

Strengthening Conduct and Culture in the Financial Industry

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Introduction

Effective corporate governance by financial institutions is critical to strengthen public trust and confidence in the financial system. Recent instances of conduct failures present a major threat to this continuing trust, as they can be seen as a reflection of underlying weaknesses of governance in financial institutions. Recognising that addressing misconduct calls for a multifaceted approach, a number of regulators have begun to focus on reinforcing ethical and professional behaviour in the financial sector. This article reviews developments in the Bank's approach towards influencing behavioural outcomes in the domestic financial industry, focusing on both contextual and individual factors that can affect behaviour.

The Evolution of Financial Reforms

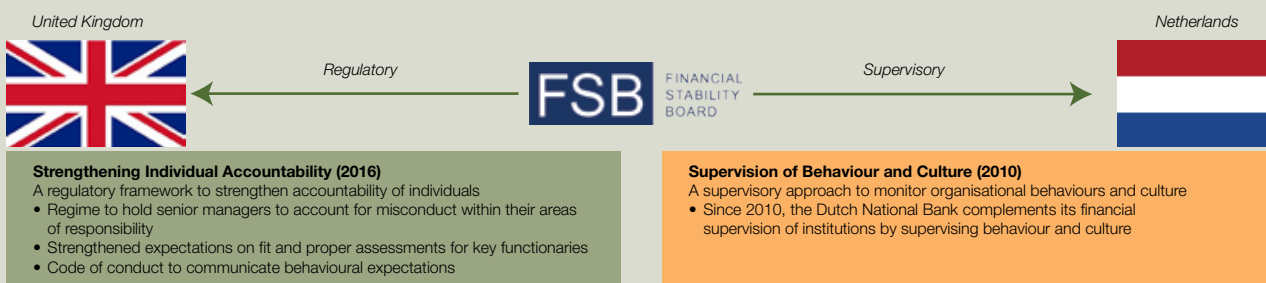
Approaches to corporate governance have traditionally been characterised by a focus on the strength of systems and processes within financial institutions. Requirements relating to board composition, disclosures and control functions endeavour to ensure that governance structures form sound foundations for effective management of risks within organisations. However, the global financial crisis revealed that failures were also driven by behavioural deficiencies¹.

This has led to a series of corporate governance reforms² that form part of the global regulatory reform agenda. In addition to raising the bar with respect to corporate governance arrangements, these reforms also introduce a focus on the behavioural aspect of governance. Of significance are efforts in aligning incentive systems with prudent risk-taking behaviour in financial institutions. While this continues to gain traction, widely publicised cases of retail banking fraud and rigging of key benchmark rates in major financial systems underscore the need for sharper efforts to tackle misconduct risk. Given these developments, authorities are turning their focus to regulatory and supervisory approaches targeted at the root causes of unethical behaviour. To date, two jurisdictions are notably advanced on these fronts (Diagram 1). On a broader level, international efforts are presently being coordinated by the Financial Stability Board to develop a toolkit for supervisors and institutions to address vulnerabilities to misconduct.

Experience suggests that as financial systems become more sophisticated, risks of conduct failure are typically heightened. Therefore, promoting ethical conduct and culture within the financial industry is an objective the Bank shares with the international regulatory community.

Diagram 1

Key Measures to Address Misconduct Risk



Source: Bank of England, Dutch National Bank

¹ The Financial Crisis Inquiry Report, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 2011.

² For example, Basel Committee on Banking Supervision: Principles for Enhancing Corporate Governance, Dodd Frank Wall Street Reform and Consumer Protection Act and G20/OECD Principles on Corporate Governance.

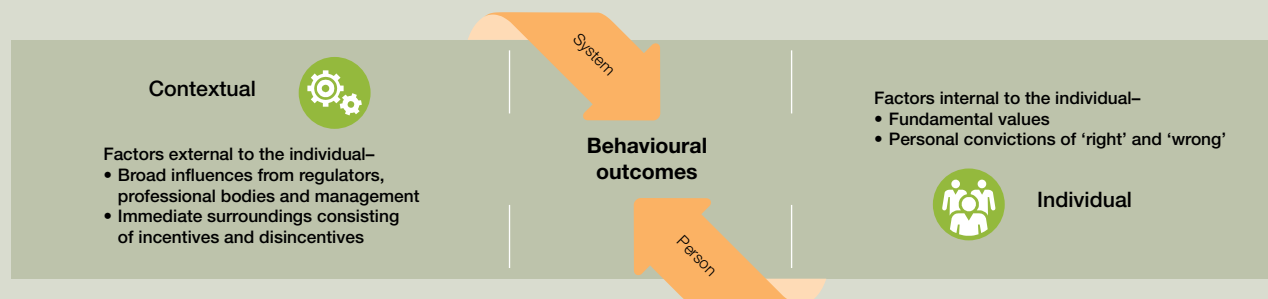
The Bank's Approach to Influence Behavioural Outcomes

The Bank adopts a two-pronged approach (Diagram 2) to influence the conduct of individuals within the financial sector—

- cultivate a system that promotes and reinforces the norms of honesty and integrity; and
- foster conditions for financial institutions to make informed hiring decisions. This includes improving access to information that is relevant to determine if an individual meets the expected standards of probity for employment in the financial sector.

Diagram 2

Two-pronged Approach to Influence Behavioural Outcomes



Source: Bank Negara Malaysia

The focus on systems alongside individual probity draws from various studies in the field of psychology. Such studies have shown that factors external to the individual (contextual factors) have a significant and important influence on behavioural outcomes. Specifically, systems create behavioural contexts that influence how individuals act in particular situations, often separate from moral or ethical values they may hold³. In this perspective, the root of misconduct may not simply be a problem of 'bad apples', but also 'bad barrels' and 'bad barrel-makers'. These findings were similarly reflected in various experiments which suggest that the sphere of influence that an individual is subject to can substantially weaken the norms of honesty and integrity⁴. The system as a whole therefore needs to promote and advocate desired norms for behaviour in the financial industry, to complement the current focus on ensuring key individuals are fit and proper.

Contextual Factors

Contextual factors make up the prevailing culture within which an individual operates. The Bank employs a balance of measures to shape cultural outcomes both across the financial sector and within each institution.



Regulation

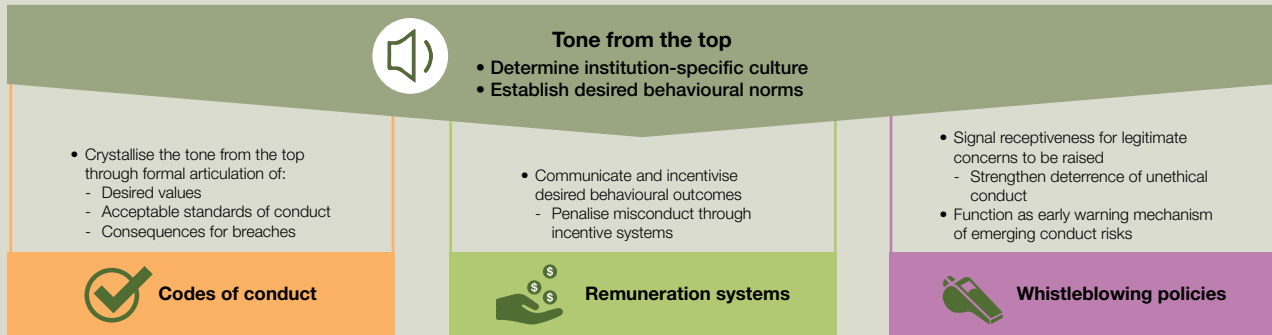
Regulations introduced by the Bank formalise its expectations on acceptable conduct for the industry. In the updated Corporate Governance standards issued by the Bank in 2016, the focus on behavioural aspects of governance was strengthened through specific expectations for ethical cultures to be embedded within financial institutions. A key determinant of corporate culture is the tone set by the board and senior management through their decisions, actions and attitudes. On this basis, the standards place a responsibility on the board and senior management to promote a corporate culture which reinforces ethical, prudent and professional behaviours. An important part of this is ensuring that the tone set from the top is reflected in the actions and decisions of middle management as they are more likely to interact directly with the wider population of staff, counterparties and customers. These standards also call for the improved articulation and enforcement of codes of conduct, better alignment of remuneration systems and effective implementation of whistleblowing mechanisms. This is illustrated in Diagram 3.

³ Zimbardo (2007).

⁴ Cohn et al (2014) and Milgram (1963).

Diagram 3

Corporate Governance Enhancements to Strengthen Institutional Culture



Source: Bank Negara Malaysia

Recognising the significance of the board and senior management's influence over organisational culture, the Bank is currently reviewing the allocation of accountability for individuals in these senior roles. The intention is to make it the direct responsibility of those at the helm of institutions to promote a sound organisational culture and address misconduct risk. A discussion paper on Responsibility Mapping, issued in February 2018, outlines the Bank's ideas for clarification of roles, responsibilities and accountability of individuals in senior positions. Precision on the expectations over each senior role will encourage individuals in these positions to take greater ownership of the areas under their purview and set the appropriate tone from the top. A formal consultation on more substantive policy proposals for the framework can be expected in the second half of 2018.

In addition, the Bank has also issued the Code of Conduct for Malaysia Wholesale Financial Markets and Principles for a Fair and Effective Financial Market for the Malaysian Financial Market in April and October 2017, respectively. Collectively, these aim to shape the desired conduct and practices of individuals involved in the financial markets, thus promoting a financial market environment which is trusted and resilient.

Supervision

The Bank, through its supervisory function, also monitors practices and cultural nuances within financial institutions to complement regulatory efforts.

In 2017, the Bank enhanced its internal supervisory framework to incorporate a focus on organisational culture and misconduct risk within financial institutions. This aims to provide added insights as to whether an institution's corporate culture is likely to influence positive or negative behaviours. Components of the supervisory assessment on culture and conduct, and the methodologies, are detailed further in Chapter 2: Banking Sector. It is expected that this framework will be iteratively refined as the Bank further develops its supervisory capabilities to discern cultural and behavioural dynamics.

Enforcement

Effective enforcement additionally serves as a credible deterrent against misconduct, thus contributing towards influencing a positive culture within the industry. As announced last year, the Bank will begin to make public, details of enforcement actions for significant contraventions and breaches from 1 January 2018 onwards. This is intended to strengthen the deterrent effect of enforcement actions.

Industry-led initiatives – Professionalising the industry

Organisations such as professional bodies play a key role in promoting professional conduct and integrity by current and future members of the financial industry. In this respect, the Asian Institute of Chartered Bankers (AICB) has introduced the Chartered Banker accreditation in 2016. The curriculum accords a significant emphasis, amongst others, on professional ethics. Through a joint declaration with the AICB in 2016, banking institutions have expressed commitment to enrol key employees and board members in this programme. The Bank has also conveyed an expectation for graduates being employed into the banking industry to be members of the AICB, and to complete a mandatory programme on ethics and professional standards. The professional qualifications offered by AICB, not only equip its members with the technical know-how to effectively discharge their functions, but also instil the principles and desired standards for their professional conduct. These efforts complement the work of the Financial Services Professional Board, which expounded a set of principles through the Code of Ethics for the Financial Services Industry, in 2016. Collectively, they contribute to stronger foundations for professional and ethical standards of conduct in the financial sector.

Individual Factors

While contextual factors play a significant role in influencing behaviour, individual (or personal) factors also have a key influence on behavioural outcomes. These factors refer to the beliefs, values and convictions of an individual. A key objective is to uphold uncompromising ethical standards for individuals who work in the financial sector.

Diagram 4

Overview of Contextual and Individual Factors to Influence Behaviour



Source: Bank Negara Malaysia

With this in view, the Bank seeks to strengthen the conditions for informed hiring decisions, and mitigate the recycling of individuals with a history of misconduct between institutions. This is achieved by addressing underlying obstacles to information symmetry, which may compromise a financial institution's ability to determine the probity of individuals it hires. In March 2018, the Bank finalised the standards on Employee Screening. The standards serve to elevate screening practices of financial institutions and improve transparency of an individual's conduct history. Effective 1 July 2018, financial institutions will be required to screen the employment history and criminal records of new hires. On receiving a request for reference information, financial institutions must provide information on an individual's conduct history with the institution. This in turn will place financial institutions in a better position to make informed recruitment decisions.

Conclusion

The strength of public trust and confidence in the financial sector is dependent on observable behaviours of the individuals within it. This underscores the importance of ensuring the highest standards of integrity and professionalism within the Malaysian financial sector, bolstered by a deep and pervasive ethical culture. Garnering the collective efforts and support of those with the capability to influence the environment within which individuals operate is certainly important. As detailed above, the Bank employs regulatory, supervisory and enforcement mechanisms to foster a system that promotes honesty and integrity. More importantly, this must be complemented by corresponding industry efforts to lift professional standards of conduct. In particular, boards and senior management must take decisive steps moving forward to drive cultural changes both within their financial institutions and across the financial sector.

References

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