COMBATING THE HIDDEN COSTS OF CONDUCT RISK WITH BEHAVIOURAL ECONOMICS

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Conduct risk and the mis-selling of financial products has become a major concern for regulatory authorities and financial institutions in recent years. Most financial firms not only struggle with overcoming the challenges it poses, they have substantial issues in defining and assessing the problem in the first place.

Rather than viewing it as a compliance challenge or a burden, behavioural economics may allow it to be viewed as an opportunity. Changing the culture of an organisation, to ensure it does not engage in deceptive or dishonest behaviour, can create a competitive advantage for a financial firm looking to build trust and loyalty with its customers.

The landmark Federal Court case of 2012 involving investment bank Lehmann Brothers Australia versus Wingecarribee Shire Council in a class action, brought a range of issues to public light and regulatory scrutiny [i].

Lehmann Brothers was found liable for deceptive and misleading conduct when advising a range of local councils and Australian community groups in regards to investments in Collateralised Debt Obligations (CDOs). Lehmann had to pay millions of dollars in compensation for the losses the councils suffered from those investments.

The costs for Lehmann Brothers didn't stop there, however.

The Hidden Cost

Financial organisations engaging in unethical or inappropriate behaviour run a gauntlet of dangers, aside from the substantial financial penalties and fines that may be imposed. The damage done to brand and reputation, legal costs, disruption to and loss of business can be just as substantial as well as ongoing.

Trust and relationships with customers and investors takes years and decades to build. They can be destroyed in an instant. Chris Perry, Managing Director, Risk, Thomson Reuters, comments, "Good conduct is good business. The cost of poor conduct is high; not just in terms of enforcement actions, now totalling in the billions of dollars, but also in the reputational damage and the wider erosion in trust that this creates across the industry." [ii]

Assessing and managing conduct risk aims to eliminate the likelihood of organisations, their staff or their management from participating in deceptive behaviour. But there are significant obstacles for organisations in implementing effective programs.

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What Is Conduct Risk?

Part of the problem in assessing and managing conduct risk is the ability to define it. A recent survey from Thomas Reuters highlights, even though the issue is one of the highest priorities for regulatory authorities, financial services firms are unclear about what conduct risk is and how to address it [iii]. ASIC (Australian Security and Investments Commission) defines conduct risk as [iv]:

> "… the risk of inappropriate, unethical or unlawful behaviour on the part of an organisation's management or employees. 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".

This definition seems relatively straight forward, but the term covers such a broad variety of diverse product areas and practices that adopting an effective approach is difficult and time consuming [v].

The effort required to address conduct risk needs to go beyond having documented codes of conduct and mission statements. It strikes at the very heart of how a financial firm does business and the way it serves its customer.

Central to any approach or strategy, according to the Reuters research, is the development of a working definition and scope of the problem. From there it's about establishing standards and a culture that drives behavioural change throughout the entire organisation.

Changing Culture and Behavioural Economics

Customers don't always base their decisions on rational considerations when purchasing financial products and services. They can demonstrate seemingly illogical biases in making their decisions. Most customers have limited understanding, time and capacity to take in financial information and assess their options.

Therefore, they can take risky short cuts in making their decisions. Behavioural economics examines the effects of psychological, social, cognitive, and emotional factors on the economic decisions of individuals and institutions. ASIC is increasingly applying behavioural economics insights to identify consumer problems and to detect when firms take advantage of consumer biases [vi].

ASIC Chairman Greg Medcraft said, "Undertaking evidence-based studies about how people think and behave in the real world is going to be increasingly important to smarter regulation. These studies provide valuable insights into how people make decisions and how ASIC can improve outcomes." [vii]

Financial firms themselves can apply these same insights in developing their approach to conduct risk. By applying these insights financial organisations can:

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1. Help drive the necessary changes in behaviour, based on the desired culture and values, to discourage unethical or deceptive practices.

2. Assist in assessing and classifying areas of risk within the business by identifying behaviour and practices that are likely to be deceptive or fraudulent.

3. Provide better advice to customers by understanding their particular biases and various levels of financial capability. In most cases, a principle led approach, where culture and values drive the customer conversation, is more effective than strict adherence or a tick box approach to governance. [viii]

How BI WORLDWIDE Can Help

BI WORDLWIDE has over six decades of experience building employee, customer and sales engagement solutions grounded in the science of behavioural economics. As well as improving the level of engagement and motivation of staff and management, our solutions are also designed to help address our clients' compliance and regulatory requirements.

In other words, we look at how thought and emotion combine to drive decisions and behaviour. We don't have to guess what might motivate your financial advisors or customers; we actually use research and data to figure out what will motivate them.

About the Author

Tricia Mikolai is the Managing Director of BI WORLDWIDE – Oceania. She is an expert in behavioural economics principles. With almost a decade of experience in understanding human behaviour and how it impacts business performance, Tricia has assisted Fortune 1000 & ASX 200 companies improve performance with measurable result. She is committed to sharing her knowledge with corporate leaders to help them drive business objectives. Contact her at tricia.mikolai@au.biworldwide.com.

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