitigating misconduct if they do not also consider organisational values and other cultural aspects. This does not mean that rules and deterrence are ineffective, just that on their own, the literature shows, they may be insufficient. Instead, their effectiveness in addressing misconduct can be reinforced through complementary approaches, which focus on culture and employee behaviour. This may be because:

- It is impossible to design rules that give guidance in all relevant situations;
- Rules are generally aimed at outcomes instead of behaviours;
- Regulatory measures may be effective in addressing problems posed by bad apples in an organisation, but be considerably less effective at addressing the well-meaning majority of employees;
- Effective deterrence depends on many conditions that are generally difficult to satisfy;
- Rules-based approaches and deterrence often have counterproductive effects, in the sense that they foster resentment, resistance, and calculating behaviour.

Culture-based approaches may ameliorate some of these challenges by addressing the underlying drivers of employee behaviour. Organisational culture is the collectiveness of beliefs that drive and guide individual and group behaviour. Culture-based approaches focus on changing these underlying collective beliefs and norms. Open, honest, and constructive dialogues throughout an organisation are a prerequisite for such change. In addition, leadership, decision-making and adequate reward structures are needed to encourage proper behaviour. Finally, it is important that employees feel safe to report bad news and incidents. The literature shows that mutual trust and an organisational attitude that encourages learning from mistakes (instead of punishment and blame) are crucial ingredients in creating “psychological safety.” All these factors are relevant to preventing misconduct.

### 2.2.1 *Rules-based approach*

A rules-based approach (legal approach) focuses primarily on preventing, detecting, and punishing violations of the law. The scientific literature indicates that this approach may sufficiently reduce misconduct in organisations for several reasons.

First, the effectiveness of rules may be restricted by the fact that it is extremely difficult to define clear and robust rules that apply to every situation in which misconduct could occur.

Bardach and Kagan explain that standardised rules are often not suited to the diversity, complexity, and fluidity of the real world.<sup>26</sup> In addition, their research indicates that uniform regulatory requirements can be perceived as unreasonable because the standard procedures do not make sense in some situations. For example, specified procedures may lead people under pressure to follow the rules when judgment is needed to respond to challenges unforeseen by the rule writers.<sup>27</sup>

Moreover, research on enforcement policy and corporate misconduct indicate that most rules-based approaches focus on defining unacceptable outcomes and holding organisations responsible for misconduct once it has happened, instead of describing what sorts of affirmative behaviours are expected to prevent such outcomes. Bardach and Kagan further explain that rules are often aimed at the smaller group of offenders, thereby neglecting the fact that the majority voluntarily complies. For this majority of good apples, however, such rules may often appear to be “unreasonable.”<sup>28</sup>

### 2.2.2 Deterrence

Deterrence approaches are often part of rules-based orientations aimed at mitigating and addressing misconduct. For instance, in the report ‘*Credible Deterrence In The Enforcement Of Securities Regulation*’ from June 2015,<sup>29</sup> IOSCO describes how a successful, credible deterrence strategy can modify behaviour and reduce securities law violations, which in turn increases investor protection and fosters fair and efficient markets.

The scientific review suggests that the effectiveness of deterrence depends on the extent to which certain influencing factors are present and that deterrence may lead to several counterproductive effects. Figure 1 includes an overview of these influencing factors and counterproductive effects, which are elaborated below.

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<sup>26</sup> Bardach, E. & Kagan, R.A. (1982). *Going by the book. The problem of regulatory unreasonableness*. Philadelphia: Temple University Press.

<sup>27</sup> Griffin, M.A., Cordery, J., Soo, C. (2015) Dynamic safety capability: How organisations proactively change core safety systems. *Organisational Psychology Review*. 1-25.

<sup>28</sup> Bardach, E. & Kagan,<sup>28</sup> Trevino, L.K., Weaver, G.R., Gibson, D.G. & Toffler, B.L, (1999). “Managing Ethics and Legal Compliance – What works and what hurts”, *California Management Review*, 41, 2, 131-151.

<sup>28</sup> Deterrence is included in the discussion of rules-based approaches because it often is a relevant part of it.

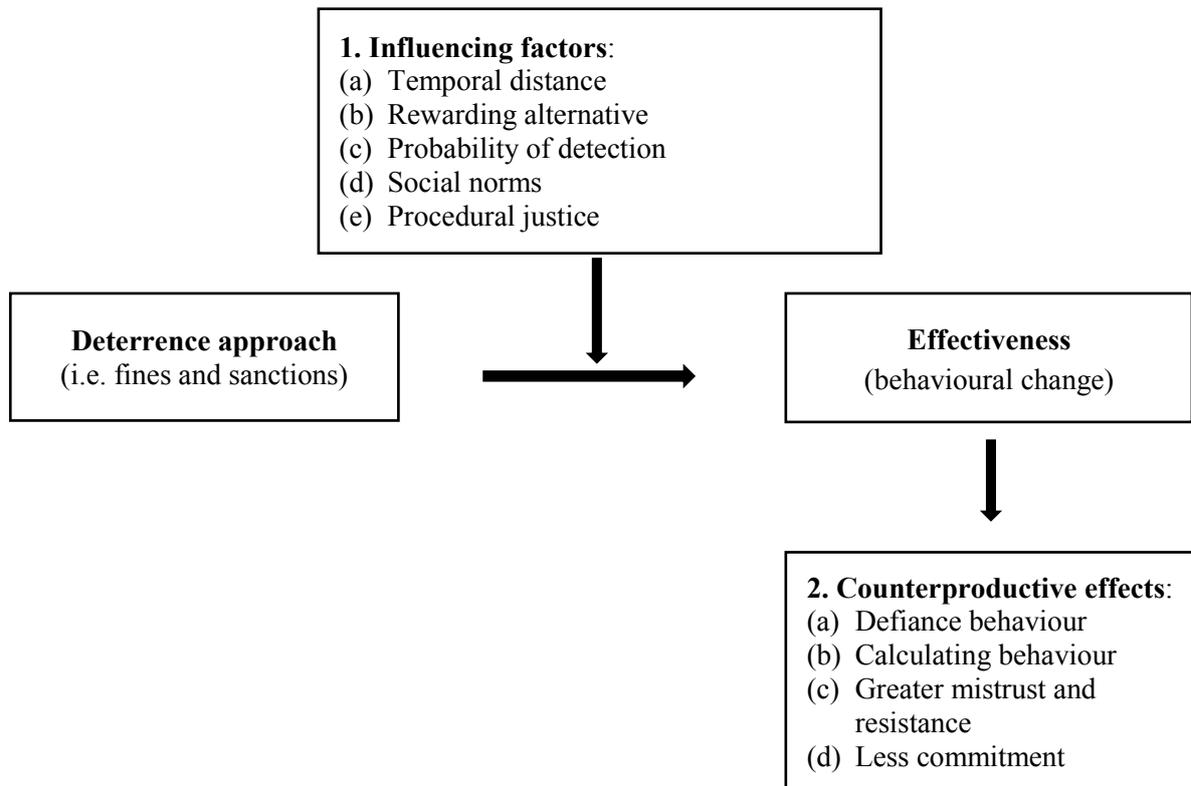
<sup>28</sup> Bardach, E. & Kagan, R.A. (1982). *Going by the book. The problem of regulatory unreasonableness*. Philadelphia: Temple University Press.

<sup>28</sup> Griffin, M.A., Cordery, J., Soo, C. (2015) Dynamic safety capability: How organisations proactively change core safety systems. *Organisational Psychology Review*. 1-25.

<sup>28</sup> See WS5 Literature review on root causes of misconduct. R.A. (1982). *Going by the book. The problem of regulatory unreasonableness*. Philadelphia: Temple University Press.

<sup>29</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD490.pdf>

**Figure 1: Overview of effectiveness deterrence approaches**



### 1. *Influencing factors*

According to the literature, punishment does have more influence than reward in the short term. However, research also shows that in the long run the effectiveness of punishment may be rather small because it depends upon several conditions, which are often difficult to satisfy.<sup>30</sup>

#### (a) *Temporal distance*

The shorter the time between an offending behaviour and its punishment, the more effective the penalty will be in deterring similar behaviours in the future. According to Paternoster, people find it difficult to imagine and consider the pain of long-term consequences. “The empirical evidence does support the belief that criminal offenders are rational actors,” he explains, “in that they are responsive to the incentives and disincentives associated with their actions, but that the criminal justice system, because of its delayed imposition of punishment, is not well constructed to exploit this rationality.”<sup>31,32</sup> In most cases, the time between an offense and the penalty is quite substantial. The investigation process is often complex and time-consuming. For instance, it took years between the offense and penalty in the London Interbank Offer Rate

<sup>30</sup> Tyler T.R. (2014) Reducing corporate criminality: the role of values. *American Criminal Law Review*, 267 – 291.

<sup>31</sup> See also Akerlof, G.A and Shiller R.J. (2009), *Animal Spirits*, Princeton.

<sup>32</sup> Pasternoster, R. (2010). How much do we really know about criminal deterrence? *The Journal of Criminal law & Criminology* Vol. 100. No. 3, 765 – 824.

(LIBOR) cases. The literature suggests that this reduces the likelihood that the penalty serves as an effective deterrent.

***(b) Rewarding alternative behaviour***

Research by Van der Pligt, Koomen, and Van Harreveld shows that the effectiveness of punishment significantly increases when alternative acceptable behaviour is rewarded simultaneously.<sup>33</sup> For instance, if openness and teamwork are rewarded at the same time.

***(c) Probability of detection & size of the penalties***

A study by Nagin and Pasternoster indicates that the probability of detection deters illegal behaviour.<sup>34</sup> At the same time, Scholtz suggests that the size of punishment does not seem to matter. These findings are aligned with a Canadian survey study, which shows that harsher penalties will not deter people from evading tax.<sup>35</sup>

***(d) Procedural justice***

The perception of fairness and distributive justice are important determinants of compliance behaviour. The concept implies that an individual is willing to accept a certain decision when it perceives the process through which the decision was made as fair.<sup>36</sup> Research indicates that the perception of fair treatment and due process enhances compliance even when considerable costs are imposed.<sup>37</sup> Consequently, it is unlikely that decisions that are perceived as unfair will enhance compliance. Moreover, research indicates that employees' perceptions of how rewards are distributed are even more important than their perceptions of the distribution of punishment (that violators are detected and punished).<sup>38</sup>

***(e) Social norms***

The results of a meta-analysis on punishment conducted by Dölling, Horst, Hermann, and Rupp show that not all criminal acts can be influenced by deterrence.<sup>39</sup> It appears that the most significant deterrent effects can be achieved in cases of minor crime, administrative offenses, and infringements of informal social norms. The study concludes that the relevance and acceptance of a norm appears to be an important condition for the effectiveness of deterrence.

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<sup>33</sup> Van der Pligt, J., Koomen, W., & Van Harreveld, F. (2007) *Bestrafen, belonen en beïnvloeden. Een gedragswetenschappelijk perspectief op handhaving*. Amsterdam, The Netherlands, Boom Juridische Uitgevers

<sup>34</sup> Nagin, D.S. & Paternoster, R. (1991). The preventive effects of the perceived risk of arrest. *Criminology*, 29, 561-585.

<sup>35</sup> Varma, K.N. & Doob, A.N. (1998). Deterring economic crimes: The case of tax evasion. *Canadian Journal of Criminology*, 40, 165 -184.

<sup>36</sup> Murphy, K. and Tyler, T. (2008) Procedural justice and compliance behaviour: the mediating role of emotions. *European Journal of Social Psychology*. 38, 652–66

<sup>37</sup> Reason, J. (2006) Human error: model and management. *BMJ.com*. 768 – 769.

<sup>38</sup> Trevino, L.K., Weaver, G.R., Gibson, D.G.& Toffler, B.L, (1999). “Managing Ethics and Legal Compliance – What works and what hurts”, *California Management Review*, 41,2, 131-151.

<sup>39</sup> Dölling, D., Horst, E., Hermann, D. & Rupp, T. (2009) Is Deterrence Effective? Results of a Meta-Analysis of Punishment. *The European Journal on Criminal Policy and Research*, 15, 201 – 224.

These observations are underpinned by scientific evidence demonstrating that social norms play a major role in influencing behaviour. For instance, a field study in a group of day-care centres completed by Gneezy and Rustichini (2000) tested the effectiveness of fines.<sup>40</sup> In this study, the scholars introduced a monetary fine for late-coming parents to collect their children. Unexpectedly, the number of late-coming parents increased significantly. After the fine was removed, no reduction in tardiness occurred. In short, it seems that the introduction of the monetary fine changed the social norm and encouraged a calculative mindset.<sup>41</sup>

## **2. Counterproductive effects**

As mentioned above, research shows that deterrence may have adverse effects. In imposing stringent oversight and control, accountability, and discipline could cause a number of counterproductive consequences, especially in the absence of alternative approaches.

### **(a) Distrust and resistance**

A study by Gunningham and Sinclair of occupational health and safety in the mine industry shows that the use of surveillance is perceived to indicate distrust.<sup>42</sup> This in turn lowers motivation, creating an adversarial relationship, and encouraging resistance. *“By embarking on a force-based strategy, authorities undermine their rapport with the people involved, who come to mistrust and even hate the authorities, to develop oppositional consciousness, and to resist and undermine those authorities. Any hope for cooperation or collaboration is undermined by feelings of distrust and anger and by motives of concealment and misdirection.”*<sup>43</sup>

### **(b) Increasing defiance**

A study by Sherman on ‘defiance’ shows that when a punishment is perceived as unfair, it can lead to unacknowledged shame (which conditions deterrence). At the same time defiant pride may increase future crime. *“Procedural unfairness seems to do far more powerful harm to legitimacy. Personal experience with unfairness, most often in the form of disrespect may be the greatest spark of defiance.”*<sup>44</sup>

### **(c) Calculative behaviour and less commitment**

Other counterproductive effects include an increase in calculating behaviour and decrease of commitment. One of the reasons that the introduction of a monetary fine for lateness increased

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<sup>40</sup> Gneezy, U. & Rustichini, A., (2000). [“A Fine Is a Price”](#), *Journal of Legal Studies*, 1–18.

<sup>41</sup> Lin, C.C. Yang C.C. (2006). Fine enough or don’t fine at all. *Journal of Economic Behavior & Organisation* Vol. 59 195–213. According to this study, there is a unique social norm that prescribes that individuals should be on time and not late. The introduction of a monetary fine for parents who come late is deemed to reduce the psychological cost arising from the violation of the social norm, and this, in turn, erodes the bite or effectiveness of the social norm against delinquency. However, this research indicates that the deterrence effect may dominate the social norm if the fine imposed is relatively large. The main policy implication from their analysis is: “Fine enough or don’t fine at all.”

<sup>42</sup> Gunningham, N. & Sinclair, D. (2009) Organisational Trust and the Limits of Management-Based Regulation *Law & Society Review*, Volume 43, Number 4, 865 – 900.

<sup>43</sup> Tyler T.R. (2014) Reducing corporate criminality: the role of values. *American Criminal Law Review*, 267 – 291.

<sup>44</sup> Sherman L.W. (1993). Defiance, deterrence, and irrelevance: A study of the criminal sanction. *Journal of Research in Crime and Delinquency*, 30, 445 -473.

the number of late-coming parents in the Gneezy and Rustichini (2000) study,<sup>45</sup> is that it changed the social norms and led parents to adopt a more calculating mindset. Further, penalties can decrease commitment, since research shows that when people become motivated primarily by avoiding external punishments, they become less likely to perform the desired behaviour in the absence of these reinforcements.<sup>46</sup>

## 2.3 Culture/values-based approach

In this chapter we will discuss values-based approaches, which aim to encourage proper organisational behaviour. Moreover we will define culture and outline the specific features that help shape it.

Research indicates that a mere rules-based approach, even accompanied by deterrence, may have limited effectiveness if applied in isolation. If such approaches also focused on employee behaviour and culture, better results might be realised. The question is whether literature and practice can offer credible examples of effective measures and programs that include one or more of the above-mentioned elements.

### 2.3.1 Definition and elements of (ethical) culture

There are numerous definitions of organisational culture. In general, it is fair to say there is considerable overlap between them. It can be defined as:

- “the collective story the group tells itself” that “drives the thinking that drives the behaviour”,<sup>47</sup>
- “a pattern of shared basic assumptions that was learned by a group as it solved its problems of external adaptation and internal integration, that has worked well enough to be considered valid and, therefore, to be taught to new members and correct the way to perceive, think and feel in relation to those problems. (...) A product of joint learning”,<sup>48</sup> and,
- “the collective values, beliefs and principles of organisational members and...a product of such factors as history, product, market, technology, strategy, type of

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<sup>45</sup> Gneezy, U. & Rustichini, A., (2000). [“A Fine Is a Price”](#), *Journal of Legal Studies*, 1–18

<sup>46</sup> Tyler T.R. (2014) Reducing corporate criminality: the role of values. *American Criminal Law Review*, 267 – 291.

<sup>47</sup> Jacobs, C.S., *Management Rewired: Why Feedback Doesn’t Work and Other Surprising Lessons from the Latest Brain Science*, New York, 2009, p.193; Heskett, J.L., *The Culture Cycle: how to shape the unseen force that transforms performance*, New Jersey, 2012, p. 22.

<sup>48</sup> Schein, E.H. (1984) Coming to a New Awareness of Organisational Culture. *Sloan Management Review*, 25 (2), 3 -17. In line with Schein, Ravasi and Schultz (2006) wrote that organisational culture a set of shared assumptions that guide what happens in organisations by defining appropriate behavior for various situations (Ravasi, D.; Schultz, M. (2006). *Responding to organisational identity threats: Exploring the role of organisational culture*. *Academy of Management Journal*. 49 (3): 433–458.). It is also the pattern of such collective behaviors and assumptions that are taught to new organisational members as a way of perceiving and, even, thinking and feeling. Thus, organisational culture affects the way people and groups interact with each other, with clients, and with stakeholders. In addition, organisational culture may affect how much employees identify with an organisation (Schrodt, P (2002). *The relationship between organisational identification and organisational culture: Employee perceptions of culture and identification in a retail sales organisation*. *Communication Studies*, 53: 189–202.)

employees, management style, and national culture: culture includes the organisation's vision, values, norms, systems, symbols, language, assumptions beliefs and habits."<sup>49</sup>

In addition, we refer to research by Trevino et al, indicating that an ethical culture is shaped by leadership, reward systems, perceived fairness, ethics as a topic of conversation in the organisation, the importance of speaking up, and an organisational focus that communicates care for employees and the community.<sup>50</sup>

Legitimacy and trust are also important enablers of sound corporate behaviour: "*In work settings, legitimacy refers to the judgement that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms values, beliefs and definitions.*"<sup>51</sup>

Finally, to further determine the nature of culture we refer to the FSB's paper on Risk Culture.<sup>52</sup> In this paper the indicators for a sound risk culture are defined as follows:

- *Tone from the top*: the leadership of the institution promotes, monitors, and assesses the risk culture of the financial institution;
- *Accountability*: Relevant employees at all levels understand the core values of the institution and its approach to risk, are capable of performing their prescribed roles, and are aware that they are held accountable for their actions in relation to the institution's;
- *Effective communication and challenge*: a sound risk culture promotes an environment of open communication and effective challenge in which decision-making processes encourage a range of views, allow for testing of current practices, stimulate a positive, critical attitude among employees and promote an environment of open and constructive engagement; and,
- *Incentives*: performance and talent management encourage and reinforce maintenance of the financial institution's desired risk management behaviour. Financial and nonfinancial incentives support the core values and risk culture at all levels of the institution.

In combination with the relevant cultural factors that were described above in Chapter 2, the above-mentioned definitions result in the following overview of important constituent elements of culture:

- Collective/Shared (basic) assumptions, values, and beliefs (emphasis is made here on *collectiveness*);
- Social norms (the way we do things here and perception of what is acceptable or unacceptable behaviour);

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<sup>49</sup> Needle, D., *Business in Context: An introduction to Business and its Environment*, 2004.

<sup>50</sup> Trevino, L.K., Weaver, G.R., Gibson, D.G.& Toffler, B.L., (1999). "Managing Ethics and Legal Compliance – What works and what hurts", *California Management Review*, 41,2, 131-151.

<sup>51</sup> Tyler T.R. (2014) Reducing corporate criminality: the role of values. *American Criminal Law Review*, 267 – 291.

<sup>52</sup> See FSB, Guidance on supervisory interaction with a financial institution on risk culture, April 2014 (<http://www.fsb.org/wp-content/uploads/140407.pdf>).

- Leadership, decision making, and reward systems;
- The level of legitimacy, trust, and ability to speak up;
- Systems, procedures, and structure; and,
- The congruence and/or alignment between all of the above-mentioned elements.

### 2.3.2 *Comprehensive approach*

Paine suggests that corporations need a ***comprehensive approach*** (that goes beyond the often punitive legal compliance stance) to foster good conduct. The value of a comprehensive approach is also highlighted by Beer. In his model, the probability of success of culture change depends on whether an organisation ***is working simultaneously on changes in the economic model and the organisational mode (which includes culture)***. Beer has pointed out that this approach has more promise than one that addresses these matters sequentially.<sup>53</sup>

Moreover, an effective rules- and values- based approach has a higher chance of creating deeper employee commitment, which is perceived as an important condition for the success of any ethics or culture change program. Trevino et al concluded that the effectiveness of a firm's approach to illegal and unethical behaviour in this respect depends on "*employee perceptions of the program's orientation towards (shared organisational) values and ethical aspirations. What helps the most are consistency between policies and actions as well as dimensions of the organisation's ethical culture such as ethical leadership, fair treatment of employees, and open discussions of ethics in the organisation.*"<sup>54</sup> In line with Pain and Trevino, a code of conduct will have little meaning unless it is tightly linked to the values and other elements of ethical culture.

#### 2.3.2.1 *Elements of a comprehensive approach*

Below is a summary of the most relevant elements of a comprehensive or culture/values-based approach.

##### 1. *Shared basic assumptions, values, and beliefs*

Shared basic assumptions, values, and beliefs are widely-accepted features of culture (and arguably the essential ones). These features drive managerial decisions<sup>55</sup> and management actions, irrespective of whether these they are based on accurate and complete information. It is impossible to act or take decisions without them.

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<sup>53</sup> Beer, M., (2009). *High Commitment, High Performance: How to Build a Resilient Organisation for Sustained Advantage*, San Francisco, 295-325.

<sup>54</sup> Trevino, L.K., Weaver, G.R., Gibson, D.G. & Toffler, B.L., (1999). "Managing Ethics and Legal Compliance – What works and what hurts", *California Management Review*, 41,2, pp. 131-151.

<sup>55</sup> Burke, C.S., Stagl, K.C., Klein, C., Goodwin, G.F., Salas, E. & Halpin, S.M. (2006). What type of leadership behaviors are functional in teams? A meta-analysis. *The Leadership Quarterly*, 17, 288–307; Kozlowski, S.W.J. & Ilgen, D.R. (2006). Enhancing the effectiveness of work groups and teams. *Psychological Science in the Public Interest*, 7, 77-124; Mathieu, J.E., Heffner, T.S., Goodwin, G.F., Cannon-Bowers, J.A. & Salas, E. (2000). The influence of shared mental models on team process and performance. *Journal of Applied Psychology*, 85(2), 273-283; Mohammed, S., Ferzandi, L. & Hamilton, K. (2010). Metaphor No More: A 15-Year Review of the Team Mental Model Construct. *Journal of Management*, 36(4), 876-910.

***Given the above, changing culture requires understanding and changing the underlying shared assumptions, values, and beliefs.***<sup>56</sup> They are “harder to influence, change and “manage” than behaviours. Much of their strength lies in the fact they are relatively timeless in how they are stated. They constitute the bedrock on which changing strategies are based. This view maintains that unless you understand the assumptions underlying values and beliefs, it is difficult to understand what makes culture work, or if it isn’t working, how to change it.”<sup>57</sup>

Open and candid dialogues, including constructive challenge between organisational members, is essential to creating shared understandings about beliefs, norms, and acceptable and unacceptable behaviour. Such debate and challenge forces teams to question implicit norms and behaviours and facilitate and discuss them from various angles. The true aim of dialogue is establishing a “*common position that mirrors the true state of the world.*” Honest and critical dialogue can unmask rationalisations that are used to neglect unethical behaviour. Without such dialogue, this behaviour will not be unearthed and put to the test.<sup>58</sup>

Beliefs may also be influenced through:

- Training;
- Experience;
- Systems for encouraging employee participation that lead people to feel responsible;
- Management behaviour that conveys vivid messages indicating what attitudes and behaviours are important;
- Perceptions on what leaders are doing and saying; and,
- Comprehensive systems of reward and recognition that are targeted at those attitudes and behaviours critical for ethical performance (including hiring and firing).<sup>59</sup>

In the following section we elaborate on the role of leaders in influencing and shaping culture and as well the importance of sound reward systems.

## **2. Social norms**

Numerous studies indicate that social norms are important factors in whether people comply with rules. For instance, Reno and colleagues (1993) show that salient norms, social cues, such as promotion, rewards, and punishment, influence and direct individual behaviour. In addition, the strongest contextual effect on behaviour are the cues conveyed by other people’s respect for norms. Demonstrating people’s responsible behaviour stimulates and validates certain desired action. Generally speaking, individuals tend to be respond to the message that most people like

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<sup>56</sup> Heskett, J.L., *The Culture Cycle: how to shape the unseen force that transforms performance*, New Jersey, 2012, p. 23.

<sup>57</sup> Heskett, J.L., *The Culture Cycle: how to shape the unseen force that transforms performance*, New Jersey, 2012, p. 34-35.

<sup>58</sup> Mooney, A.C., Holahan, P.J. & Amason, A.C. (2007). Don’t take it personally: exploring cognitive conflict as a mediator of affective conflict. *Journal of Management Studies*, 44(5), 733-758; Edwards, B.D., Day, E.A. & Arthur Jr., W. & Bell, S.T (2006). Relationships among team ability composition, team mental models, and team performance, *Journal of Applied Psychology*, 91(3), 727-736; Amason, A.C. (1996). Distinguishing the effects of functional and dysfunctional conflict on strategic decision making: Resolving a paradox for top management teams. *Academy of Management Journal*, 39(1), 123-148; De Dreu, C.K.W. (2006) – When too little or too much hurts: Evidence for a curvilinear relationship between task conflict and innovation in teams. *Journal of Management*, 32, 83-107; Trevino, L.K., Weaver, G.R., Gibson, D.G. & Toffler, B.L, (1999). “Managing Ethics and Legal Compliance – What works and what hurts”, *California Management Review*, 41,2, pp. 131-151.

<sup>59</sup> Bossidy, L., Charan, R. (2009), *Execution: The Discipline of getting things done*, New York, p. 89; Tushman, M.L., O’Reilly III, C.A., (2002), *Winning through Innovation*, Harvard Press, p. 129-154.

them comply with certain rules or display certain behaviours. This is particularly sobering, given that currently, rules-based approaches tend to highlight improper behaviour.

The importance of social context is also highlighted by a meta-analysis of Kish-Gephart, Harrison, and Treviño (2010). This study demonstrates that organisations create different social environments (“barrels”) that can influence individual-level unethical choices, and thereby influence (un)ethical behaviour: “Firms promoting an “everyone for himself” atmosphere (egoistic climates) are more likely to encourage unethical choices. However, the reverse relationship is found where there is a climate that focuses employees’ attention on the well-being of multiple stakeholders, such as employees, customers, and the community (benevolent climate), or on following rules that protect the company and others (principled climate). Likewise, a strong ethical culture that clearly communicates the range of acceptable and unacceptable behaviour (e.g., through leader role-modelling, rewards systems, and informal norms) is associated with fewer unethical decision.”

Finally, as the root cause analysis demonstrated, the normalisation of deviance is an important social cause of misconduct. For example, in a number of the cases considered, management observed small incremental deviations from accepted norms and did not act. Thus, these behaviours became ‘normalised.’ Vaughan called this the ‘normalisation of deviance.’ **“Social normalisation of deviance means that people within the organisation become so much accustomed to a deviation that they don’t consider it as deviant, despite the fact that they far exceed their own rules for the elementary safety.”**<sup>60</sup>

### 3. Leadership

Scientific research shows that leaders are often seen as playing a key role in the management of major accident hazards or misconduct.<sup>61, 62</sup> This is in line with literature on leadership, which states that leaders influence organisational performance directly by making strategic decisions and indirectly by influencing employees (through role modelling, feedback, choices, and the use of rewards and sanctions).<sup>63, 64</sup>

Therefore, the way leaders express their values and motives is an important factor in determining the organisation’s culture, and culture will in turn affect employees’ behaviour and

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<sup>60</sup> Vaughan, D. (1996). *The Challenger Launch Decision. Risky Technology, Culture and Deviance at NASA*, Chicago, IL: University of Chicago Press.

<sup>61</sup> Treviño, L.B., Den Nieuwenboer, N.A., & Kish-Gephart, J.J. (2014). *(Un)Ethical behavior in organisations. Annual Review of Psychology*, 65, 635-660.

<sup>62</sup> Kish-Gephart, J.J., Harrison, D.A., & Treviño, K.L. (2010). *Bad apples, bad cases, and bad barrels: meta-analytic evidence about sources of unethical decisions at work. Journal of Applied Psychology*, 1, 1-31.

<sup>63</sup> Schein, E.H. (2010), *Organisational culture and Leadership* (4th edition), San Francisco.

<sup>64</sup> Hogan, R. & Kaiser, R.B., (2005), *What we know about leadership, Review of General Psychology*, 5, 169-180; Hollander, E.P., (1992), *The essential interdependence of leadership and followership*, *Current directions in Psychological Science*, 1, 71-75; Hogg, M.A., (2010), *A Social Identity Theory of Leadership. Personality and Social Psychology*, 5, 184-200; Hambrick, D.C. & Mason, P.A., (1984), *Upper Echelons: The organisation as a reflection of its top managers*, *The Academy of Management Review*, 9, 193-206.

performance.<sup>65</sup> In addition to the above, a study by Ashforth and Anand<sup>66</sup> indicates that leaders do not have to actually engage in corruption to serve as role models: rewarding, condoning, ignoring, or otherwise facilitating corruption – whether intentionally or not, or explicitly or not – often sends a clear signal to employees. This was also apparent in the root cause analysis, which showed that in cases of organisational failure the tone from the top was directed towards growth, profit, and/or cost reduction to the detriment of ethics or safety.

As indicated above, leaders at every level serve as role models. The study of Trevino and colleagues reveals that in organisations where employees believe that their leaders pay attention to ethical behaviour, ethics is taken more seriously.<sup>67</sup> This results in less unethical/illegal behaviour, higher awareness of ethical/legal issues, and more willingness to deliver bad news to management and to report ethical violations.

According to Sonnenfeld, following good-governance regulatory recipes will not suffice to produce good boards. ***“The key isn’t structural, it’s social. The most involved, diligent, value-adding boards may or may not follow every recommendation in the good-governance handbook.”*** In short, exemplary boards distinguish themselves by being robust effective social systems. An effective board requires a climate of trust and candour, a culture of open dissent, a fluid portfolio of roles, individual accountability, and that an evaluation of the board’s performance.<sup>68</sup>

There are various methods for enforcing individual accountability. Research shows that the tone from the top is especially important. Leaders play a key role as authority figures and role models, and they influence subordinates’ attitudes and behaviours. Moreover, a review of (un)ethical behaviour in organisations concludes: *“Employees are more likely to be unethical in the presence of unethical colleagues, abusive leaders, or unfair treatment, but they are more likely to be ethical when they are led by ethical leaders at multiple levels, feel supported by ethical colleagues, and are fairly treated.”*<sup>69</sup>

#### **4. Decision-making**

Decision making is among the core activities of management. In the end, all decisions taken together determine the future success and financial strength of financial organisations.<sup>70</sup> Research indicates that complex decisions are largely the outcome of behavioural factors rather

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<sup>65</sup> Dragoni, L. (2005), Understanding the emergence of state goal orientation in organisational work groups: The role of leadership and multilevel climate perceptions, *Journal of Applied Psychology* 90, 1084-1095; Römer, M. (2015), *Supervision of behavior and culture, Foundations, practice & future developments*, red. M. Raaijmakers, Amsterdam, p. 139.

<sup>66</sup> Ashforth, B.E., & Anand, V. (2003). The normalisation of corruption in organisations. *Research in Organisational Behavior*, 25, 1-25.

<sup>67</sup> Trevino, L.K., Weaver, G.R., Gibson, D.G. & Toffler, B.L., (1999). “Managing Ethics and Legal Compliance – What works and what hurts”, *California Management Review*, 41,2, pp. 131-151.

<sup>68</sup> Sonnenfeld, J.A. (2002). What makes great boards great. *Harvard Business Review*, 1 -9.

<sup>69</sup> Treviño, L.B., Den Nieuwenboer, N.A., & Kish-Gephart, J.J. (2014). (Un)Ethical behavior in organisations. *Annual Review of Psychology*, 65, 635-660.

<sup>70</sup> Hambrick, D.C. & Mason, P.A. (1984). Upper Echelons: The Organisation as a Reflection of Its Top Managers. *The Academy of Management Review*, 9(2), 193-206; Eisenhardt & Brown 1992, Finkelstein, S., Hambrick, D. C. & Cannella Jr, A.A. (2009). *Strategic Leadership: Theory and Research on Executives, Top Management Teams, and Boards*. New York: Oxford University Press.

than a mechanical quest for economic optimisation, whereby the more complex the decision, the more applicable this behavioural theory is thought to be.<sup>71</sup> For instance, people's judgments in difficult situations are often systematically distorted by cognitive and motivational biases.<sup>72</sup>

Similarly, the root-cause analysis revealed weaknesses in decision-making processes, stemming from a focus on growth, profit, and cost cutting, which ultimately led to disastrous consequences. This focus caused blind spots, thereby reducing attention on risk management, compliance or ethical considerations. This was of particular impact in the absence of challenge and critical debate at board level (and within the rest of the organisation). This lack of challenge was often caused by a combination of structural and behavioural factors, such as dominant leadership, a strain for consensus and overconfidence, or because important information was ignored or not taken seriously by the Board or senior management.

There are a lot of structural and behaviour measures that can contribute to the quality of decision-making (see figure 2). One type of factors relate to role clarity, meaningful involvement of relevant people and functions, and the quality of information. Another types of factors, behavioural indicators, relate to impeding group patterns and the quality of challenge. Constructive challenge does not often come naturally within boards and organisations and, therefore, must be designed. The following approaches may enhance the quality of challenge and debate:

- Facilitative leadership styles, which improve the free flow of opinions and perceptions, promote collaborative decision-making, and support information sharing and teamwork. Ultimately, this leads to more carefully considered decisions, taking into account more alternatives, facts and risks;<sup>73</sup>
- Group norms that tolerate and even expect different opinions to be raised, challenged, and discussed, which may have a positive effect on the group as a whole in the form of better decisions and intragroup interaction.<sup>74</sup> The same holds true when group members are convinced that they are able to solve conflicts. This “resolution efficacy” contributes towards interpersonal communication and trust, thereby enhancing decision making.<sup>75</sup> Training decision makers on how to engage in constructive conflict

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<sup>71</sup> Hambrick, D.C. & Mason, P.A. (1984). Upper Echelons: The Organisation as a Reflection of Its TopManagers. *The Academy of Management Review*, 9(2), 193-206; Hambrick, D.C., Finkelstein, S. & Mooney, A.C. (2005). Executive job demands: new insights for explaining strategic behaviours and leader behaviors. *Academy of management journal*, 30(3), 472-491; Mooney, A.C., Holahan, P.J. & Amason, A.C. (2007). Don't take it personally: exploring cognitive conflict as a mediator of affective conflict. *Journal of Management Studies*, 44(5), 733-758.

<sup>72</sup> Forsyth (2010). *Group dynamics*, Belmont. Wadworth.

<sup>73</sup> Lorinkova, N.M., Pearsall, M.J. & Sims Jr., H.P. (2013). Examining the Differential Longitudinal Performance of Directive versus Empowering Leadership in Teams. *Academy of Management Journal*, 56(2), 573–596; Neck, C.P. & Moorhead, G. (1995). Groupthink remodeled: The importance of leadership, time pressure and methodical decision making procedures. *Human Relations*, 48(5), 537-557. Nemeth, C.J. (1986). Differential contributions of majority and minority influence. *Psychological review*, 93, 23-32.

<sup>74</sup> Jehn, K.A., Greer, L., Levine, S. & Szulanski, G. (2008). The Effects of Conflict Types, Dimensions, and Emergent States on Group Outcomes. *Group Decision and Negotiations*, 17, 465–495; Marks, M.A., Mathieu, J.E. & Zaccaro S.J. (2001). A temporally based framework and taxonomy of team process. *Academy of Management Journal*, 26(3), 356-376.

<sup>75</sup> Jehn, K.A., Greer, L., Levine, S. & Szulanski, G. (2008). The Effects of Conflict Types, Dimensions, and Emergent States on Group Outcomes. *Group Decision and Negotiations*, 17, 465–495.

positively affects team performance.<sup>76</sup> In general, one can say that a team's performance is enhanced, when it believes it is able to successfully accomplish a task;<sup>77</sup> and,

- An environment of psychological safety<sup>78</sup>, which is defined as “the shared belief that the team is safe for interpersonal risk taking”. It is a sense of confidence that the team will not embarrass, reject, or punish someone for speaking up. This perception stems from mutual respect and trust among team members.<sup>79</sup> Psychological safety enables individual team members to speak up and contribute.<sup>80</sup> In addition, trust helps to prevent task conflict from escalating into personal conflict.<sup>81</sup> Psychological safety can be promoted through positive interactions between group members, especially under situations of stress<sup>82</sup>, and the availability of resources and information.<sup>83</sup>

### **5. Importance of speaking up/psychological safety**

Another pattern revealed in the root cause analysis involves a reluctance to hear and deliver bad news. Most organisations also find it very difficult to confront lessons inherent in large failures. If employees believe that they can deliver “bad news” to management without fear of repercussions, they may be willing to inform management of developing ethical risks or problems while there is still time to make corrections.<sup>84</sup>

According to Sonnenfeld, a CEO, chairman, lead director, and board in general need to demonstrate through their actions that they understand the difference between dissent and

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<sup>76</sup> Rispens S. (2014). Beneficial and detrimental effect of conflict. In: Aoyoko, O.B. & Ashkanasy, N.M. & Jehn K.A. Handbook of conflict management research. Cheltenham, Edward Elger, 19-32.

<sup>77</sup> Gully, S.M., Incalcaterra, K.A., Joshi, A. & Beaubien J.M. (2002). A meta-analysis of team-efficacy, potency and performance: Interdependence and level of analysis as moderators of observed relationships. Journal of applied psychology, 87(5), 819-832.

<sup>78</sup> Burke, C.S., Stagl, K.C., Klein, C., Goodwin, G.F., Salas, E. & Halpin, S.M. (2006). What type of leadership behaviors are functional in teams? A meta-analysis. *The Leadership Quarterly*, 17. 288–307; Edmondson, A (1999) Psychological safety and learning behavior in working teams. *Administrative Science Quarterly*, 44(2), 350-383.

<sup>79</sup> Edmondson, A (1999) Psychological safety and learning behavior in working teams. *Administrative Science Quarterly*, 44(2), 350-383.

<sup>80</sup> Bradley B.H., Postlethwaite, B.E, Klotz, A.C., Hamdani M.R. & Brown, K.G. (2012). Reaping the benefits of task conflicts in teams: The critical role of team psychological safety. *Journal of Applied Psychology*, 97(1), 151-158; Edmondson, A (1999) Psychological safety and learning behavior in working teams. *Administrative Science Quarterly*, 44(2), 350-383.

<sup>81</sup> Simons, T. & Peterson R. (2000). Task conflict and relationship conflict in top management teams: The pivotal role of intragroup trust. *Journal of Applied Psychology*, 85, 102-111.

<sup>82</sup> Burke, C.S., Stagl, K.C., Klein, C., Goodwin, G.F., Salas, E. & Halpin, S.M. (2006). What type of leadership behaviors are functional in teams? A meta-analysis. *The Leadership Quarterly*, 17. 288–307.

<sup>83</sup> Edmondson, A (1999) Psychological safety and learning behavior in working teams. *Administrative Science Quarterly*, 44(2), 350-383.

<sup>84</sup> Trevino, L.K., Weaver, G.R., Gibson, D.G. & Toffler, B.L. (1999). “Managing Ethics and Legal Compliance – What works and what hurts”, *California Management Review*, 41,2, pp. 131-151.

disloyalty.<sup>85</sup> This same study indicates that the highest performing companies have extremely contentious boards that regard dissent as an obligation and treat no subject as off limits.<sup>86</sup>

**Research of high-reliability organisations indicates that deliberate learning helps prevent mistakes from being repeated.** “Deliberate learning involves conscious effort to gather and use information and is contrasted with tacit learning which develops through the accumulation of experience over time. Studies of safety culture and high-reliability organisations show that leaders can increase compliance of employees and build a positive safety culture through role modelling and prioritising safety in decision making.”<sup>87</sup> Furthermore, research acknowledges that a positive culture supports the enactment of values that can influence a range of safety outcomes: “a safety culture refers to the values and beliefs that are shared within an organisation...A positive safety culture is an important element for developing an environment in which individuals are motivated and able to report errors and incidents.”<sup>88</sup> These findings underpin those made above with respect to the relevance of psychological safety as an enabler of open and productive discussions. Therefore, working on culture requires working on a climate of trust in which bad news can be discussed and learnt from.

## 6. Reward systems

A final key-component of a sound corporate culture is the reward system. The root cause analysis reveals that in all the cases of misconduct and organisational failure at financial institutions, except one, involved a mindset of growth and profit enforced by (financial) incentives.

### (a) Bad incentives

Research of Trevino et al. (2014) demonstrate that performance management systems are important components of ethical culture at the organisational level. According to their study, people in organisations pay close attention to what is rewarded and what is disciplined. Performance management systems (including setting goals and tying rewards to those goals) are particularly important.<sup>89</sup> Research indicates that if systems which are designed to achieve a specific goal, give wrong incentives, people will be motivated to do something else or even do the opposite.<sup>90</sup> This is consistent with findings from the earlier root cause analysis.

Moreover, Moore and Gino (2013) indicate that goals and incentives can both telescope our attention toward an outcome and blind us to the reasons the goal or incentives were set up in

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<sup>85</sup> Sonnenfeld, J.A. (2002). What makes great boards great. *Harvard Business Review*, 1 -9.

<sup>86</sup> Eisenhardt, K. Bourgeois, L.J. as mentioned in Sonnenfeld, J.A. (2002). What makes great boards great. *Harvard Business Review*, 1 -9.

<sup>87</sup> Griffin, M.A., Cordery, J., Soo, C. (2015) Dynamic safety capability: How organisations proactively change core safety systems. *Organisational Psychology Review*. 1-25.

<sup>88</sup> Guldenmund, 2000 as mentioned in Griffin, M.A., Cordery, J., Soo, C. (2015) Dynamic safety capability: How organisations proactively change core safety systems. *Organisational Psychology Review*. 1-25.

<sup>89</sup> Treviño, L.B., Den Nieuwenboer, N.A., & Kish-Gephart, J.J. (2014). (Un)Ethical behavior in organisations. *Annual Review of Psychology*, 65, 635-660

<sup>90</sup> Kerr, S. (1975). On the folly of rewarding A, while hoping for B. *Academy of management Journal*, 769 – 783.

the first place.<sup>91</sup> Organisations create a social environment that influences unethical choices. For example, research indicates that if leadership, norms, and reward policies encourage the achievement of bottom-line goals only, with no attention to ethical concerns, the culture is more likely to support unethical conduct.<sup>92</sup>

Some of the reasons that policymakers and administrators fail to design better reward systems include the *fascination with objective criteria* and the *overestimating of visible behaviour* (some parts of the task are highly visible while other parts are not).<sup>93</sup> Kerr, for example, illustrates how bad incentives systems work drawing from the case of an insurance company that wants to achieve accurate and speedy processing of healthcare claims.

**Example of a poor reward system:**

*“Attempting to measure and reward accuracy in paying surgical claims the firm systematically keeps track of the number of returned checks and letters of complaints received from policyholders. However, underpayments are likely to provoke cries of outrage from the insured, while overpayments often accepted in courteous silence. Since it often is impossible to tell from the physician’s statement which of two surgical procedures, with different allowable benefits, was performed, and since writing for clarifications will interfere with other standards used by the firm concerning “percentage of claims paid within two days of receipt, the new hire in more than one claims section is soon acquainted with the informal norm: “When in doubt, you have to pay.”*”

Furthermore, research indicates that employees’ perceptions of how rewards are distributed are even more important than their perceptions of the distribution of punishment (that violators are detected and punished).<sup>94</sup>

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<sup>91</sup> Moore, C., & Gino, F., (2013). Ethically adrift: How others pull our moral compass from true North, and how we can fix it. *Research in Organisational Behaviour*, 33, 53-77.

<sup>92</sup> Kish-Gephart, J.J., Harrison, D.A., & Treviño, K.L. (2010). Bad apples, bad cases, and bad barrels: meta-analytic evidence about sources of unethical decisions at work. *Journal of Applied Psychology*, 1, 1-31.

<sup>93</sup> Kerr, S. (1975). On the folly of rewarding A, while hoping for B. *Academy of management Journal*, 769 – 783.

<sup>94</sup> Trevino, L.K., Weaver, G.R., Gibson, D.G. & Toffler, B.L, (1999). “Managing Ethics and Legal Compliance – What works and what hurts”, *California Management Review*, 41,2, 131-151.

## **Annex: Literature reviewed**

### **Financial sector**

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