



Best practice for managing conduct risk in South African banks

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Thesis submitted in fulfilment of the requirements for the de-
gree

Doctor of Philosophy in Risk Management

at the North-West University

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Graduation ceremony: October 2018

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Preface

This thesis was completed in publishable article format as a requirement for the attainment of the degree of *Philosophiae Doctor* in Risk Management at the School of Economics of North-West University (Potchefstroom Campus, South Africa). Professor Gary van Vuuren was the supervisor for this thesis.

This study is the original work of the author and contains three separate studies, which have not been submitted to a different educational institution in any form. The work of others has been acknowledged accordingly in the text as well as the References and Bibliography sections.

Chapter 1 provides insight into the topic of conduct risk in the South African banking sector. It also presents an introduction to the three studies and motivates why they form part of this thesis: they cover three main stakeholders affected by and three main perspectives used to look at conduct risk. Lastly, it summarises the research methodology used for the three studies.

Chapter 2 contains the first study, which assembles a regulatory model that could be used by regulators in developing countries to ensure conduct risk in the banking sector is contained and managed appropriately. The research uses Kenya, Malaysia and South Africa as examples of developing markets, in order to set the scene and compare other developing countries with South Africa.

The second study is detailed in Chapter 3, and it explores which conduct risk management approach South African banks should follow in a time of uncertainty around new regulations, and increasing fines by regulators; all of this complicated by the call for sustainable business models in banking, and financial exclusion.

The third study investigates how conduct risk in banking should be measured in a developing context, using South Africa as an example. This study is presented in Chapter 4, and relies partly on data from bank customers to gain an understanding of how the measurement should be approached from this perspective.

The conclusions drawn from the respective articles, and the contributions they have made to the existing knowledge about the new phenomenon of ‘conduct risk’, are summarised in Chapter 5. The chapter also outlines additional research opportunities that could be considered to increase the body of work on this new topic.

Antje Hargarter

30 July 2018

Acknowledgements

I would like to acknowledge the assistance, guidance and support that I have received from:

- my supervisor, Prof. Gary van Vuuren.
- specialists in the field of conduct risk.
- everyone at my workplace, especially colleagues who participated in one of the surveys, my immediate team and my manager.
- my family and friends.

Their continuous encouragement throughout my PhD journey, one that I have undertaken while working full-time in a demanding job and being a parent, deserves an enormous, heartfelt thank you.

Abstract

Since the global financial crisis, a new risk, known as conduct risk, has emerged. Financial institutions worldwide are grappling with how to manage and mitigate it, while regulators are trying to control it. Developing markets are behind with these developments, and also struggle with additional complexities, such as the lack of financial education on the part of their customers. The serious nature of the situation is expressed in the massive fines that financial institutions around the world, especially banks, have received for misconduct. The problem is exacerbated by the demand for sustainable business models and profits. All stakeholders could be negatively affected by the problem. Academia has not produced much guidance on the topic, especially with regard to developing markets. This research is the first of its kind, in that it assesses conduct risk in South African banks from three different perspectives: the regulatory, the business and the customer perspectives. It works with a qualitative and exploratory approach to produce potential models for regulators and banks, in an attempt to bring clarity to a critical challenge: the regulation, the measurement and the mitigation of conduct risk, using South African banks as an example of a developing market.

The findings suggest, firstly, that regulators in developing countries should work with and learn from each other, rather than merely imitating regulators' approaches in developed countries; secondly, banks need to ensure their top-down strategy filters through to every employee by using a bottom-up approach in combination with a top-down approach; and, thirdly, customers in developing countries lack a thorough understanding of conduct risk, based on limited financial knowledge, which makes it difficult for banks to successfully measure and mitigate conduct risk. Banks need to take the new risk phenomenon seriously and engage with it fully to avoid more damage for all stakeholders.

Keywords: banks, conduct risk, South Africa, Twin peaks model, bank regulation, risk management

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List of abbreviations

BASA – Banking Association of South Africa

BC – Before Christ

BCBS – Bank for International Settlement's Basel Committee on Banking Supervision

BIS – Bank of International Settlements

CCP – Conduct Cost Project

CoFi – Conduct of Financial Institutions

ESRB – European Systemic Risk Board

ES – Existing Surveys

EU – European Union

FCA – Financial Conduct Authority

FSB – Financial Services Board

FSCA – Financial Services Conduct Authority

FSR – Financial Sector Regulation

G-SIBs – Globally Systematically Important Banks

I – Interviews

IMF – International Monetary Fund

KBA – Kenya Bankers' Association

OECD – Organisation for Economic Cooperation and Development

PA – Prudential Authority

PhD – Philosophiae Doctor

Q – Questionnaire

SARB – South African Reserve Bank

SD – Secondary Data

TCF – Treat Customers Fairly

UNEP – United Nations Environment Programme

Chapter 1

Introduction

1.1 Background

Banks attract public deposits and then use these funds to lend to debtors. This means that capital needs have to be constantly evaluated, relative to risks (BIS, 2006). Banks are therefore an important pillar of the economy and their regulation and supervision is critical. Regulation and supervision are often used interchangeably, but they are not the same: "Bank supervision involves monitoring and examining the condition of banks and their compliance with laws and regulations. (...) Bank regulation includes issuing specific regulations and guidelines to govern the operations, activities and acquisitions of banking organisations" (Federal Reserve Bank, 2015:1).

The Bank for International Settlement's Basel Committee on Banking Supervision (the BCBS) has been tasked with establishing minimum regulatory and supervisory standards to enhance financial stability globally (BIS, 2014). Various banking risks have to be defined, categorised and measured as part of this job. For example, credit, operational and market risk, as well as liquidity risk, are covered and reported on as part of the various so-called Basel accords (I, II and III) (BCBS, 2006 and 2011).

Partly as a result of the global financial crisis of 2008/2009, a new type of risk, known as conduct risk, has emerged in the financial services industry (National Treasury, 2011). Conduct risk arises when financial services companies fulfil their main goal of meeting specific sales targets within a company by selling products and services which are not appropriate for their customers (FCA, 2013b). In most cases, the eventual outcome for the customer, the bank and its stakeholders will be undesirable, and the functioning of a country's financial and economic system can also be negatively influenced. Developing market banks find themselves in an even more complex situation, influenced by heightened consumer protection, pressure for financial inclusion and limited financial education (Ali, 2014).

1.1.1 *The conduct risk triangle*

The conduct-risk problem that lies at the heart of the financial and banking world can be illustrated using a triangle with three role-players and/or perspectives, as illustrated in Figure 1 below.

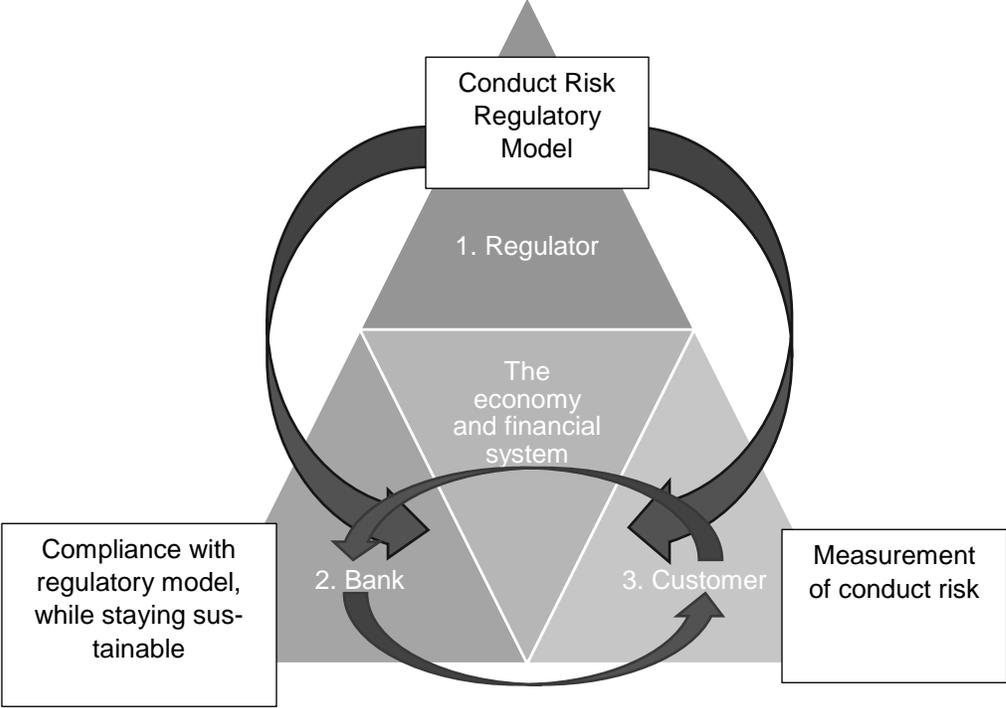


Figure 1: The conduct-risk triangle.

Source: Author.

Conduct-Risk Regulatory Model

From a regulatory point of view, the Basel Accords are not formally covering conduct risk as a new risk. Regulators and central organisations locally and internationally are attempting to control conduct risk. For example, the Organisation for Economic Cooperation and Development (OECD) provides some guidance to its members on how to integrate conduct risk into their regulatory approach (OECD, 2013 and 2011). Since the global financial crisis, regulators around the world have decided to heavily fine banks for conduct failure, which indicates the seriousness of the conduct-risk problem (FCA, 2015 and European Systemic Risk Board [ESRB], 2015). An overview of conduct costs, and provisions for it on the part of some of the biggest banks globally since 2008, is presented in Figure 2.

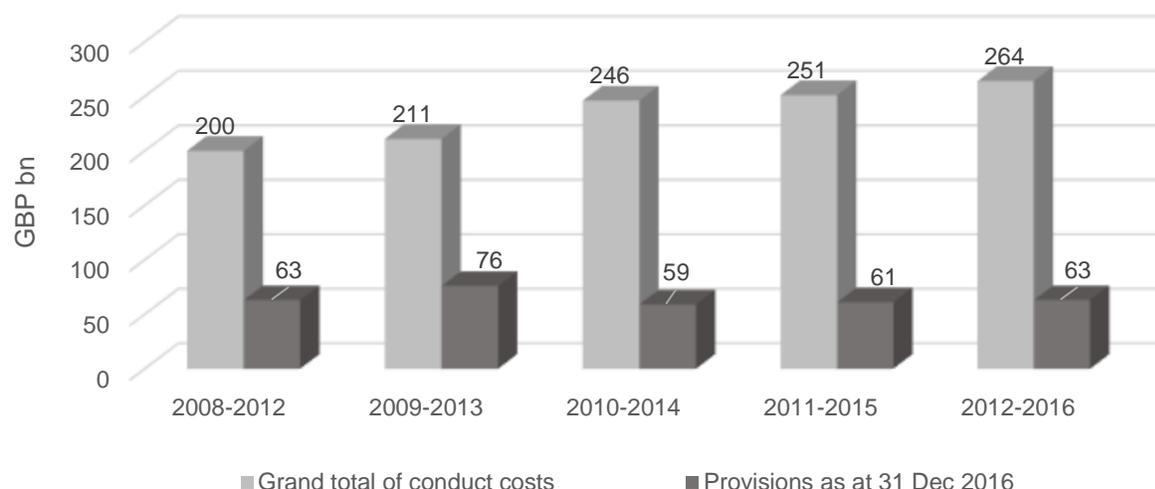


Figure 2: Grand total of conduct costs for a given period (i.e. costs crystallised during the period, plus provisions as at 31 December of the previous year) and the provision sums for that period. Banks included in the survey: 20 banks based in the US, Europe and Australia.

Source: CCP Research Foundation, 2017 – with permission.

There is no one-size-fits-all approach for different countries, and many regulators in developed countries are further ahead than those of developing countries. However, developing countries, such as South Africa, have also received penalties (SARB 2014; 2015; 2016a; 2016b; 2017), as have countries in Asia (Oliver Wyman, 2014). All these fines and resulting media reports will affect banks' financial success, and also have a negative effect on their stakeholders.

Conduct-risk regulation has only been implemented in a few countries and it has only been in place for a short time. It would be worth exploring best-practice approaches for the development and adoption of suitable regulatory and supervisory models that add value to all stakeholders in the financial system and the economy of a country – especially in the developing world. Selected developing market case studies could be used for this approach.

Compliance with the regulatory model, while staying sustainable

From a banking business point of view, banks might believe in the principle that every risk to which a business is exposed could create (financial) opportunities. However, if banks' business strategies incorporate ethical behaviour, they should not accept *any* conduct risk in the system. If this is the case, regular fines could indicate that banks struggle to control, manage and mitigate

conduct risk and that they are not sustainable as a business. Either way, the financial impact for banks is drastic: "Without past litigation costs and provisioning for future litigation costs, the total accumulated profits of EU G-SIBs [globally systematically important banks] for the past five years would have been a third higher" (ESRB, 2015:14). If no solutions are found, there could be serious, undesirable consequences for all role players who participate in the economic and financial system of a country (banks and their employees, shareholders, bank regulators, government and society, industry and bank customers) (Baijal, 2018).

Managing and mitigating conduct risk and complying with regulation is complicated by the fact that the new risk is vastly different to other banking risks. Generally, risk management involves the question whether risk is within appetite, however when it comes to conduct risk, the question is more around how a scenario should be tackled when risk appetite is too high (Management Solutions, 2016). Raj and Sindhu (2013) are convinced that this new type of risk needs to be fully integrated into the general risk framework of banks.

Given these regulatory and financial pressures, it would make sense for banks to find a best-practice approach for managing conduct risk that would allow for the successful selling of the right products to the right customers in a sustainable way. This may, in turn, impact the (financial) success of the bank. It would be worth investigating whether there is a best and most-successful approach that developing market banks could adopt.

Measurement of conduct risk

From a customer point of view, it will be critical to understand how conduct risk can be measured whereby a bank is able to prove to stakeholders that the risk is contained. If conduct risk was not a problem within the sector, customers would not receive unsuitable products. Hence, customers are at the heart of measurement. Regulators are examining outcomes-based approaches, which makes the measurement on the part of banks challenging in itself. Lastly, measurement in a developing country might have to be tackled slightly differently to that of a developed country, taking into consideration the lack of financial education.

There are various reasons why measuring concepts like culture and conduct remains difficult for banks. Firstly, conduct risk is not easily quantified, since it has qualitative aspects (Thomson Reu-

ters, 2017). Secondly, different stakeholders may have distinct perceptions. Thirdly, many important conduct-risk failures might never be reported. Lastly, even though conduct risk might be evident in the organisation, there is not always enough evidence of it to easily detect it.

If banks could find a best-practice approach for measuring conduct risk, it would assist them to manage conduct risk more efficiently. If the correct measures are used, the indications about misconduct in the organisational system would be reliable and easier to mitigate and manage. Again, the situation in a developing market might be slightly different. Bank customers in developing markets may be more vulnerable to mis-selling, on account of having less financial knowledge (Klapper *et al.*, 2015), and conduct-risk measurements would have to consider this.

1.1.2 Conduct risk in developing markets and the example of South Africa

When assessing the problems at hand, it is clear that developing markets are affected to a greater extent than developed markets. South Africa is an interesting example of a developing market. On the one hand, it is ranked 37th (out of 138 countries) for soundness of banks in the 2016/2017 Global Competitiveness Report (World Economic Forum, 2017). On the other hand, over-indebtedness is of great concern, as 16% (5.7 million) of South African adults are still financially excluded from the banking system (BASA, 2014). There is also an imminent change in South African regulation that will significantly impact banks, partly because it creates uncertainty.

Other developing countries comparable to South Africa are difficult to find – based on the dichotomy described above. Kenya is a country with a unique position in cellphone banking and experience with consumer-protection regulation. Malaysia is a good example of a developing country that has progressed in terms of financial education and inclusion, as well as consumer protection in the financial services arena.

1.2 Problem statement

As outlined in Chapter 1.1 (Background), there could be serious consequences if the new phenomenon of conduct risk is not regulated, managed and mitigated effectively. One would therefore expect to find some initial developments in practice, or even real case-study examples. However, conduct risk is a novel concept that is difficult to measure, and therefore little publicly available

information exists, especially for developing markets. The issue is further exacerbated by the fact that some financial institutions await new or changed conduct-risk regulation in their countries.

Existing academic studies are rare and mainly focus on developed countries. Most research consists of popular press articles, reports from consulting companies or banks, and general guidelines from different regulators or international organisations. As far as the authors are aware, Chapter 2 of this dissertation presents the first published article on banking conduct risk in a developing setting. An overview of the studies that may be applicable to the three perspectives introduced in Chapter 1.1.1 is provided in Chapters 2, 3 and 4.

Given its potential negative consequences, and the knowledge gap in the literature, conduct risk should be academically researched so as to explore best-practice approaches for possible solutions.

1.3 Research questions and objectives

The following specific research questions were formulated from the three perspectives introduced earlier:

- *Which influencing factors should regulators in developing countries take into consideration when constructing a (country-specific) regulatory approach for conduct risk in the banking sector in order to ensure that conduct risk is managed and mitigated by the banks in a way in which the outcome will be positive for customers?*
- *With which approach can South African banks achieve compliance with future and existing conduct-risk regulation and at the same time keep their businesses sustainable?*
- *How should South African banks approach the measurement of conduct risk?*

In order to answer these research questions, the following research objectives were set. The general objective of this research was to recommend to South African banks best-practice approaches for managing conduct risk. The specific objectives of this research were as follows:

- *To assemble a conduct risk regulatory model for developing market banks.*
- *To determine a new approach to South African banks' conduct risk, while, at the same time, ensuring business sustainability.*

- *To develop a first best-practice proposal of how to approach the measurement of conduct risk in South African banks.*

Based on the three perspectives described above, these issues are of vital importance to the following role players: firstly, banks and their stakeholders have an interest in controlling, and the power to control, conduct risk; secondly, regulators are searching for the best way to achieve their ultimate, outcomes-based goal of minimising misconduct; and, thirdly, customers are concerned about conduct risk – since they want to receive suitable products.

1.4 Research output and methodology

Table 1 summarises the research output for this dissertation.

Table 1: Research output.

	Article number		
	1	2	3
Title	Assembly of a conduct-risk regulatory model for developing market banks	Conduct risk in South African banks: Aligning regulatory compliance with business sustainability	Measuring conduct risk in South African banks
Status quo	Hargarter, A. & van Vuuren, G. (2017). Assembly of a conduct-risk regulatory model for developing market banks. <i>South African Journal of Economic and Management Sciences</i> , 20(1): 1-11	First submitted to <i>Southern African Business Review</i> , March 2018. Re-submitted after 2 nd round of comments, June 2018	Submitted to <i>Qualitative Research in Financial Markets</i> , March 2018
Research philosophy	Realism/Interpretivism	Realism/Interpretivism	Realism/Interpretivism
Research strategy	Inductive/Qualitative	Inductive/Qualitative	Inductive/Qualitative
Research design	<ul style="list-style-type: none"> • Comparative • Exploratory 	<ul style="list-style-type: none"> • Cross-sectional • Exploratory 	<ul style="list-style-type: none"> • Cross-sectional • Exploratory
Research entity and method I = Interviews SD = Secondary Data ES = Existing Surveys	<ul style="list-style-type: none"> • Selective specialists: I • Literature: SD 	<ul style="list-style-type: none"> • Bank staff: I • Selective specialists: I • Literature: SD, ES 	<ul style="list-style-type: none"> • Customers: I • Literature: SD, ES

The research methodology is described below.

1.4.1 *Research philosophy*

Research philosophy concerns itself with epistemological and ontological considerations. Bryman and Bell (2007) state the following as the central issue: researchers need to ask themselves what is acceptable knowledge in a specific discipline.

While misconduct can be classified as a risk and can be tackled as part of a wider risk management approach within banks, it is influenced by human behaviour and how humans make sense of their world. A positivist approach might help to explain the phenomenon, but it is not suitable for understanding the phenomenon. It is also impossible to generate law-like generalisations (Saunders *et al.*, 2015).

Given the problem at hand, the most appropriate research philosophy would be realism and/or interpretivism (Saunders *et al.*, 2015). Interpretivism is suitable because this research attempts to understand the subjective reality of an industry as a whole, as well as the individual banks and their stakeholders, and to make sense of their actions and related motives and intentions. Realism is suitable because there may be broader forces, structures or processes that can influence those actions (such as regulation). In terms of social ontology, this research prescribes to a constructivist approach. While it is assumed that the organisations and the culture in question exist, humans are part of the organisation and the culture, and will hence influence both (Bryman and Bell, 2007).

1.4.2 *Research strategy*

Bryman and Bell (2007) state that a research strategy differentiates between qualitative (mostly inductive) and quantitative (mostly deductive) research, with some researchers also combining qualitative and quantitative research. The strategy for this research was qualitative, based on the fact that initial best-practice models for conduct risk were developed, and the focus was mainly on the 'how'.

Grounded theory (Glaser and Strauss, 1967) was used as a strategy for this research. The best-practice approaches were constructed based on the central themes that emerged from the data and the specific situation in which the research was conducted (Saunders *et al.*, 2015). Even though wider generalisations from this research will be risky, this research strategy was deemed suitable based on the nature of the topic and the fact that very little formal

academic research has been conducted to date, as far as the authors are aware. In order to achieve credibility, this research assesses the new phenomenon of conduct risk from three different perspectives.

1.4.3 *Research design*

A comparative study was used for the first article, in which three developing countries were analysed. For the other two articles, a cross-sectional research design was used, as the specific phenomenon of conduct risk was studied at a particular time (Saunders *et al.*, 2015).

For most of the research, the goal was to explore and find solutions to the new and vital topic of conduct risk and gain new insights, and therefore an exploratory approach was used (Saunders *et al.*, 2015).

1.4.4 *Research entity and method*

Limited data was available from the literature review and from secondary data-sets in the form of existing surveys, and therefore some additional data were collected. Bank employees, banking industry specialists and bank customers were used to gather data. Focus was directed to the 'big four' South African banks, as the small banks in South Africa are not as far ahead in terms of implementing conduct risk – as specified in the last self-assessment exercise conducted by the FSB (2013) in South Africa. Interviews were conducted with specialists on conduct risk or similar concepts (such as ethics and sustainability), Heads of Conduct Risk (or similar) in the big four banks, as well as existing bank customers.

Relevant institutions and appropriate persons were carefully selected using the purposive sampling technique to ensure that the research was valid. This technique was deemed appropriate to gain access to information-rich cases that would enable the researcher to answer the research questions as best as possible (Saunders *et al.*, 2015). Access to specialists on the topic, as well as to bank employees, was facilitated through existing contacts in the industry, based on the researcher's employer. Access to existing bank customers was gained through the researcher's employer.

Qualitative data was analysed in an exploratory way, in search of a direction for future research. Emerging themes and explanations were compared to the limited existing academic studies. A more detailed description of the data analysis, per article, is contained in the relevant chapters.

1.5 Structure of PhD dissertation

Best-practice approaches for managing conduct risk are relevant for the financial services industry, in particular, and the economy, in general, in that they encompass the main role-players that are affected (see Figure 1) – regulators, banks and customers.

The publishable articles have been split into the following chapters in the final submission, preceded by an introduction (including a research methodology section) and summarised by means of a conclusion.

Chapter 2, Article 1: Assembly of a conduct-risk regulatory model for developing market banks. The objective for this article was as follows: *To assemble a conduct-risk regulatory model for developing market banks.*

Chapter 3, Article 2: Conduct risk in South African banks: Aligning regulatory compliance with business sustainability. The objective for this article was as follows: *To determine a new approach to South African banks' conduct risk, while at the same time ensuring business sustainability.*

Chapter 4, Article 3: Measuring conduct risk in South African banks. The objective for this article was as follows: *To develop a first best-practice proposal of how to approach the measurement of conduct risk in South African banks.*

1.6 Conclusion

As a new banking risk phenomenon, conduct risk needs to be regulated, measured and managed to avoid negative consequences for all stakeholders (including regulators, banks, shareholders, employees and customers). This is especially true for developing markets. Current knowledge around conduct risk is limited. This research therefore uses qualitative research methods to explore possible best-practice approaches for South African banks, which were chosen as an example of banks in a developing market. Three studies consider three perspectives: the regulatory, the banking business and the customer perspectives.

Chapter 2

Assembly of a conduct-risk regulatory model for developing market banks

Assembly of a conduct-risk regulatory model for developing market banks

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Published: 2017

Abstract

Background/Social Value: The substantial penalties imposed on banks in the recent past for various conduct irregularities have given rise to a new type of risk called conduct risk. Conduct risk comes about when financial services companies conduct themselves in an inappropriate way towards their customers, resulting in a negative (economic) outcome for the customer.

Scientific value/knowledge gap: What makes the management and mitigation of conduct risk by banks so different is that it cannot be easily integrated into a bank's standard risk management framework. So far, the concept of conduct risk has not been formally covered by the Basel Accords.

Aim: There are, however, global efforts by international organisations and local regulators to control it – with little clarity on the 'how'. The aim of this study is to explore this 'how'.

Setting: While regulators need to protect customers, resulting in a positive outcome for the customer, they must also ensure that banks take conduct-risk management and its mitigation seriously. At the same time, any regulatory model for conduct risk needs to be incorporated into the existing bank regulatory strategy and methodology and assimilated with the profile of a country.

Methods: An exploratory model that regulators could use to keep conduct risk at bay is developed based on primary and secondary data and this is then applied to the South African, Kenyan and Malaysian milieus to determine what can be learnt about conduct risk in emerging economies.

Results: The model investigates the interrelationships between different goals that regulators ideally need to achieve and the findings show that regulators have a difficult task balancing these goals and at the same time achieving a positive outcome.

Conclusion: Based on the model, the recommendation for regulators in the developing world would be to collaborate in their approach to conduct risk, as they might face similar difficulties and operate in a comparable context.

Keywords: Bank Regulation; Financial Crisis; Conduct Risk; Risk Management; Consumer Protection; Policy

JEL Classifications: D180, G010, G280, G210

1. Introduction

Banking can be traced back to the 18th century BC when the first records of loans were found (Gascoigne 2001). Banking institutions fund themselves with public deposits, and they then lend out these funds to debtors. This is one of the reasons that the regulation of banks, more so than other industries, is crucial. The Bank for International Settlement's Basel Committee on Banking Supervision (the BCBS) works globally to establish minimum global regulatory and supervisory standards, with the goal of enhancing financial stability (BIS 2014). The risks covered by the various iterations of the so-called Basel Accords (I, II and III) are credit, operational and market risk – and liquidity risk was recently added (BCBS 2006, 2011). The concept of conduct risk has not been formally covered by the Basel Accords. There are, however, global efforts by international organisations and local regulators to control it. Conduct risk surfaced after the global financial crisis of 2008/2009 (National Treasury 2011). One example that highlights how important the concept of conduct risk has become globally is that the Organisation for Economic Cooperation and Development (OECD) expects all its members to integrate conduct risk into their regulatory approach (OECD 2011, 2013). In the standard approach to risk management, banks ask whether the risk is within appetite, whereas in the approach to conduct risk, banks ask how a scenario will look when risk appetite is breached (Management Solutions 2016). Because the approach is slightly different, this new type of risk cannot be covered under operational risk only; it needs to be added to the general risk framework of banks and managed and mitigated accordingly (Raj and Sindhu 2013). In the last three years, many banks have received considerable fines based on conduct failure (FCA 2015). As part of the EU-wide 2016 stress test, banks had to forecast operational risk losses using their internal models. 15 European banks estimated the aggregate potential loss from conduct risk to be 71 billion Euros for 2016–2018 (CCP 2016).

This article presents the necessary background to the topic of conduct-risk regulation for banks. A model is then constructed to show how regulation should be approached by the

regulator in order to ensure effective market conduct regulation. Case studies of developing countries are used to indicate whether such a model could be successful. In most countries, conduct-risk regulation has either not been implemented at all or not for an extensive period. This research will provide direction, rather than pinpointing exact results.

This article is organised as follows. Section 1 presents an introduction to the concept of conduct risk and related concepts. Section 2 covers the literature review. Assembling an appropriate banking conduct regulatory model is covered in Section 3, and the model is then tested in Section 4. Section 5 provides a conclusion as to whether the proposed model could work, as well as recommendations for furthering this research.

1.1 Definitions

Conduct risk, from a bank's point of view, is defined as '... the risk that detriment is caused to the bank, [our] customers, clients or counterparties because of the inappropriate execution of [our] business activities' (Barclays 2012:189). A distinction should be made between the conduct of business and financial market integrity, sometimes referred to as retail versus wholesale conduct risk (National Treasury 2014).

Regulators differentiate between market conduct and consumer empowerment/protection. Within market conduct, the focus is on the institutional framework and supervision, sales and marketing practices, fees and charges, lack of transparency and disclosure and responsible lending; whereas in terms of consumer empowerment/protection, the focus is on consumer financial literacy and awareness and avenues for help and redress (Alliance for Financial Inclusion 2015).

For the purpose of this research, effective bank conduct-risk regulation means the following: the bank conduct-risk regulation model is developed, with consideration to all relevant influencing criteria, and leads to a situation where banks are compliant (manage and mitigate conduct risk according to the laws and regulations set out). As a result, the outcome for customers is positive in the sense that they receive financial products/services that suit their needs. It should be mentioned at this point that the measurement of this outcome is challenging.

The term 'customer' is used to refer to the client of a bank. The term 'consumer' is used in the context of consumer protection and education across industries.

1.2 Research philosophy, question and relevance

The research methodology suggested for this type of research is inductive and exploratory (Trochim 2006), as a model is developed that could constitute a new approach/theory. The main research question is: which influencing factors should regulators in developing countries take into consideration when constructing a (country-specific) regulatory approach for conduct risk in the banking sector in order to ensure that conduct risk is managed and mitigated by the banks in a way in which the outcome for customers will be positive?

This research will help stakeholders understand banking conduct-risk regulation as a new concept and how it can be implemented successfully in developing countries to the benefit of both the customer and the bank.

2. Literature review

2.1 Bank regulation as a necessity

Banks have to comply with more specific laws and regulations than companies from other sectors:

It is likely that, in the absence of prudential regulation, deposit-takers, insurers and investment firms would be less resilient against failure, and risk more disruption to the continuity of financial services, than is in the public interest (Bank of England 2012:5).

However, 'it is an illusion to believe that there is a single, superior model of institutional structure that is applicable to all countries' (Llewellyn 2006:7). In addition to other criteria, the structure of the banking sector and the financial sector as a whole would need to play a role in the selection of a suitable model (Sum 2016).

Another topic of interest is the question of whether institutions or financial products should be regulated by the same entity. For example, in South Africa, the market conduct authority will in future be responsible for regulating how banks design and price their products; however, the prudential supervisor also needs to ensure that the financial products that are sold are consistent with prescribed principles, even though their focus is on the supervision of institutions (National Treasury 2013). This may prove challenging if both entities do not work together closely.

2.2 Prudential regulation versus market conduct regulation

Within bank supervision and regulation, prudential regulation and market conduct regulation can be differentiated. On the one hand, the prudential regulator is typically responsible for ensuring the safety and soundness of banks and minimising the adverse effects that they can have on the stability of the financial system. On the other hand, the market conduct regulator usually ensures that relevant markets function well, and that banks conduct themselves appropriately (Bank of England 2012). Čihák and Podpiera (2008) have discovered that there is some support for the ‘Twin Peaks’ approach, which integrates supervision across sectors and, at the same time, separates business conduct and prudential supervision.

Generally, financial consumer protection should be an integral part of the legal, regulatory and supervisory framework, and should reflect the diversity of national circumstances and global market and regulatory developments within the financial sector (OECD 2011:5).

Dias (2013) also recommends that bank supervisors leverage positions in the existing institutional landscape to advance and add financial consumer protection topics to existing oversight practices. He puts forward a risk-based approach to consumer protection, in line with prudential regulation, to strengthen the banks’ existing risk management framework.

When it comes to conduct risk, some countries have regulated credit-related products separately from investment-related products. For example, South Africa introduced the National Credit Act in 2005, to ensure credit providers do not encourage customers to take on loans to the point where they become over-indebted (BASA 2016).

This raises the question of whether there should be a single piece of conduct regulation or not. In many countries, conduct risk spans across various different regulations and is not captured in one piece of regulation.

2.3 Bank regulation in different countries

2.3.1 South Africa as an example of ‘Twin Peaks’

After the global financial crisis, and partly on account of the Competition Commission Banking Enquiry (Competition Commission 2008), South Africa decided to change its financial sector legislation and is currently moving towards a new Twin Peaks approach that separates prudential regulation and market conduct regulation. The South African Financial Services Board (SA FSB) has implemented the Treating Customers Fairly (TCF) approach to supervision

across the financial services industry in preparation for the new conduct regulation (National Treasury 2014).

The new Financial Sector Regulation (FSR) Bill will be enacted in late 2016, after which time the two new authorities – the Prudential Authority (PA) and the Financial Services Conduct Authority (FSCA) – will be established. Until the new Conduct of Financial Institutions Act (CoFi Act) comes into effect (likely to occur in 2017), the FSCA will work with existing laws that already require specific conduct from financial services companies (National Treasury 2015).

2.3.2 Malaysia as an example of 'non-Twin Peaks'

In Malaysia, financial consumer protection and market conduct supervision are the responsibility of the Central Bank, and they need to leverage existing internal synergies. However, there is an internal Twin Peaks structure that promotes 'checks and balances' and a strong focus on safety, soundness and consumer-protection objectives. The enforcement function is separated from prudential and conduct supervision and resides with the Financial Intelligence and Enforcement Department of the Bank (Ali 2014).

2.3.3 Other developing banking market examples: Kenya

Kenya follows neither a Twin Peaks nor a One Peak model. The country's current approach is to keep banking supervision separate within the Central Bank of Kenya (CBK), but to integrate both prudential supervision and conduct of business supervision of all the other regulators in the Financial Services Council (Capital Markets Authority Kenya 2014; Central Bank of Kenya 2014 and 2015).

In 2013, the CBK, as the main banking regulator in Kenya, published a new set of prudential and risk management guidelines, which includes a specific section on consumer protection and a specific section on reputational risk. The CBK is using remedial actions provided for under certain sections of the Banking Act and may take other action as it deems appropriate (Central Bank of Kenya 2013a, 2013b).

2.4 Financial crises and regulation

The global financial crisis has resulted in many countries reviewing and reinventing their financial sector policy priorities as a whole (National Treasury 2011). Nichols, Hendrickson and Griffith (2011) suggest that every major financial crisis in the USA has brought about some

new legislation, and that the same regulatory response is likely to have an influence on the next financial crisis. Ojo (2010) pointed out a growing global trend in 2010 (after the global financial crisis) towards enforced self-regulation in the sense that regulators no longer prescribe strict rules, but rather encourage firms to use their own approach (meta-risk regulation). Sepe (2012) argues that crises are erroneously held responsible for managerial moral hazard. Instead he recommends a contractarian approach to bank regulation, where '[...] regulators act as debt holders, and [would] offer lower capital requirements and lower deposit insurance premiums while demanding the same governance concessions' (Sepe 2012:328).

2.5 Profitability, sustainability and socioeconomic realities

'The post-crisis pressure on firms to rebuild prudential soundness, attract new funding and maximise profits could lead to short-sighted strategies that have unintended conduct consequences' (FCA 2013:48). The challenge presented in this statement is particularly important for banks that are operating in developing economies, where consumer protection, financial inclusion and education are more important concepts than in the developed world. The United Nations Environment Programme (UNEP) (2015) is convinced that sustainable behaviour and practice (economic, environmental and social) can drive economic profits.

2.6 Culture and other intangible factors that influence regulation

It would seem as though cultural norms that prevail in certain countries influence the effectiveness of specific regulatory approaches. This should be even more distinct when one considers conduct risk, as it is influenced by values and culture. According to Cohen, Pant and Sharp (2001) a strong uncertainty-avoidant culture requires extensive rules and regulations for various situations, while weak uncertainty-avoidant cultures are more tolerant of ambiguity.

Chen, Danbolt and Holland (2014) insist that intangible factors do in fact have relevance for systemic risk and bank regulation. Alemanno (2015) argues that many OECD countries are becoming aware of how important public engagement is in policymaking. Finally, trust between the regulated and regulators is vital for regulation to function effectively (Ugeux 2014).

2.7 Customer responsibility and complaints resolution

The financial crisis highlighted the importance of financial consumer protection for the long-term stability of the global financial system. At the same time, rapid increases in the use of

financial services have pointed to the need for strengthened financial regulation and consumer education to protect and empower consumers (The World Bank 2012:1).

This quote makes reference to a consumer who is educated and able to take responsibility for his actions and decisions. However, one of the challenges is that bank customers might not behave rationally with regard to their financial choices at all times (Azis & Shin 2015).

3. Constructing an effective model for banking conduct-risk regulation in developing countries

Regulators will try to influence banks' conduct with regard to their complete value chain (Figure 1), from the agenda of top management to product design and after-sales, with the ultimate goal of creating a positive outcome for the customer. Concepts similar to conduct need to be considered when constructing the model, as they may be influencing factors with regard to the outcome the regulator is trying to achieve.

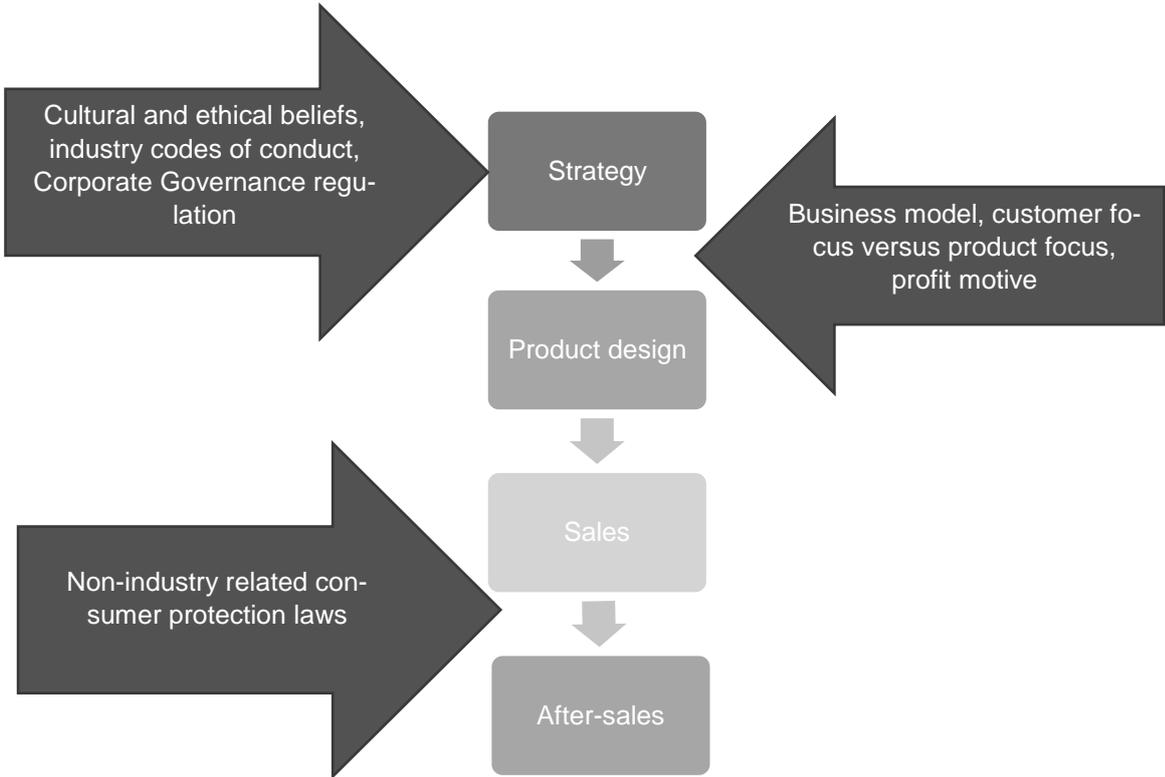


Figure 1: Value chain of banks.

Source: Authors.

3.1 Model proposal

Although regulatory approaches, and the question of whether they are effective, mainly require a qualitative mind-set, it is important to explore relationships and interdependencies between different influencing factors (Figure 2).

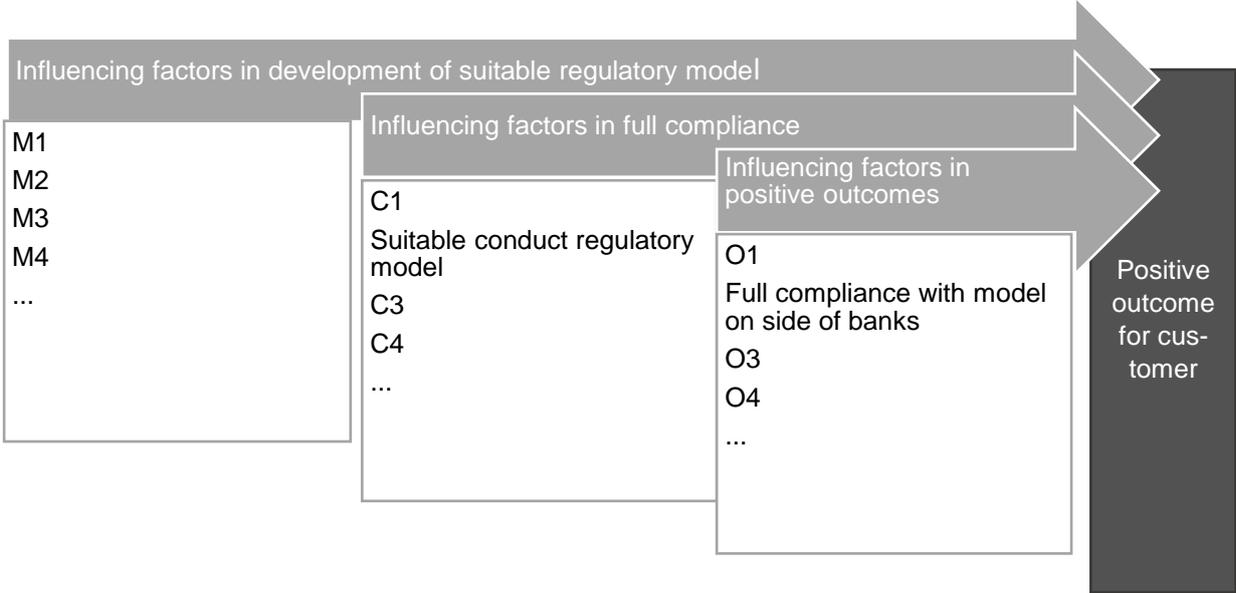


Figure 2: Relationships and interdependencies between influencing factors in the model.

Source: Authors.

The end goal of all conduct regulation is that the outcome for the customer should be positive. What exactly does this mean and how will it be measured? A positive outcome for a customer should, at minimum, mean that he has a positive customer experience; his financial needs are evaluated; and he is sold a product that is suitable for his financial needs. It is difficult to measure this outcome because the bank alone cannot take responsibility for the measurement thereof. Although banks can compile customer surveys, the response rate is often poor and customers might not always communicate their discontent. Furthermore, customers might be sold a product, but never use it.

Although regulators might think that a suitable regulatory model is all that is needed to achieve a positive outcome for the customer, the reality is more complex. Various factors influence this final outcome, as shown in Figure 2 by O1 to O4 (examples of possible factors such as these will be covered in the 'Reviewing (seemingly) indirect influencing factors (Cs and Os) for effective conduct-risk regulatory model' section). One of the influencing factors (shown as O2) is the full compliance with the conduct-risk regulation on the part of the banks in the sense that

appropriate management and mitigation techniques need to have been applied. It also means that the bank is managing conduct throughout the value chain; that processes are in place to ensure that each customer's needs are analysed and a suitable product is recommended; and that the utilisation of the product is tracked. Full compliance by the banks will be influenced by various factors, shown in Figure 2 as C1 to C4 (examples of these are presented in the 'Reviewing (seemingly) indirect influencing factors (Cs and Os) for effective conduct-risk regulatory model' section). One of the influencing factors is likely to be a suitable regulatory model (shown as C2). A regulatory model will be suitable if it leads to a situation where banks will comply with the regulation, and if the end goal of a positive outcome for customers is achieved. The suitability of the model depends on certain influencing factors, shown in Figure 2 as M1 to M4 (some possible factors are presented in the 'Reviewing direct influencing factors (Ms) for effective conduct-risk regulatory model' section). First and foremost, these factors need to be managed by the regulators as effectively as possible to achieve the end goal. Apart from this, the regulator also needs to understand, interpret and potentially influence the (independent) influencing factors of banks' compliance (Cs) and positive outcomes for customers (Os) as well. For ease of reading, Figure 2 only shows four influencing factors for each case; in reality, however, there could be more or fewer influencing factors. Also, the factors might not be stable over time and could be subject to change.

3.2 Developing an effective banking conduct-risk regulatory model

3.2.1 Reviewing direct influencing factors (Ms) for effective conduct-risk regulatory model

Table 1 indicates possible influencing factors in the banking conduct regulatory model, based on the literature review (in the first column) and questions regulators should ask themselves to best manage those influencing factors (in the second column).

Table 1: Decision-making criteria and questions (Ms).

Decision-making criteria (Ms)	Questions
Global trends for conduct regulation and influence on country-specific approach	Is there a global trend on how to approach conduct regulation? If so, are there any lessons we could learn from this, or do the arguments not apply to our (country) case? Are we sharing ideas with other countries that are in a similar situation?
Financial crises and their effect on cycles of open versus strict rule-based approaches	When did the last financial crisis happen and how did regulations change thereafter? After that, was there a trend towards more flexibility or less flexibility? After analysing these issues, what would this mean for a stable regulatory model that can function over the medium term (at least)?
Socioeconomic profile and financial inclusion or education	What is the socioeconomic profile of our country? What is our financial inclusion and education rate? How do these issues need to be incorporated into our regulatory framework to make it suitable?
Cultural norms and type of enforcement	Are there any cultural norms prevalent in our country that would influence the efficacy of the approach and also the enforcement strategy to be chosen?
Structure of the banking sector and stakeholder involvement	How much market share do the biggest four banks have in our country? Will this influence our approach in the sense that we need to involve fewer stakeholders?
The acceptance of sustainability as a business model	Do we believe that banks need to be sustainable, rather than being only profit-oriented? If not, can the model be constructed in a way in which it supports banks in finding solutions for the conflict between profit goals and ethical conduct?
The link to other legislation already in place	Do we strive for one piece of conduct risk regulation or is the legislation for conduct included in various pieces of legislation? If the latter, how can confusion and regulation-fatigue be avoided?
The degree of product versus bank regulation	Are we regulating banks' behaviour or are we taking the regulation to a point where banks are limited in the products that they can design?

Source: Authors.

3.2.2 *Reviewing (seemingly) indirect influencing factors (Cs and Os) for effective conduct-risk regulatory model*

As mentioned previously, in order for regulators to achieve the end goal of a positive outcome for the customer, they also need to examine and understand the variables shown in Table 2.

Table 2: Cs and Os for consideration by the regulator.

Cs and Os	Questions
Behavioural aspects	How can we ensure that we get buy-in for our model from the various banks and – linked to this – that conduct risk is implemented across the organisation and included in the bank’s general risk management framework?
Profit motive and business model	Given the suggested regulatory model, is it possible for banks to run a profitable business?
Individual banks’ agendas	Do any individual banks have an agenda of which we need to be aware? If so, how can we engage with those banks and remedy the situation?
Guidance with regard to the regulator’s reaction	How can we guide banks with regard to possible reactions and sanctions (including fines) by the regulator to enable them to manage and finance their conduct risk in a more effective manner?
Customer responsibility and education	How can we foster customer responsibility, considering the profile of customers in our country? Who takes ultimate responsibility for the customer’s education – is it the customer, the bank, the regulator, the government, or all of them?
Complaints resolution at national level	Did we make provision in our model for a functioning complaints-resolution system? How would such a system need to look?

Source: Authors.

3.2.3 Understanding the relationship between direct influencing factors (Ms) and a suitable regulatory model

The relationship between the direct influencing factors and a suitable regulatory model is straightforward in the sense that the better the regulator's grip on the influencing factors, the more suitable the regulatory model should be. Figure 3 highlights this relationship.

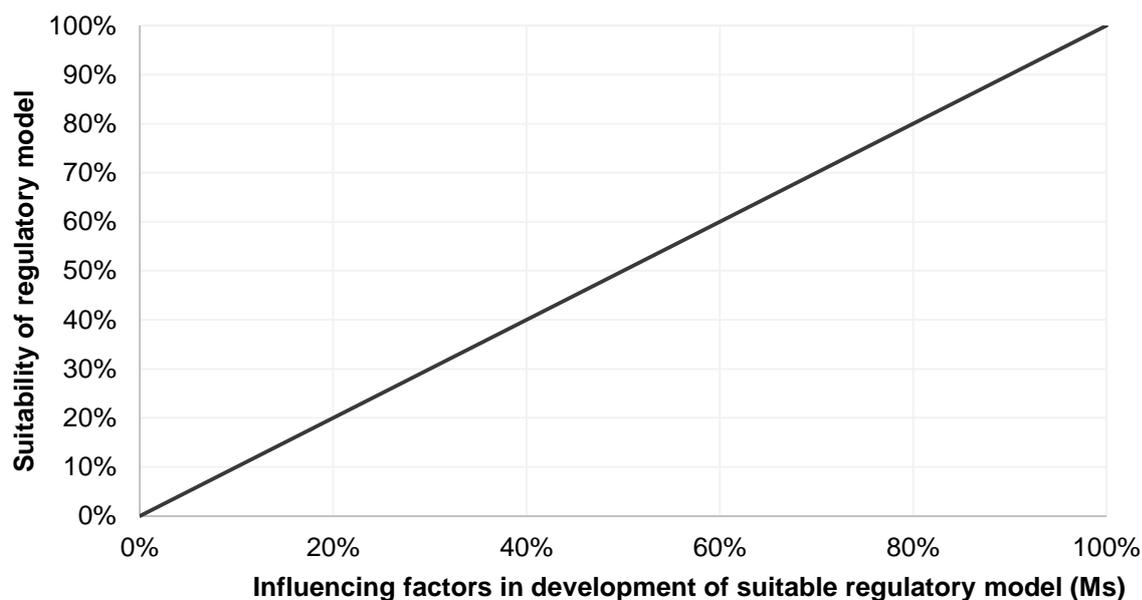


Figure 3: Suitability of regulatory model and the factors that influence it.

Source: Authors.

3.2.4 Understanding the relationship between direct influencing factors (Cs) and full compliance on the part of the banks

As the regulatory model becomes more and more suitable, banks' compliance should increase: the relationship should be positive. Firstly, however, as other factors (Cs) influence the compliance of banks – introduced in the 'Reviewing (seemingly) indirect influencing factors (Cs and Os) for effective conduct-risk regulatory model' section (for example, whether banks are actually willing to comply) – the relationship is not linear: As the level of compliance increases, suitability is not increasing at the same rate, so a more suitable model will not automatically lead to a higher compliance by banks. Secondly, banks need to first understand what is required in terms of compliance, and so they need time to adapt. In order to ensure banks comply with ease, regulators need to attempt to influence the Cs as well, which will ideally shift the curve in the direction of the arrow, as shown in Figure 4.

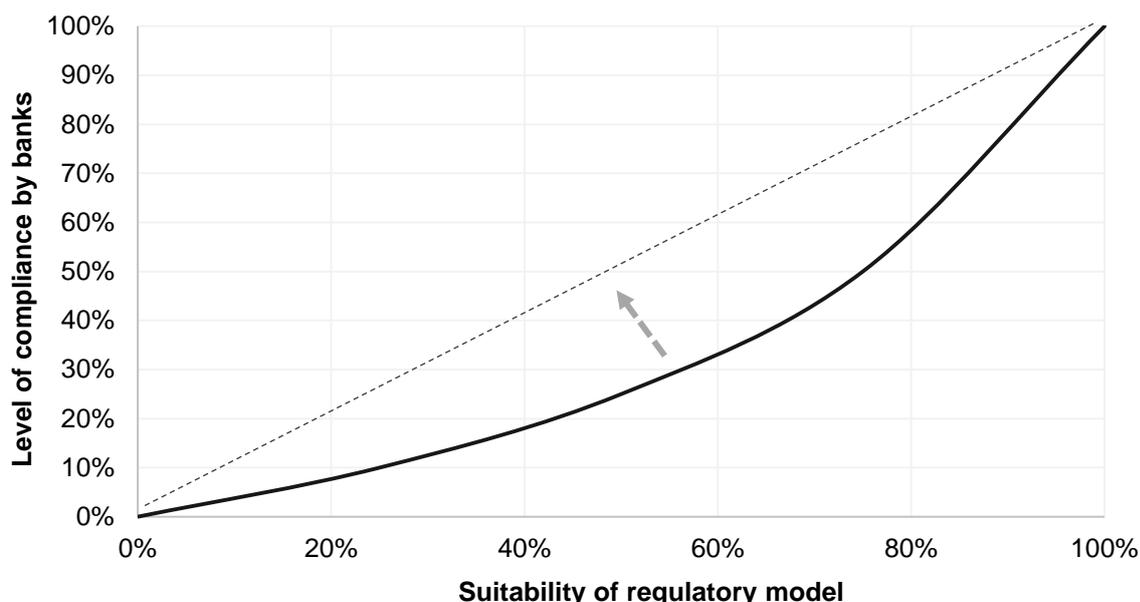


Figure 4: Suitability of regulatory model and level of compliance.

Source: Authors.

3.2.5 Understanding the relationship between direct influencing factors (Os) and a positive outcome for customers

Figure 5 shows that the customer outcome will be negative if minimal or no implementation occurs. The customer will be at risk. As conduct risk is managed and mitigated effectively by the bank, the customer outcome becomes more positive. However, there is a lag here: for every customer who feels a real positive impact, banks first need to perfect the implementation across the organisation for every single staff member. Regulators would need to create a model that can secure ‘quick-wins’ for banks in terms of compliance so that customers will feel the benefit immediately.

In their regulatory approach, regulators should make provision for banks to use existing processes and data to measure whether outcomes are positive, instead of having to ‘re-invent the wheel’. The more burdensome regulatory approaches and processes are, the more negative the sentiment towards compliance will be. This will result in a negative outcome for the customer.

In order to shift the curve dramatically (Figure 5), regulators need to attempt to influence the other Os. The more educated customers are, and the better the complaints-resolution process is, the more independent they are in terms of whether banks comply with conduct-risk regulation or not. For example, if a customer is sufficiently educated about financial products, it will

be more difficult for the bank employee to conduct himself unethically and sell an unsuitable product to the customer. Regulators should also attempt to create positive feedback forums, instead of only focusing on complaints resolution.

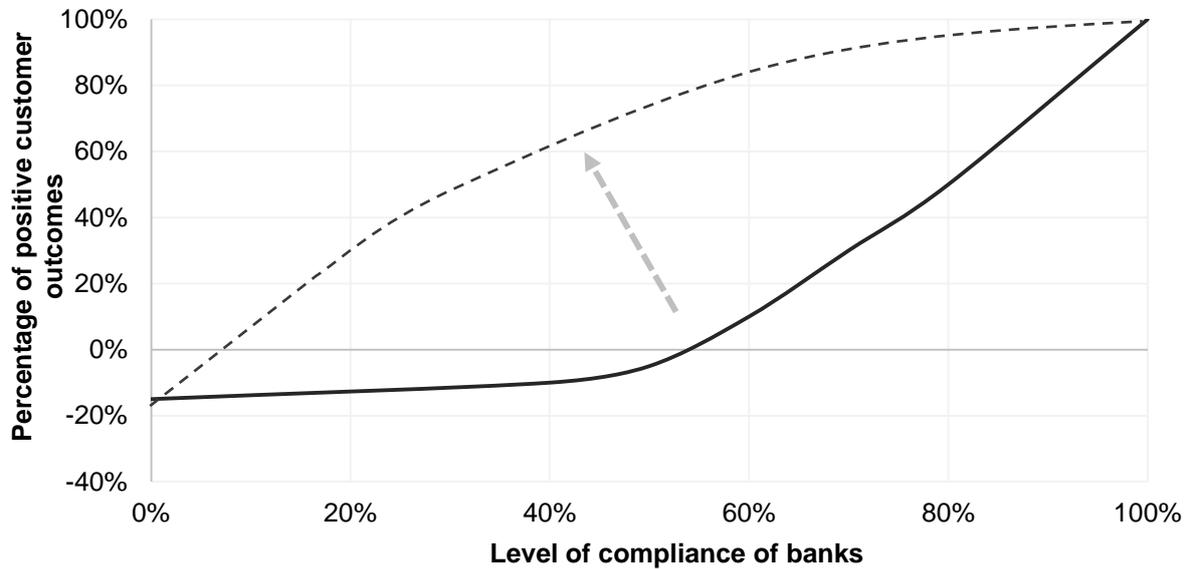


Figure 5: Compliance of banks versus positive customer outcome.

Source: Authors.

3.2.6 The ideal world

In an ideal world then, what results would a perfect model achieve? The perfect model would achieve 100% in all three factors, as shown in Figure 6. Somewhere in between, the customer would be sufficiently educated to not have to rely too much on conduct-risk regulation. Banks would be convinced of the importance of conduct risk and approach its management and mitigation in the best way possible, even if the regulatory model were not as perfectly suitable. This would be partly as a result of their ability to conduct themselves accordingly, while still maintaining their profitability.

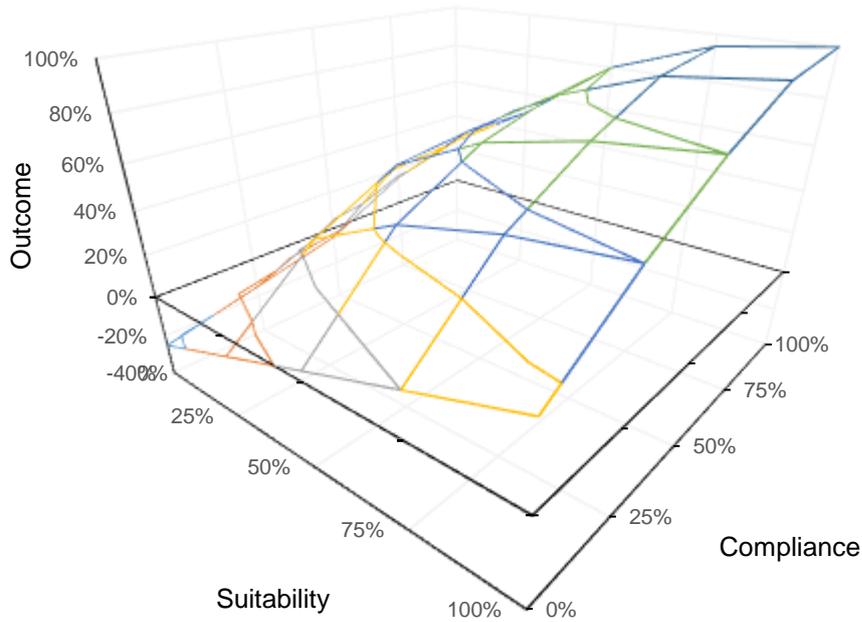


Figure 6: Three-dimensional graph to show regulatory model interdependencies.

Source: Authors.

4. Testing the model: Specific developing country examples

Appendix A offers a detailed evaluation of whether the constructed regulatory model could work in South Africa, Malaysia and Kenya. This is presented in table format, including references – based on the model constructed in the ‘Constructing an effective model for banking conduct-risk regulation in developing countries’ section. In Table 3, a short summary evaluation of the effectiveness of the approach of the different countries is provided.

Table 3: Evaluation of assembled model using South Africa, Malaysia and Kenya as developing country examples.

Country	Positives	Negatives
South Africa	<ul style="list-style-type: none"> • New planned legislation attempts to link the country's specific desired economic outcomes with positive customer outcomes • Government involves stakeholders in developing conduct approach • Financial education is high on agenda 	<ul style="list-style-type: none"> • Government mainly looked at developed countries when developing the conduct-risk regulatory model
Malaysia	<ul style="list-style-type: none"> • Central Bank uses the concept of moral suasion in conduct-risk regulation • The regulators' expectations are communicated to the industry continuously • Deep understanding of consumer behaviour has driven financial literacy and education in a major positive way, with multiple redress avenues for consumers • Building credibility with customers and banks alike is a priority 	<ul style="list-style-type: none"> • Government has a stake in most banks and seems to prioritise consumers over banks, which can be viewed negatively from a free market point of view • The Central Bank is aware that the cost of compliance is often transferred to customers, but there is no attempt by the Central Bank to tackle this
Kenya	<ul style="list-style-type: none"> • Kenya has a track record for looking at country-specific requirements to create conduct regulation for mobile banking providers (instead of following other countries' models) 	<ul style="list-style-type: none"> • The challenges are slightly more pronounced, as the country has a low-income profile; hence financial education cannot be relied upon as yet • Complaints resolution can be improved

Source: Authors.

5. Conclusion and recommendations

This research attempts to construct a model that points regulators in developing markets in the right direction. Regulators need to take challenges specific to developing markets into account. Regulators also need to influence the sentiment of the banking sector around conduct-risk regulation, as well as consumer education. Lastly, it is of utmost importance that the regulatory model is set up in a way that allows banks to run profitable businesses.

Examples of three developing countries show that regulators are approaching the regulation of conduct risk in a way that is unique to each country. Country-specific issues, such as the mobile banking trends in Kenya and the low savings rate in South Africa, are influencing the way regulators think and operate.

The recommendation for regulators would be to cooperate with other developing countries in designing banking conduct-risk regulation and financial education and inclusion strategies. Certain ideas could be implemented successfully in various developing market scenarios, such as introducing young schoolchildren to the study of financial education or approaching the extension of credit to lower economic profile customers in a way that ensures customers can actually afford the repayment.

Over and above this specific research, it would be interesting to explore more case examples of other developing countries, such as countries in South America, Asia and Africa. The collection of information might present challenges for some of these countries. It would be beneficial to measure the efficiency of some of the regulatory approaches to banking conduct risk in more detail once they have been implemented fully and more time has passed. Other research areas related to this specific research and worth exploring could focus on how both banks and customers have reacted to the introduction of the new conduct regulation. This could provide some direction to the banks as to how they should position themselves from a financial success and business point of view. Finally, researchers could investigate how banks prepare themselves in order to comply with conduct regulation, and whether customers will value these preparations.

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Appendix A: Details of model testing

Summary	Descriptors	South Africa^a	Malaysia^b	Kenya^c
Ms	Global trends for conduct regulation and influence on country-specific approach	Have looked mainly at other Twin Peaks approaches, such as those used in the UK, Australia, Netherlands and Canada (1.).	Focus on conduct came about after the Asian currency crisis, as a result of the total transformation of the Financial Sector (6.).	Compared to the other two countries, who are defined as middle-to upper-income countries, Kenya is defined as a low-income country, so the challenges faced by the country should be slightly different (7.).
	Financial crises and the effect of these on cycles of open versus strict rule-based approaches	Have attempted a principles-based, proactive approach (2.).	Moral suasion remains prominent in Malaysia (5.).	More rules-based approach (5.).
	Socioeconomic profile and financial inclusion/education	Attempting to link (national) economic outcomes (e.g. higher savings rate) to customer outcomes; discussions about a relieved regulatory burden (and with that, relieved cost) for certain types of financial services product, and	Understanding consumer behaviour is key for policy makers to design appropriate financial literacy initiatives and undertake policy interventions; consumer empowerment is the first line of defence (4.).	Introduced a new regulatory framework covering conduct for the mobile banking sector to ensure consumers are treated fairly (8.); facilitating the introduction of initiatives that promote enhanced

		about different banking licenses for second- and third-tier banks (2.).		financial inclusion, such as the introduction of agent banking, credit information-sharing and licensing of deposit-taking microfinance institutions (9.).
Cultural norms and type of enforcement		There seems to be a preference for rules based on feedback from the industry; new conduct authority with strong and adequate powers (2.).	Moral suasion seems to work (5.); the legislative framework has recently been strengthened to provide adequate powers to the Central Bank (4.).	Central Bank of Kenya has adequate powers for enforcement through the Banks Act (9.).
Structure of the banking sector and stakeholder involvement		The banking sector, together with the Banking Association of South Africa (BASA), has strong opinions (5.); National Treasury engages policymakers and policy analysts, financial institutions, consumer rights organisations and South Africans more broadly for new regulation (2.).	Distribution channels with widespread access. For example, agent banks, financial advisers, direct channels, iBR1M and diverse range of financial service providers (FSPs). Periodical engagement with industry associations, consumer groups and FSPs (4.).	The Central Bank of Kenya's Bank Supervision Report based on the 2012 financial results shows that six banks hold 54% of the market share for loans and deposits; based on that, banks faced probe by competition watchdog in 2013 (11.).
The acceptance of sustainability as a business model		Although sustainability is a worldwide trend and some banks (for example, Nedbank) are trying to	Government holds stakes in majority of bigger banks and Islamic Finance plays an important role in	In 2013, the Kenya Bankers' Association (KBA) approved a move forward to create a joint initiative

		achieve certain sustainability goals (3.), it does not seem that South African banks have fully embraced this concept from an ethics versus profitability point of view.	Malaysia (6.). This might influence the acceptance of sustainability in a positive way.	that promotes best practice in sustainable finance (12.).
	The link to other legislation already in place	Fragmentation, inconsistency and 'incompleteness' of regulation across the sector currently (FAIS, NCR, Banks Act) (2.).	Separate section on business conduct and consumer protection in Financial Services Act of 2013 (4.).	Each area is specifically covered within two pieces of regulation by the CBK (8.).
Cs	Behavioural aspects	Trying to influence behavioural aspects by involving banks in development of new regulation (2.).	Regulation has its limits; therefore, consumer empowerment forms the first line of defence; cannot prevent intentional bad behaviour (4.).	KBA has a strong association in terms of stakeholder influence and professionalism. Such an organisation should be able to influence behaviour if necessary (14.).
	Individual banks' agendas	Some banks (like ABSA) buy more into the concept than others, as they have closer ties to developed countries where conduct risk has been a topic for longer.	No evidence for specific individual banks' agendas found.	No evidence for specific individual banks' agendas found.

	Guidance with regard to reaction of the regulator	Judgement of regulator might be questioned for a while to come, because experienced staff members first need to be attracted to the new entity.	Continuous communication of supervisory expectations and concerns to industry in order to influence agendas (4.).	Rules-based approach should make it easier to understand the regulator's reactions.
		Phase 1 will involve the creation of the new conduct authority, while the proposed new legal framework is envisaged in Phase 2. Interventions to address conduct failures in various sub-sectors will continue to take place within the existing legal framework (2.).		
	Industry initiatives	Some industry initiatives and working groups through BASA (2.).	Industry-driven initiatives to increase efficiency (4.).	Many industry initiatives through KBA (14.).
Os	Customer responsibility	Financial customers are not yet sufficiently empowered to hold financial institutions accountable – this makes it difficult to shift the responsibility to the customer; financial education initiatives should be	Increased financial competence of households and small businesses has seen greater demands for better-suited financial services; integration of FE elements into school curriculum, AKPK (Credit	Shifting responsibility to consumers will be difficult, based on the economic profile of Kenya. The National Financial Educators Council has taken on specific

		coordinated across stakeholders, as far as possible (2.).	Counselling and Debt Management Agency) for adult financial education (4.).	tasks in accordance with the Capital Market Master Plan launched in 2014 (12.).
	Complaints resolution at national level	Need to ensure that dispute-resolution mechanisms – in particular the Ombud system – are easily accessible and effective. The current system therefore needs to be improved (2).	Credible supervisory actions that ensure consumers get fair deals; multiple redress avenues for financial consumers; complaint management with FSPs and the Central Bank; free access to financial mediation, counselling and Debt Management Program with AKPK (4.).	There is an Ombudsman service, but it is generic across industries. The competition authority looks into cases as well (13.).

^a1, 2, 3, 5

^b4, 5, 6

^c 5, 7, 8, 9, 10, 11, 12, 13, 14

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Chapter 3

Conduct risk in South African banks: Aligning regulatory compliance with business sustainability

Conduct risk in South African banks: aligning regulatory compliance with business sustainability

Abstract

Regulators have imposed heavy penalties on banks for conduct failure since the global financial crisis. As banks play an important role in the economy, the public and the government have an interest in banks offering their services appropriately and having an effective conduct-risk approach in place that ensures compliance with regulation and the sustainability of banks' business. Currently (2018), conduct-risk approaches are inadequate, and literature is sparse, especially in developing economies. The goal of this research was thus to explore ways in which banks could manage and mitigate conduct risk, while simultaneously ensuring sustainability of their businesses. The qualitative design of this study used South Africa as an example of a developing market and employed primary and secondary data. The analysis showed that banks are focusing mainly on a suitable strategy at a high level, but neglect the lower level (at the juncture of employees and customers). Consequently, banks expose themselves to conduct risk. Based on these findings, this article suggests a new approach whereby banks' strategy should be tackled in a top-down fashion, while concurrently pursuing customer outcomes from the bottom-up. This study is crucial, as banks must prepare for new legislation, avoid fines, and position themselves strategically to satisfy customers and remain sustainable. Since the last self-assessment by the Financial Services Board in 2013, no formal assessment of the South African banking industry has taken place in terms of conduct risk.

Keywords: Banks; conduct risk; financial regulation; twin peaks model

JEL classification: G28, G41, L51, D23

1. Introduction

Since the global financial crisis, a new risk, known as conduct risk (National Treasury 2011), has been identified. It arises when financial institutions sell unsuitable products to customers to meet specific company sales targets (Financial Conduct Authority [FCA] 2013b): "The post-crisis pressure on firms to rebuild prudential soundness, attract new funding and maximise profits could lead to short-sighted strategies that have unintended conduct consequences" FCA (2013a, 48).

Like most risks, conduct risk negatively affects stakeholders (BIS 2015), and hence is an urgent and serious issue: conduct-risk regulations have been developed and launched globally and institutions must comply or face penalties, while at the same time maintaining the sustainability of their businesses. When tackling the issue, financial institutions need to consider two aspects. Firstly, conduct risk involves human behaviour and people risk, so managing it must connect with the institutions' strategy in some way. Secondly, conduct risk spans different areas of banking – from strategy and design of products to sales and after-sales – so it needs to be incorporated into an existing bank risk management framework that is already complex and interconnected (Financial Services Board [FSB] 2013). Traditional risk-mitigation strategies may be inappropriate.

Schaltegger and Wagner (2006) identify risk reduction as one of the drivers that can lead to a sustainable future for businesses because sustainability actively seeks and realises economic success. This could mean that a reduction in conduct risk has a positive influence on improving the competitiveness and success of banks, leading to an improved economic situation for them. Based on this, aligning regulatory compliance of conduct risk with business sustainability seems worthy of further exploration.

2. Background

To avoid negative consequences for all stakeholders, banks must drive an effective overall risk management approach, comply with conduct regulations, avoid fines and create positive outcomes for their customers to re-build the trust they lost during the global financial crisis and to ensure sustainability (McKinsey 2013). They also need to "(...) strive for financial success while accepting responsibility for their impact on and relationships with a diverse group of stakeholders" (AON 2007, 1). On the positive side, banks' economic profits could be influenced by sustainable behaviour and practices (UNEP 2015).

Judging by the significant increase in conduct fines for not serving customers appropriately, banks are not addressing these challenges adequately – as shown in Figure 1 (McCormick and Stears 2014; European Systemic Risk Board [ESRB] 2015; CCP Research Foundation 2017).

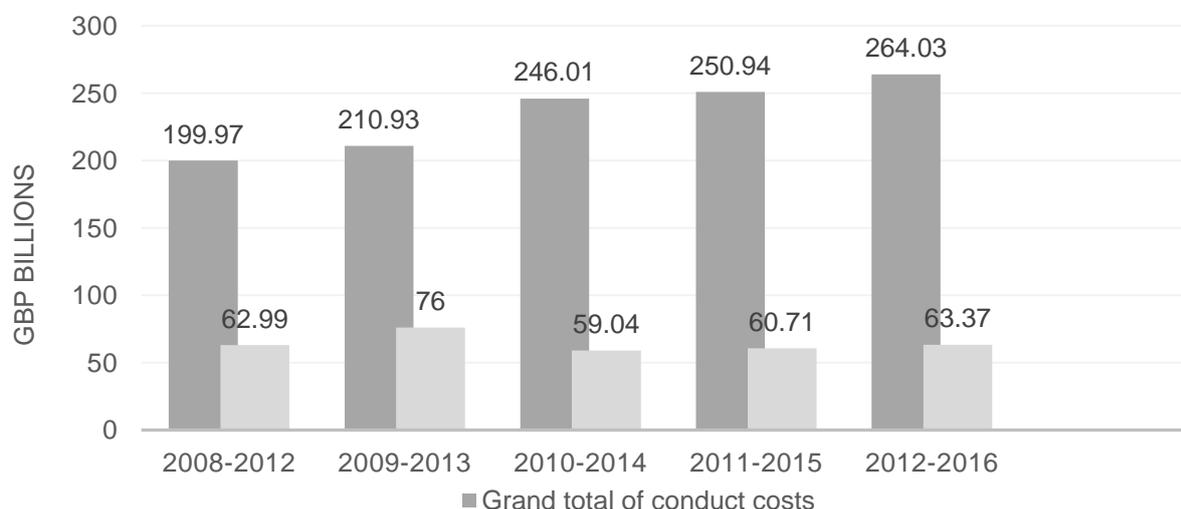


Figure 1: Conduct costs and provisions for banks since 2008. (Banks included in the survey: 20 banks based in the US, Europe and Australia.)

Source: CCP Research Foundation, 2017 – with permission.

Fines for misconduct are not restricted to developed economies. Developing countries, such as South Africa, have also received penalties (SARB 2014; 2015; 2016a; 2016b; 2017), as have countries in Asia (Oliver Wyman 2014). It is almost certain that these fines and resulting media reports affect banks' financial success.

Regular fines could suggest that banks tolerate a level of conduct risk, based on the principle that every risk to which a business is exposed could create (financial) opportunities. However, if the business model and the high-level strategy incorporate ethical values and 'doing the right thing', it would be unethical to accept *any* appetite for conduct risk. The regular fines could also be a sign that banks struggle to control, manage and mitigate conduct risk throughout their businesses, in a way in which sustainability is secured. Either way, if fines persist in future and no solutions are found, there could be serious, undesirable consequences for all role players who participate in the economic and financial system of a country (banks and their employees, shareholders, bank regulators, government and society, industry and bank customers) (Bajjal 2018). This could arise through a less-sustainable business situation, which could, in turn, result in banks' failure to fulfil their role in the economic system.

While conduct risk is a global phenomenon, developing banking markets must deal with added complexities related to conduct risk, such as consumer protection, financial inclusion and education (Ali 2014). South Africa makes an important and interesting case study for a developing market, given that its banking market is dichotomous. While it is ranked 37th (out of 138 countries) for soundness of banks in the 2016/2017 Global Competitiveness Report (World Economic Forum 2017), over-indebtedness is of great concern and 16% (5.7 million) of South African adults are still financially excluded from the banking system (BASA 2014). At the same time, a new Financial Sector Regulation (FSR) Bill was signed into law (FSR Act No. 9 of 2017) in 2017 (Parliamentary Monitoring Group 2017). As a result, the Financial Services Conduct Authority (FSCA) on the one hand and the Prudential Authority (PA) on the other hand will be configured as part of a new Twin-Peaks model. The two entities will work according to current laws, until such time that the new Conduct of Financial Institutions Act (CoFI Act) is signed into law (Parliamentary Monitoring Group 2017).

3. Literature review

Most of the information on conduct risk consists of popular press articles, reports and surveys from consulting companies or other organisations, as well as publications from banks in the form of annual or risk reports. Limited formal academic research has been undertaken on conduct risk in the banking sector, specifically. The authors of this study are not aware of any formal academic conduct-risk management studies on South Africa or any other developing country, other than their own published work. Based on this, the following literature was reviewed for this study.

Specific studies on conduct-risk management in the financial services industry were rare and based on the United Kingdom (UK) and the United States (US). The conduct-risk situation for UK and US banks is slightly different in that the standard of financial education is higher and the focus is more on selling savings products than it is in South Africa (Kasongo and Ocran 2017). Nevertheless, given the lack of academic literature, they were considered.

Miles (2017) concentrates on helping individuals predict specific conduct-risk situations, rather than providing input into a more company-wide and generic approach to conduct-risk management. He developed a behavioural model that incorporates accepted and expected behaviour, and misconduct. Miles' model is based on behavioural science, decision theory and political science of regulatory design. Yet, there is no detailed explanation of how these theories were built into this model. This makes it difficult to assess its future success and suitability for the South African market. The study might be useful though when looking at more detail in

further research, based on this article. Nicolas and May (2017) identify key drivers that conduct-risk assessments should target: (1) firm culture ('tone at the top'); (2) conflicts of interest (created by business models and strategies); and (3) 'people risk' (created by behavioural incentives or disincentives; in particular, compensation and disciplinary practices). They also state that "there is no one-size-fits-all approach to managing conduct risk" (Nicolas and May 2017, 222).

Thomson Reuters (2016) surveyed 260 compliance and risk practitioners from financial services companies globally. When asked who owned the conduct-risk policy in the organisation, 61% said Compliance, Risk and the Board. Similarly, when asked who was accountable for implementing the conduct-risk policy, 59% said Compliance, Risk and the Board. 69% stated that a conduct-risk policy was in the development stage or it had been implemented, but required additional work and/or resources. With regard to changes the organisation had made to address conduct risk, the top three named changes were: 'implemented new policies', 'implemented training' and 'tone from the top'. This result reflects the stage in which banks currently (2018) find themselves. The results also suggest that conduct is tackled at senior management level, but is not necessarily filtered through to all levels in the organisation.

In 2015, the FSB in South Africa rolled out the 'Treating Customers Fairly' (TCF) approach to financial consumer protection (FSB 2015). After Nedbank, ABSA, Standard Bank and First Rand Group completed a self-assessment tool for TCF, the FSB (2013) found that the overall average TCF-readiness rating was 67%. Outcome one (corporate culture) attracted the lowest average rating of all outcomes and within this outcome the alignment of reward, remuneration and incentives with TCF objectives was rated lowest. This suggests that historically, while TCF-readiness was already quite high, corporate culture had not been tackled as yet. Also, there is no easy solution for conduct-proof remuneration or incentives (in line with what Nicolas and May 2017 believe).

Additional studies on enterprise risk, operational risk or people risk management were reviewed, in the hope that some of this information was relevant for conduct risk as a new risk in the financial services sector. Studies were not focused on developing markets.

Bessis (2011) questions how the top-down processes (in which *management* initiates, sets out and controls policies) with global guidelines for risk appetite can be integrated with bottom-up-oriented reporting (in which reporting is monitored and implemented according to the advice of the affected teams; and not management, which might be remote and unaware of relevant issues) and monitoring of risk. This conclusion is important for the construction of the

ideal conduct-risk approach. Raj and Sindhu (2013) assert that every bank needs to develop an overall risk management strategy which incorporates conduct risk, as opposed to it only being implemented within the operational risk management arena. However, there is not much information about the 'how'. Cohen (2015) suggests certain rules for improving the governance and culture around enterprise risk. The following rules stand out: front-line employees should actively provide assessments, learn from the firm's own mistakes and run lessons-learnt sessions. These lessons could be important in implementing an appropriate conduct culture.

Blacker and McConnell (2015, 125–126) define people-risk as the risk that arises "because of decisions made, or not made, by individuals and/or groups of individuals, which are somewhat at odds with the goals/objectives of the firm, and may cause losses". This definition emphasises the significance of complementary (and sometimes contradictory) objectives and motivations of management and teams. Besides this, individuals tend to make common rationalisations, which must also be managed. Azis and Shin (2015) suggest that both employees and bank customers do not behave rationally. All of the aspects mentioned above can be considered for the human side of an effective approach for banking conduct risk in South Africa. Buckley, Avgouleas and Arner (2016) emphasise that market conduct risks often emerge before prudential risks. They suggest criminal sanctions be implemented, since they are more effective against misconduct. Although this is an interesting approach, the specific government will have to decide on possible sanctions.

Since studies are not forthcoming on the conduct-risk topic, additional studies that cover similar concepts (such as strategy, value and ethics) were also considered.

Hernandez and Sitkin (2012) emphasise that there is a relationship between employees' perceptions that executives and supervisors sincerely care about ethics, and the amount of unethical conduct observed in the organisation. However, despite this evidence suggesting that leaders 'matter' when it comes to organisational ethics, the exact relationship between the role of leadership and unethical behaviour in the workplace still needs to be explored. Jondle *et al.* (2013) claim that certain assessment and improvement tools need to be used to ensure that the gap between professed values and values in action is minimised. They acknowledge the importance of uniting banks' cultures and value systems with their risk management policies and practices, but concede that both the identification and establishment of these connections is not widely understood. The authors attempt to identify these associations by exploring banks' 'ethical organisational cultures' – their assumptions and beliefs.

In their South African Business Ethics Survey (SABES), The Ethics Institute of South Africa (2013) interviewed 4 099 staff members from 15 different South African companies across various industries. Four companies from the Financial Services Industry took part in the study, alongside other industry players. According to The Ethics Institute of South Africa (2013), three problems are worth highlighting and incorporating into a bank conduct-risk approach. Firstly, companies can create ethics programmes at a high level, but if they are not implemented effectively, employees will not internalise the values or demonstrate the desired behaviour. Secondly, senior managers tend to be more optimistic about the organisational culture than non-managerial employees. Thirdly, being aware of what the appropriate behaviour is does not automatically result in people embodying such behaviour. The results propose that a strategic approach to ethics is not sufficient on its own.

Based on the intended link between conduct and sustainability, studies on business models, profitability and sustainability were worth exploring, especially those that can link to conduct risk in developing banking markets.

Chen, Danbolt and Holland (2014) strongly recommend that bank business models include intangible factors and that they become relevant for systemic risk and bank regulation. An example of intangible factors might be an improved knowledge of employees and customers. This improved knowledge could stabilise banks' expected income, because banks could then provide better forecasts and manage the flow of transactions, thereby improving risk management and intermediation processes and stabilising supply, demand, costs and revenues through market cycles. While the authors explore valuable questions, they fail to clarify how the improved knowledge of employees and customers should be implemented. Galamadien (2011) researched sustainability reporting and recommends that concrete policies centred on maintainable banking sectors should be developed and formalised. To achieve this in practice, banks need to focus on capacity-building, training, and motivating and rewarding employees. Galamadien (2011) concludes that the challenge facing banks is to create new ideas through the collaboration of all stakeholders to find lasting solutions for South Africa – not through endless climate-change debates or sustainable development projects.

These sentiments have been reiterated by Weber and Feltmate (2016) in their discourse on the way in which banks can make positive impacts on society. Studies that assess how governance and regulation can be aligned with sustainability have been undertaken, but they focus on generic principles across industries and on the developed world (Doppelt 2017; McNall, Hershauer and Basile 2011).

4. Research problem

South African banks experience difficulties in both managing conduct risk and preparing for the new regulation and may therefore face further fines. At the same time, they must continue to lead their businesses in a sustainable way. The problem is serious, and affects various role-players negatively. Banks have the power to implement a solution and hence alleviate or solve the problem.

However, there is a knowledge gap in that academic studies about conduct risk in the South African banking sector are not available, and existing research can only be relied on to a limited extent, since it is generic and based on developed markets. If new knowledge can be created, society, academia and industry in South Africa will greatly benefit. Society may expect a better customer outcome, industry may deepen their understanding of how to tackle the topic, and academia may benefit from additional research for South Africa specifically.

The following research question was therefore worth answering: *With which approach can South African banks achieve compliance with future and existing conduct-risk regulation and at the same time keep their businesses sustainable?* The research objective of this study was to determine a new approach to South African banks' conduct risk, while at the same time ensuring business sustainability. The following assumptions and comments are important:

- The information needed about the link between conduct risk and sustainability and the situation in South Africa specifically, had to be sought from the industry itself. Primary data in the form of interviews with stakeholders in the South African banking industry, as well as secondary data in the form of reports that South African banks have published, were consulted. This information was obtained between 2015 and 2017.
- The approach is a framework to tackle a specific banking risk, rather than a detailed plan of action. This means that apart from the data collected, there were some lessons from existing studies, even if they did not specifically focus on conduct risk in the South African banking sector. This research only gives direction, not exact solutions.
- Keeping the business sustainable is defined for the purposes of this research as ensuring the business is viable to exist in future and will be profitable. Achieving compliance means that no fines will occur in the future.

5. Research methodology

Research design/approach: Based on the research question ("With which approach..."), the following was true for this research: the research approach was inductive – the researchers' goal was to understand the nature of the problem better and to develop an initial approach, and hence qualitative primary data and secondary data were collected and analysed; the strategy for this research was cross-sectional – this research studied the phenomenon of conduct risk at a particular time; and the research was exploratory – it sought new insights from subject-matter experts and conducted initial interviews/surveys (Saunders, Lewis and Thornhill 2015).

Data sampling: A small, non-random sample of subject-matter experts on the topic was selected for interviews, based on the qualitative nature of the study and the goal to generate rich information (Terre Blanche *et al.* 2006). For this qualitative study it was decided that a sample of ten specialists would be sufficient, based on the highly specialised and new topic (Strauss and Corbin 1990). Firstly, the four major South African banks were selected for the study (ABSA – part of Barclays at the time, Standard Bank, Nedbank and FNB). These banks represent about 83% of total banking assets (BASA 2014) and are actively tackling conduct risk, as communicated in their annual reports. One representative from each of the 'big four' South African banks was contacted. The Group Head of Conduct Risk or, if this role did not exist, another similar individual who holds responsibility for conduct risk across the company, such as the Group Ethics Officer, was interviewed. Secondly, a representative from one of the foreign banks in South Africa (Standard Chartered Bank) was also contacted to provide insight into how international banks transfer their knowledge to the South African context. This individual is a specialist in conduct risk and was selected on this basis. Thirdly, other industry specialists were sampled as follows: consulting firms that specialise in conduct risk in South Africa, in this case one representative from KPMG was chosen; one independent consultant who was recommended as a South African bank regulatory and risk management specialist from the World Bank, as well as the Head of Market Conduct at the FSB; and two specialists from the most acknowledged sustainability or ethics institutes in South Africa (the Sustainability Institute based in Stellenbosch and the Ethics Institute based in Pretoria), since those concepts are related to conduct. Further interviews were considered, but after concluding the first ten interviews, saturation occurred (Strauss and Corbin 1990).

Based on the selection of the big four South African banks above, the secondary data in the form of reports were also limited to those companies when sampling was undertaken.

Data collection: Face-to-face and/or telephonic interviews with ten subject-matter specialists were conducted for primary qualitative data collection, and a brief introduction to the topic was provided. An interview guide with three questions was used (based on the link between conduct risk and sustainability management as described in the research problem section), yet interviewees were left to express what they believed was the most important topic. Zeegers and Barron (2015) argue that participant-centred, open-ended questioning techniques might encourage more in-depth responses. More profound conversations might be possible if interviewees direct the discussion. Given the qualitative and exploratory nature of this study, this was suitable. The data collected from the interviewees were recorded into individual text documents by the researcher during the course of the interviews. Secondary data were collected via the Internet.

Ethical considerations: Ethical clearance for primary data collection was sought and received from the affiliated university for this study. Informed consent was sought and received from interview participants directly via email. Secondary data were freely available publicly. The data may be biased, since they have been assembled by staff members of the banks, who may hold a particular view (bias).

6. Data analysis

Zeegers and Barron (2015) state that qualitative data analysis needs to address the context, different views and communalities, frequency and intensity of comments, and emerging patterns.

The primary data tool employed is interpretative analysis (Terre Blanche et al. 2006). Accordingly, the following steps were followed: a) Familiarisation and Immersion; ideas were developed while the data were gathered, notes were re-read and re-looked at several times in order to get a sense of which interpretations are likely. b) Inducing themes; an appropriate number of themes were induced looking at the main direction that the conversation took when open-ended questions were asked. It was important to use the language of the interviewees and also to move beyond summarising the interviews. c) Coding; the data were coded to the themes identified. No specific software was used for data analysis other than MS Office. d) Elaboration; themes were explored more closely as an opportunity to re-code, where necessary. e) Interpretation and Checking; interpretation was completed using themes as subheadings and – through specific questions – ensuring objectiveness.

Secondary data were analysed, looking for specific information regarding the three topics related to conduct risk and sustainability management. Content analysis was used – sufficient to analyse specific documents and describe content in relation to the three topics systematically (Bryman and Bell, 2007).

Both primary and secondary data focused on the following topics, linked to the research question:

- Difference between conduct and sustainability
- Current approach for both
- Common thread going forward.

Primary data: Table 1 below shows the interview guide. After the data had been recorded, the researcher formulated themes by looking at the main direction that the conversation had taken when the open-ended questions were asked. As a next step, the data were coded to these themes. Below, main arguments from the data were summarised and quotes cited under the different themes. The data-analysis tool used is described as interpretative analysis (Terre Blanche *et al.* 2006). No specific software was used for data analysis, other than MS Office.

Table 1: Interview guide

Topic of interest	Question 1	Question 2	Question 3
Question itself	<p>What is sustainability management and conduct-risk management? How does regulation influence both?</p>	<p>As a company and a bank, how are you approaching and measuring both sustainability and conduct risk? If you are a specialist, provide your opinion on how banks might answer.</p>	<p>As someone who works at a company or a bank, do you think there are any responsibilities, activities or interventions that span across the two tasks, being sustainability management and conduct-risk management? Do you report on them? If you are a specialist, provide your opinion on how banks might answer.</p>
Conversation centered around the following themes	<p>Conduct vs. profitability/sustainability</p> <ul style="list-style-type: none"> • Interesting quote from one interviewee: "Ethics is the relationship between sustainability and conduct-risk management." • Disagreement noted on some issues; interesting quotes related to this: "Conflict does not exist between profit and sustainability." BUT "Will it be possible to innovate, comply fully 	<p>Reporting</p> <ul style="list-style-type: none"> • Banks are waiting to hear which reports regulators will ask for, they have a wait-and-see attitude; Sustainability is reported on already. <p>Demonstration/Measurement of conduct</p> <ul style="list-style-type: none"> • Financial needs analysis has been in place for a long time, and that will demonstrate conduct. 	<p>Conduct and company strategy</p> <ul style="list-style-type: none"> • There should be alignment between the commercial strategy and conduct: many banks in fact used the new conduct regulation discussions to review their strategies and build a competitive advantage. <p>Conduct-risk management approach</p> <ul style="list-style-type: none"> • Banks tasked individuals with and implemented committees to review conduct risk management, but are still unsure of how exactly to address the issue.

	<p>and be profitable at the same time?"</p> <p>Conduct regulation</p> <ul style="list-style-type: none"> • Banks have a code of conduct and other rules in place for staff already. Banks are apprehensive about future regulation and the implementation costs involved. 	<p>Sustainability can be measured in many ways.</p>	
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Source: Authors.

Based on the primary data collected and analysed, the following conclusions were made:

- Banks do not seem to agree on the nature of the relationship between sustainability and appropriate conduct, and seem wary about more regulation. They seem to think that 'their house is in order'.
- Banks seem to not want to implement too many activities/reports around conduct risk, based on the uncertainty around the regulation. Again, they seem to think all is in order, as they have always used financial needs analysis.
- Banks have used the discussion around conduct to review their strategies, and they have started employing individuals and putting communities in place. However, the drive is mainly top-down at this stage.

Secondary data: The data were analysed. Specific information was sought on the three topics related to conduct risk and sustainability management, as listed earlier. Table 2 provides a summary of the analysis.

Table 2: Summary of analysis of annual/risk reports of four sampled South African banks.

Barclays Africa Group (2015a and b):

The **Risk Management Report 2015** mentions conduct risk as a separate risk and lists the following key themes:

- Resilience of technology
- Continued levels of regulatory change.

The report also provides an example of certain activities (e.g. several accounts deemed non-compliant with know-your-customer (KYC) regulations were blocked; significant events and issues were considered in the remuneration decisions of individuals and in bonus pools). A link to reputational risk is provided.

One of the goals is: “enhance controls and key performance indicators to track and manage conduct risk”.

The **2015 Integrated Report** mentions balanced scorecard items and relates these to how sustainability is measured:

- Conduct is listed as a separate issue.

It is described as follows: “Doing the right thing, in the right way, is central to long-term sustainability. It enhances our reputation, promotes trust in the financial system and it helps [to] ensure that we provide appropriate products and services”.

Under Citizenship, ethical conduct is mentioned separately. This topic is related to responsible lending, financing green initiatives, and active supplier management. Responsible lending is mentioned again under Conduct.

Barclays speaks about a forward-looking approach to conduct and that they will place emphasis on the Retail Distribution Review (RDR).

Nedbank Group (2015):

The **Integrated Annual Report 2015** mentions the following:

Conduct and Consumer Protection under "Engagement with Regulators".

Nedbank speaks about an independent assessment of Nedbank Group’s state of readiness for TCF and conduct-risk management and that it revealed no material issues with the implementation programme.

Nedbank speaks about a forward-looking approach to conduct and they place emphasis on the RDR.

Risk Reporting 2015 mentions conduct risk as a separate risk in the group’s Enterprise Wide Risk Management Framework (ERMF).

First Rand Group (2015):**The Integrated Annual Report 2015:**

- Mentions conduct under insurance control functions only.
- Mentions regulatory and legal risk.
- Reputational risk is mentioned under strategic and business risks.

First Rand Group believes that strong customer relationships underpin the sustainability of its business.

Sustainability is defined as: deliver[ing] sustainable returns with acceptable levels of earnings volatility; managing the business on a through-the-cycle basis and utilising strategic and operational levers – capital, balance sheet and operating platforms.

The 2013 Annual Integrated Report had a Social and Ethics Committee Report.

Environmental and social risks included in Banking and Equator Principles Report.

Standard Bank Group (2015a and b):**Standard Bank's Report to Society 2015** states that:

- more than 50 workshops were held with executives and senior managers on the implications of the Twin Peaks model.
- a Market Conduct Board will be established to drive an integrated approach to conduct requirements.
- the Conduct Framework across the continent will be expanded.

The Report also includes the following material issues:

- Managing regulatory change
- Understanding clients.

The Risk and Capital Management Report and Annual Financial Statements 2015:

- Reputational risk is listed as a separate risk, and the group's Code of Ethics is mentioned here as well; it is not, however, linked back to conduct risk.

- Compliance risk (and conduct risk is mentioned within compliance risk) is said to cover all aspects of market conduct; the outcome-based approach runs through all parts of the business; the TCF programme is mentioned; a customer resolution centre and internal complaints adjudicator have been installed.
- Management of conduct risk is listed as being integral to the group's Code of Ethics.
- Misconduct issues in Tanzania and Nigeria were detected early (no fines paid).

Source: Authors.

In conclusion, based on the analysis of the secondary data collected, banks are:

- implementing certain frameworks and deciding where conduct risk should fit.
- reporting on sustainability, but not in tandem with conduct risk in every case.
- beginning to assess themselves or are being assessed.
- looking at how to measure conduct risk.
- training employees.
- establishing various committees.
- becoming aware that regulation will change again and trying to engage with relevant authorities.

7. Result interpretation

It can be concluded that South African banks (measured by the 'big four' banks) have acknowledged conduct risk and the regulatory changes that will affect them – but mainly from a top-down level. Each bank is at a different stage of preparation and has adopted a slightly different method for how to incorporate conduct into their strategy and risk management framework and sustainability strategy. Some banks are being assessed on their conduct-risk strategy by stakeholders, but not from customers specifically. At this stage, a bottom-up approach does not seem to feature, or banks find it difficult, as they are navigating their way through the current situation and waiting for more information from regulators. An approach such as this may, however, help banks to proactively work towards finding a solution that is specific to their customer base, with the possibility of gaining an extensive competitive advantage and making their businesses even more sustainable.

One of the most interesting findings of the research is that banks are confident they are already conducting themselves appropriately, and are more concerned with how to demonstrate this. There was also frequent mention of committees that review conduct cases, but these groups seemed to be working in isolation. Strikingly, as banks believe that they 'just need to measure their good behaviour', their approach to risk management is closer to risk avoidance. They link conduct to the company's strategy and expect that all staff members will work towards the same goal and will, inevitably, comply. According to the research, the major risk for the banks would be a situation where they fail to *demonstrate* the appropriate conduct.

However, by struggling to ensure that their strategies filter through to each individual and that their end goal is achieved, banks are exposing themselves to considerable conduct risk, and it appears they are unaware of this. The process of convincing staff members to adopt from top-down prescribed values is challenging, as described by the results of the ethics survey in the literature review. Although training employees may be the correct approach, training needs to be conducted in a way in which experiences are created, so that certain behaviours become natural for individuals. Customers also need to be trained and educated, and there is no evidence to suggest that this is occurring. The effectiveness of the training would also have to be measured, as changing people's behaviour can be difficult.

8. New approach

In answer to the research question and based on the summary of results, it can be concluded that there is a 'black box' between a suggested, communicated and partly implemented high-level strategy that claims to incorporate ethical conduct and sustainability in a confident manner (top-down approach), and knowing how exactly to produce a measurable positive outcome for the customer and comply with conduct-risk legislation in an uncertain time and without affecting financial success negatively (bottom-up approach). It can be assumed that the main risk in this 'black box' is likely to be compliance risk, in that the bank is still exposed to conduct risk, as the strategy may not filter through to every employee. This means that the possibility of receiving fines still exists.

The new approach promised, as part of the research objective, needs to recommend a way to bring light to the 'black box', while keeping the South African situation with all stakeholders and the idea of sustainability in mind. The general approach was informed by information from the data collection and analysis. For some of the more detailed and specific suggestions, selected findings from the literature review could be used. For example, Bessis (2011) recognises that risk management needs to be tackled from top-down and bottom-up. Further studies are mentioned below. Lastly, some of the specific ideas were developed by the researchers themselves.

Figure 2 below illustrates the new approach in general, and is followed by a description of how the 'black box' can be uncovered. By taking all stakeholders into account and asking the right questions to control and minimise conduct risk, sustainable solutions will be found, based on findings by Schaltegger and Wagner (2006), AON (2007) and UNEP (2015).

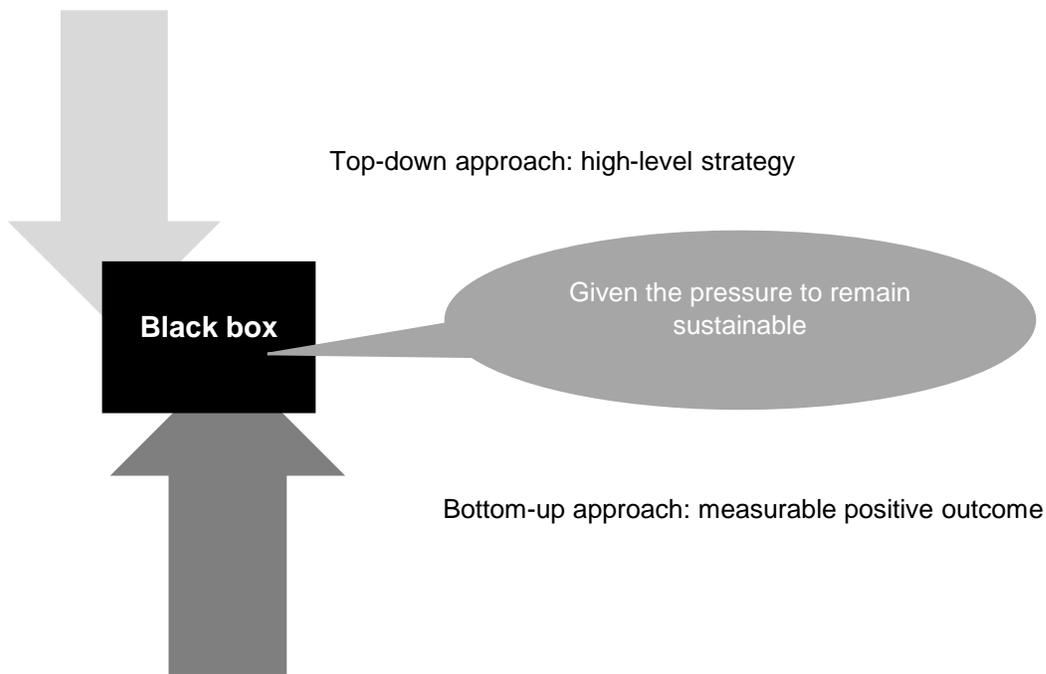


Figure 2: 'Black box'.

Source: Authors.

Regulator:

The CoFI Act will probably only be passed in 2019 (Murray and Phelan 2017), so banks will have to work with the existing regulation, which includes FAIS and TCF, for now. Most banks already comply with these Acts, which is positive. If regulators are driving an outcomes-based approach, like in South Africa, they have to influence the outcome for the customer indirectly – which is difficult (Hargarter and van Vuuren 2017). There is therefore a risk that the new regulator will try to regulate at product level going forward. Banks are apprehensive about this, and also about more regulation resulting in higher implementation costs. They also are proactively engaging with the regulator about the new regulation, and should continue to do so.

Industry, investors and society:

Banks that confront the issues raised above will be at the forefront of conduct-risk management and will gain a competitive advantage. Banks' business models must be innovative and solutions-driven, and should use resources efficiently and build trust to ensure a continued sustainable business for the future (McKinsey 2013). This is especially true in developing markets. Banks could develop socially outstanding and ethical products by partnering with non-traditional players, as suggested by Galamadien (2011) and Weber and Feltmate (2016).

Management:

Once the professed values, awareness and the ideal strategy are defined, banks need to prioritise one important aspect: to guarantee that employees, and not only management, work towards making their dedication to conduct a reality (Jondle *et al.* 2013 or Thomson Reuters 2016). Hernandez and Sitkin (2012) believe that managers need to manage issues such as fairness and approachability, and avoid situations where they themselves are more positive about the new conduct-risk approach than their employees. Management must empower employees to fulfil their roles and, as a result, employees may 'live' their values in a more meaningful way. The use of committees should be tackled in an integrated manner; they should not work in isolation.

Employees:

In terms of employees and customers, a priority for banks would be to incorporate intangible factors and relationship-building, as well as fairness, into the implementation of the business model, as recommended by Chen, Danbolt and Holland (2014). Furthermore, the bank needs to create accurate incentives, which is difficult according to the FSB (2013). One idea is to incentivise positive customer feedback and/or cross-selling, rather than handing out targets for specific products – which is in line with what the new regulation in South Africa prescribes. Training should be offered to employees and customers, with emphasis on action-based learning rather than only on policies and procedures. This is based on the research of Blacker and McConnell (2015), who claim that people-risk is best managed by allowing and requesting every staff member to take personal accountability for their decisions. They also stress that values need to be ingrained in individuals and behaviour needs to come naturally to them.

Customer:

Currently, the main customer outcome tool used by banks is financial needs analysis. To make a successful needs analysis possible, every employee would need to be carefully selected, trained and incentivised, as suggested by Galamadien (2011). However, this can be expensive. In a developing economy like South Africa, bank customers often struggle to understand their financial needs fully (National Treasury 2014). This could influence customer satisfaction negatively, and customer education might become an important tool for achieving compliance. Malaysia is a respectable example of how financial education can make a difference: an increased demand for more appropriate financial services has been fuelled by an improved financial knowledge on the part of the households and small businesses (Ali, 2014). However, not all South African banks

are convinced that it is possible to be profitable and ethical, given the South African socio-economic situation. Banks could offer free financial education online courses in partnership with educational institutions, instead of only capturing the status quo of the customer's financial knowledge. In doing so, conduct risk could be reduced in a different way, by fostering a reputation for sustainability and ensuring that customers remain loyal.

9. Conclusion

South African banks are facing a serious challenge in that they have to comply with new conduct-risk regulation and at the same time stay sustainable as businesses, otherwise all stakeholders will be negatively impacted. Primary and secondary data were collected to fulfil the research objective of developing a new approach for South African banks, who should tackle regulatory compliance around conduct risk alongside ongoing sustainability efforts. Literature on the topic is sparse, but selected studies were used to inform the approach somewhat.

Based on the research, it can be concluded that South African banks are in differing stages of preparation and have divergent viewpoints in terms of integrating conduct into risk management framework strategies, based on uncertainty regarding legislation. However, they have begun to put measures in place via a top-down approach. Failure to ensure that the strategy filters through to the juncture between customers and employees means that banks expose themselves to considerable conduct risk. Given this, the 'black box' between a high-level strategy (top-down) and a measurable result at customer level (bottom-up), with the added difficulty of remaining sustainable as a business was uncovered by this research through the suggestion of possible strategies from different stakeholders' perspectives (as summarised in Figure 3).

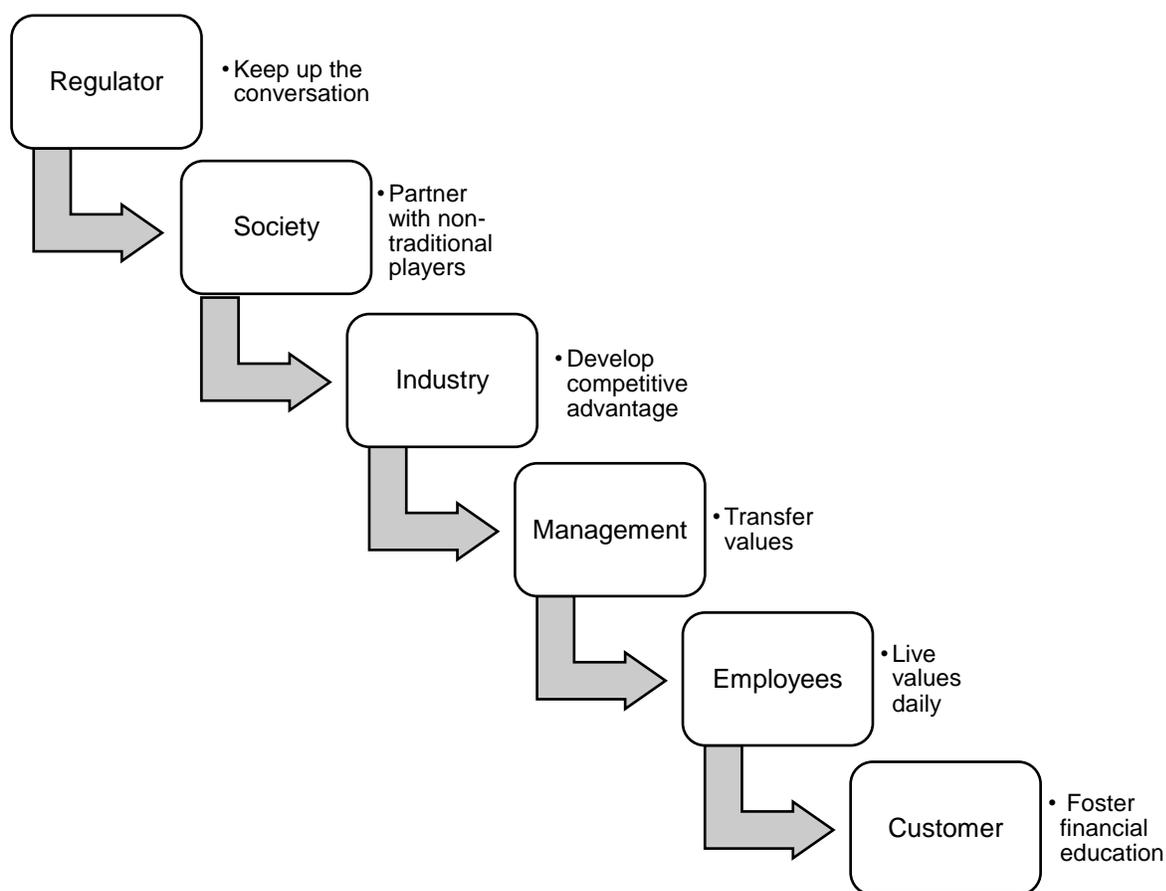


Figure 3: Uncovering the ‘black box’.

Source: Authors.

10. Recommendations

Banks should focus on people-risk management. They should also be careful of thinking that the only risk they need to manage is failure to demonstrate their good behaviour. Conduct risk could occur at any time, since the behaviour of every employee may not always be appropriate. This must be managed carefully and not only from the top down. Banks could overcome their ‘wait-and-see’ approach by addressing the risk from various angles. A top-down approach should be complemented by a bottom-up approach to mitigate conduct risk. Banks need to work more closely with customers to become compliant; they should not rely solely on other stakeholders’ opinions or on training employees. In the end, the customer will decide whether the overall expe-

rience has been positive. The biggest challenge is to ensure that all employees conduct themselves in the defined company-wide manner at all times, and that banks implement a system to demonstrate this.

11. Implications and further research

The implications of this research for South African banks are a greater in-depth-understanding of conduct risk and 'out-of-the-box' and cost-conscious thinking, if the problem can be tackled in tandem with sustainability. For government and regulators this would mean that banks will be more able and willing to comply with regulation and fulfil their role in the society and economy. Academia will also profit from this research, as initial academic knowledge is being built on a new and relevant topic, like conduct risk, in a developing banking market, like South Africa.

This work has provided first insights into how to approach a serious challenge. Possible limitations to this research are that it provides direction, but no detailed recommendations. Further research could be undertaken to break down the suggested approach into a more detailed guideline. This new research would need to include banking staff members' views, and not just banks' top-management who oversee conduct in the bank.

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Chapter 4

Measuring conduct risk for South African banks

Title: Measuring conduct risk in South African banks

Abstract:

Purpose: This paper examines the problem of conduct-risk measurement for banks, using South Africa as an example of a developing market. Conduct risk is a new and complex phenomenon in global financial services, and could negatively impact various stakeholders. There are concerns about new regulations and potential misconduct fines affecting profitability and sustainability for banks. While presenting a serious problem, especially in developing markets, with the added challenge of financial inclusion, conduct risk and its measurement have not been researched sufficiently. If the measurement problem could be solved, the management could be facilitated.

Design/methodology/approach: Based on a literature review, existing surveys and new interviews, a best-practice proposal for measuring conduct risk was developed. The approach was exploratory and inductive, and added primary insights.

Findings: Measuring concepts like conduct is a global challenge. This aside, South African banking customers are concerned about fraud and safety, and administrative service hassles, rather than conduct in the regulatory sense. Best-practice measurement must account for these findings by working with a scoring for behavioural, organisational/procedural and perception indicators, and suggestions on specific related surveys.

Research limitations/implications: Analysing the data measured and deciding what action should be taken if conduct risk is detected, could be considered.

Practical implications: South African banks are guided in measuring a difficult and unique concept, at a time of regulatory change, stakeholder pressures and limited existing knowledge.

Originality/value: The authors believe this is the first study on a critical and new challenge in banking risk measurement in a developing market.

Keywords: Conduct risk, banks, Twin Peaks model, South Africa

JEL classification: G21, G32

1. Introduction

Conduct risk is a new and complex risk in the financial services sector, which emerged after the last global financial crisis. Conduct risk arises when financial services companies sell products that are unsuitable for customers, with the goal of meeting specific sales targets (Financial Conduct Authority [FCA], 2013). This can lead to negative outcomes for customers and have an undesirable economic impact. It may also have indirect, detrimental financial consequences for banks, even though the effect may be delayed. As a result, there have been efforts to regulate and manage conduct risk in different countries (The Organisation for Economic Co-operation and Development [OECD], 2011 and 2013). Figure 1 indicates that many developed-economy regulators have imposed heavy penalties on global banks for conduct failure (CCP Research Foundation, 2017; FCA, 2015 and European Systemic Risk Board [ESRB], 2015), leading to a substantial rise in conduct costs; although, not in the provisions for conduct costs in the banking sector over the last ten years. Although this may suggest that banks underestimate costs and deliberately accept a portion of conduct risk, it may also indicate that banks believe their conduct is being effectively managed, and they will not take action until proven incorrect.

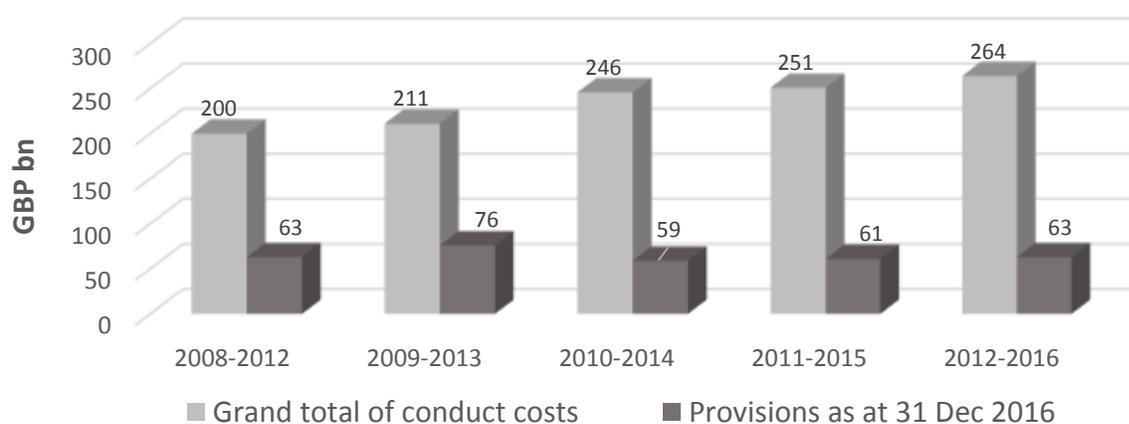


Figure 1: Grand total of conduct costs for a given period (i.e. costs crystallised during the period, plus provisions as at 31 December of the previous year) and the provision sums for that period.

Source: CCP Research Foundation, 2017 – with permission.

Fines for misconduct are not restricted to developed economies. Developing countries, such as South Africa, have also received penalties (SARB, 2014; 2015; 2016a; 2016b; 2017), as has Asia (Oliver Wyman, 2014).

The discussion concerning appropriate conduct is fueled by calls for sustainability of banks as businesses (Schaltegger and Wagner, 2006; AON, 2007; Galamadien, 2011; McKinsey, 2013 and The United Nations Environment Programme [UNEP], 2015) and the theme of financial inclusion and education, particularly in developing banking markets (Alliance for Financial Inclusion, 2015).

Banks, especially developing market banks, are under pressure to measure this new phenomenon of conduct risk to convince various stakeholders that it is under control. This assumes that if the measurement of conduct risk is approached correctly, then conduct risk can be more successfully managed: relevant pieces of information would be measured, and those could then be used to better manage and mitigate conduct risk.

Unfortunately, measuring concepts like culture and conduct remains difficult for banks, for various reasons. Firstly, it has qualitative aspects and is not easily measured using quantitative tools (Thomson Reuters, 2017). Secondly, distinct perceptions of different stakeholders play an important role. Thirdly, not all events that may have actually taken place end up being reported. Lastly, it may be that conduct risk is hidden in the bigger 'system' of banks, but has not yet 'reared its head', and so there is no evidence of it.

There is little knowledge available on how to overcome these serious measurement challenges to ensure banks are managing conduct risk appropriately, with positive consequences for all stakeholders. There is, therefore, a need to explore possible solutions regarding the measurement of conduct risk for South African banks, as an example of a developing market. The authors believe this study is the first to do so.

Section 1 introduces the topic of conduct risk and provides context. Section 2 outlines the background to the research and the research problem, while Section 3 summarises the research design. In Section 4, existing literature is reviewed. In Section 5, the data collected are described and analysed. Section 6 covers a best-practice proposal for measuring conduct risk, based on the data collected, while Section 7 includes a discussion of the results. Section 8 concludes.

2. Background to the research and research problem

Since conduct risk was the defining cause of the financial crisis (The Financial Standards Board, 2013), it is almost certain that a suitable approach to measuring conduct risk will become mandatory for all banks. They need to be aware of and be able to demonstrate to various stakeholders the progress made in the measurement and management of conduct risk. The problem, however, is that global banks are currently (2018) struggling to measure and mitigate conduct risk (Thomson Reuters, 2017). Various stakeholders could be negatively affected by this problem: banks' profits could be reduced by regulatory penalties or by losing customers (thereby affecting shareholders), customers could lose money by purchasing unsuitable financial services products and the relevant government could fail in its role to protect citizens, as consumers and the country could suffer economically because banks failed to fulfil their financial intermediation role.

Banks in developing markets are more adversely affected, and the problem may therefore be more pronounced. If bank customers are less financially educated (Klapper *et al.*, 2015), and hence more vulnerable to mis-selling, the measurement of conduct risk could be more cumbersome and may need to be amended.

South Africa, as one example of an emerging market, is ranked 37th (out of 138) for soundness of banks in the Global Competitiveness Report (World Economic Forum, 2017), while 16% (5.7 million) of South African adults are financially excluded from the banking system (Banking Association of South Africa [BASA], 2014). This dichotomy makes for an interesting case study. Apart from this, financial market regulation is changing in South Africa and clarity around conduct risk is essential to overcome uncertainty.

The pressure of finding a suitable approach to the measurement of conduct risk is exacerbated by the fact that limited formal knowledge is available and the situation is dire for developing countries. The few existing studies (as reviewed in Section 4) do not focus on developing markets, and they also lack depth about the measurement problem. Other obtainable information consists of popular press articles and reports from consulting companies. These facts contributed to the reason that this research was conducted.

The **research question** is: *how should South African banks approach the measurement of conduct risk?* For the purposes of this work, conduct risk comes about when South African banks sell products that are unsuitable for their customers, with the goal of meeting specific sales targets

(Financial Conduct Authority [FCA], 2013). For this study, measuring means to ascertain the specific degree of conduct risk within an organisation by using a measurement system marked in standard units, using scores. An outcome-based approach, as recommended by the South African regulator and defined as assessing the extent to which an approach has achieved its intended result, has to be applied to this study. It is assumed that conduct risk cannot be solely assessed using mathematical models (such as Pflug and Römisch, 2007; Barsalou, 2015; Hassani, 2016b) or using behavioural approaches (such as Ewen, 2014; Miles, 2017).

The **research objective** is: *to develop a first best-practice proposal of how to approach the measurement of conduct risk in South African banks*. Given the limited knowledge that exists regarding the concept, but also the approach of the regulator looking for best-practice approaches from the various banks, this study proposes a ‘best-practice approach’, defined as a standard, which could lead to optimal results. The preliminary best-practice proposal consists of a scoring model as a measurement system. It also includes suggestions around specific surveys to enable a precise allocation of scores.

Information from South African bank customers and staff members about their understanding of what conduct risk is and how it can be measured, and similar information from other countries and on similar concepts (such as ethics and business conduct), was required to answer the research question. Information about possible expectations from the regulator and the industry body about the measurement and demonstration of suitable conduct was also important. The information was obtained from worldwide secondary data and selected primary data in South Africa in 2017 and 2018. Since the research question asks about the ‘how’, sourced information was mainly qualitative.

There are numerous role-players that have an interest in the conduct-risk measurement problem and its solution. However, South African banks are the main beneficiaries of this research. Banks have the resources to influence the progress of the research and its solution. The government, the new Financial Services Conduct Authority [FSCA] and bank customers and shareholders could also profit from the study.

3. Research design

3.1 Research approach and strategy

This research prescribes to the following research approach and strategy (Saunders *et al.*, 2015), based on the research question: **inductive** – understand the nature of the problem better and develop a first best-practice proposal, collect qualitative data; **cross-sectional** – measure conduct risk at a particular time; **exploratory** – interrogate literature and subject-matter experts' opinions, conduct interviews and/or initial surveys.

3.2 *Research method*

The researchers are not aware of any publications about conduct risk in the South African banking sector, other than their own published work. Besides this, data from bank customers and bank staff are confidential and difficult to access. Selected existing surveys of staff from the banking sector and from other industries were available from consulting companies and interest groups. Even though they only consider the global situation, the surveys were considered and analysed by interpreting the results. Information about the current regulatory situation in South Africa was collected from secondary data and through a conversation with a specialist from BASA. These data were reported on by citing and interpreting the most important findings.

Primary data were collected through interviews with selected banking customers in 2017. Interviews were conducted in person and via video conference and phone, depending on where the interviewees were based and their availability. An interview guide was used, mainly with open-ended questions (see the appendix), given the nature of the study. Secondary data were collected electronically.

It was assumed that all 241 employees at Milpark Education, a South African private higher-education provider and one of the researchers' employers, consisted of a representative sample of existing banking customers in South Africa. The staff complement of Milpark was sufficiently diverse. It was assumed that they all have a banking relationship and no adverse effects were expected in terms of them working in the educational sector. 12 interviewees were randomly selected by identifying the 20th person on an alphabetical list of names (Goddard and Melville, 2001). Where individuals were not available or were not comfortable being interviewed, the 21st person was selected. This was the case for two individuals. The number of individuals interviewed was suitable for this qualitative, exploratory study (Saunders *et al.*, 2015). Interviewees were based in Cape Town and Johannesburg, with an equal split. The interviews were voice-recorded and transcripts were reproduced in spreadsheets (with augmented notes and comments).

The role of the interviewer, the scope of the project and an introduction to the research topic were explained to all interviewees before each interview. Ethical clearance was applied for and approval was obtained from the research committee at Milpark Education (thereby ensuring compliance with the institution's research policy). A plain language statement was issued and consent forms were signed prior to each interview. Interviews were recorded and summarised in individual documents.

Primary data were coded and analysed through thematic data coding (Attride-Stirling, 2001). All answers were categorised into various themes per question, and it was recorded regarding how many interviewees' answers fitted into those themes. Themes were developed by the researchers while listening to the recordings, making notes and transcribing interviews, and the themes were allowed to evolve during the course of this process. An example of this is found in Appendix B3. The number of answers recorded for the different themes was interpreted and trends were summarised. Primary data were reported on by citing selected statements, summarising trends, and through graphical representation.

4. Literature review

4.1 Definitions

According to Green (2015:15), "**risk management** is the coordinated set of principles, processes, activities, roles and responsibilities, and infrastructure, combined into a system and used to control the actions of an organization in light of the risks it faces". He also specifies that the term '**risk mitigation**' is used if risks that have negative consequences are treated, which involves improving or modifying risk controls. Lastly, Green (2015:6) gives an example of how different organisations might **measure or quantify risks**: "For example, one organization may choose to classify risks as 'high', 'medium', and 'low'; another to rank them from highest to lowest; and a third to assign a number, based on likelihood and consequences, to each."

4.2 General risk management literature

Conduct risk is new and challenging to quantify. It must be incorporated into the general enterprise risk management (ERM) strategy of the organisation and it also requires different ways of thinking

to traditional risk management (Raj and Sindhu, 2013). However, there is not much evidence about the 'how'.

McCormack *et al.* (2014) point out that systematic risk management only evolved in the last 15 years or so (since 1999), as pressure from stakeholders and from the regulator – in the case of banks – increased. In this realm, 'the three-lines-of-defense' approach to risk management was born: the first line of defense consists of the respective business units; the second is represented by a centralised risk function, which guides the first; and the third line entails the internal audit function. In the case of conduct risk, this defense model is important, as good conduct should run through the business from strategy to product design, and on to selling and after-sales. The model would affect the measurement of conduct risk in that all different lines of defense have to be included.

Taylor (2014) presents a summary of supporting documents needed for embedding ERM into the organisation. Measuring conduct risk would also necessitate proper documentation, especially at risk-appetite, risk-register and dashboard level.

As a specialist in fraud, Koletar (2010) invites risk practitioners to re-think risk management. Below is a summary of some of his suggestions regarding where traditional risk management goes wrong and what this could mean for conduct-risk measurement:

- "The highway to hell is traveled in small steps" (Koletar, 2010:96). Measurement needs to incorporate the idea of repeatedly scoring at a low level of concern, but not at zero, when it comes to conduct risk.
- "If you guys found something bad, it could be a deal killer" (Koletar, 2010:98). Measurement needs to understand that not all departments are interested in finding fault.
- It is important for firms to use the ABC principle, especially for behavioural risk, and find out whether the firm has one bad apple, a bad bushel or a bad crop. Measurement needs to be able to detect As, Bs and Cs, and not only focus on Cs.
- While documentation is crucial in risk management, there are many cases where documentation is forged or altered. Measurement needs to detect those cases.

- Many firms prescribe to zero-tolerance programmes. These are often problematic, as it is extremely difficult to ensure uniform enforcement, plus there is a great need for additional (and expensive) reporting resources. Measurement needs to differentiate between small warning signals that are serious and others that are not as worrisome.
- With IT technology improving daily, making actionable intelligence out of a multitude of data is challenging. This will be a challenge for measurement specifically.
- Firms should pay attention to words: is someone going to be more discreet without changing their behaviour? Measurement should leave room for individual and freely formulated responses, rather than focusing only on ticking boxes in surveys.
- Sometimes, in risk management practice, possible causes are diagnosed quickly and solutions to risk sought early. This will be difficult to take into consideration, as conduct risk often has a tipping point; at which point a company will have to react quickly.

4.3 *Literature on concepts similar to conduct risk*

It can be argued that conduct risk is equal to people risk. However, as Blacker and McConnell (2015:136) point out: "While one could argue that [conduct risk] . . . is indeed a wholly People Risk issue ('poor governance'), there is obviously a process dimension that must be taken into account". Ewen (2014) states that personalities can show a wide range of stable human behaviours. However, some aspects of personalities are observable and some unobservable, some conscious and some unconscious. This makes conduct risk difficult to measure.

Fitzsimmons and Atkins (2017) examine new developments in reputational risk. Firstly, they state that it is important to set risk appetite and tolerance and think about acceptable levels of reputational risk. Interestingly, they quote Berkshire Hathaway as having decided that their tolerance is going to be zero. Secondly, they recommend that behavioural and organisational risks which underlie reputational risk are identified. They bring in the work of Nobel-prize winner and psychologist Daniel Kahnemann (Kahnemann, 2003; 2011), and suggest that reputation is driven by the perceptions of stakeholders. Behavioural and organisational risks have to be taken into account when measuring conduct risk and perceptions need to be considered carefully; the focus cannot only be on real events.

Deutsche Bank (2014:1), a bank that operates globally, is convinced that being sustainable and profitable is not a contradiction: "Short-term strategies that are aimed exclusively at quick profits

are not consistent with the expectations of society, which wants to see responsible financial institutions anchoring the economy". Chibba (2009) states that the global financial crisis has made financial-inclusion programmes more imperative.

4.4 *Specific conduct-risk literature*

Hassani (2016a) is one of several authors who believe conduct risk can be minimised solely by appropriate product design and control as well as correct segmentation, supported by superior data science. He does not see measurement as a separate challenge. Miles (2017) and Thomson Reuters (2017), who have been running an annual conduct-risk survey for a number of years, are of the opinion that measurement is problematic. It would seem that more emphasis should be placed on the opinions of Miles (2017), since he is one of the few conduct-risk specialists, and on Thomson Reuters (2017), because their conclusions have been achieved by actively engaging with the industry for a number of years.

Miles (2017:150) recommends a simple strategy for financial institutions to measure conduct risk: "Ask, and keep asking, simple questions about the behavior that customers look for". He proposes the following measurement tools for conduct risk: questionnaires, mystery shopping, online complaint forums, and customers' advocacy groups. He feels that customers' views need to be incorporated throughout the value chain and recommends that the risk team should have full sight of the value chain, from 'A to Z'.

Two other arguments he makes are the importance of noting the tipping point in an organisation and striking a balance between the company's 'big picture' and individual employee experiences. Soares (2003:147) agrees "that the notion of a corporation cannot be reduced to the mere behavior of individuals (who are also abstract in character)".

Miles' (2017) model is based on behavioural science, decision theory and political science of regulatory design. However, there is no detailed explanation of how exactly those theories were built into this model, which is problematic. Similarly to Fitzsimmons and Atkins (2017), Miles refers to Daniel Kahnemann's work in his research. Miles' model consists of two parts. The first part entails a five-factor model. The model works with questions that companies should ask to gain clarity around conduct risk. The second part of the model entails three viewpoints, with which Miles (2017) recommends individuals should look at the questions in model one.

While Miles's model is valuable as an overall approach to managing and mitigating conduct risk, it delivers no answers on how exactly to measure conduct risk. Miles (2017) expresses his concerns about so-called grey areas. These could exist where, for example, regulators change their approach and penalise a bank in retrospect. He provides limited guidance on how companies could prepare for such an occurrence.

5. Data collection and analysis

5.1 The regulatory situation in South Africa

A new Financial Sector Regulation (FSR) Bill was signed into law in South Africa (FSR Act No. 9 of 2017) on 21 August 2017 (Parliamentary Monitoring Group, 2017). The Prudential Authority (PA) and the FSCA will, as a result, be configured as new, distinct units in an attempt to establish a twin peaks model. The new Conduct of Financial Institutions Act (CoFI Act) will be signed into law in 2018 or 2019 (Parliamentary Monitoring Group, 2017). Until then, the FSCA will work according to existing laws. Currently (2018), National Treasury is engaging with different financial services sectors around licensing based on activities, and is also working on high-level principles for conduct. The regulator plans to look for best-practice approaches within the industry, and to request industry members to learn from them (National Treasury, 2018). It seems the regulation will be outcomes-based, and will build on the existing 'Treating Customers Fairly' [TCF] approach to financial consumer protection (FSB, 2015). This means that the regulator would have to influence the outcome for the customer indirectly – which might be difficult (Hargarter and van Vuuren, 2017). One of the future challenges for the regulation could be whether bigger and smaller banks will be treated in the same way.

5.2 Existing surveys

The Ethics and Compliance Initiative (2016), in a multi-country inquiry into worker conduct and workplace integrity, found that the narrow definition of doing the right thing in the form of avoiding corruption and complying with the law is no longer relevant. The world seems to have moved on to what is right in a professional context: 'workplace integrity'. The survey published four different metrics of ethical issues, with a percentage of how many workers experienced those: pressure (22%), observed misconduct (33%), reported misconduct (59%) and experienced retaliation (36%).

Remarkably, more employees in three of the BRICS countries (Brazil, India and Russia) experienced pressure to compromise standards, and have observed misconduct, than in the other ten countries surveyed (South Africa was not part of the survey). Furthermore, employees of multinational companies are more likely to be affected than employees of companies that operate in only one country. This may be in an effort to grow those important economies, albeit at a price, and how this will affect other BRICS countries, like China and South Africa, needs to be considered.

Thomson Reuters (2017:42) believe that "one size rarely fits all, and there is unlikely to be a single measure that can provide the information required. Firms need to develop and refine a range of measures to capture the context and the quantum of culture and conduct-risk issues in their business." They recommend extensive evidence and documentation on parameters, assumptions and data. They offer the example of complaints analysis: while the number of complaints might be an appropriate quantitative measure for the purpose of measuring conduct risk, the data would have to cover various indicators, such as timeliness of response, customer satisfaction, product governance issues, review of sales process, training needs and compensation implications.

While various tools could be used to assess conduct risk, Pitts and Grouk (2014) stress the importance of an employee survey that is forensic in nature and which allows employees to fully express themselves in a confidential way. They recommend responses to statements using scorings such as Likert scales, and also free expression (similar to Koletar, 2010). They advocate that employees need to understand why the survey is being conducted and what the benefits are for them.

5.3 *Interviews with existing banking customers*

Questions for the interviews with existing bank customers were put together based on findings from the literature analysis. For example, Miles (2017) recommends that customers should be asked about the behaviour that they would like to see, which was incorporated into the questionnaire. The questionnaire also covered the topic of what would make customers leave. Graphical representations of some of the main outcomes of the interviews are provided in the appendix.

The age of the respondents was evenly distributed, with the biggest group aged between 30 and 40. Respondents were employed in entry-level, middle management and senior management roles, with junior management roles slightly underrepresented. Interviewees banked with ABSA,

Capitec, First National Bank (FNB), Nedbank and Standard Bank (SBSA), and some make use of two or more banks' services.

In the older and more senior group of respondents, longstanding relationships were important. Statements like, "the banker helped me through difficult times and sees the bigger picture" and "if the banker doesn't see grey and just sticks to rules, which is a problem for me", support this. Respondents also stated that "it's all about relationships" and "the bank should be a partner". Those results signal a difference between private banking and retail banking. Private banking customers want a less process- and more analysis-driven approach and seem to value the relationship they have with their banker.

In the younger and less senior group of respondents, rewards were important. Statements like, "if fees rise dramatically, I will change" and "if it was easier to switch, people would switch", play into a similar theme. Interestingly, one young respondent said that "banks need us, they need to keep customers happy at all times", which reflects a shift of power from the bank to the customer. Younger respondents also said that customers would switch for rates or more reward points, since "struggles are real". Innovative products, like pocket savings and eBucks that show the customer he is valued, create loyalty, which means charges could become less important.

Throughout the sample, respondents raised the question: "What's my alternative?", and felt that "all banks can give you hassles". 25% of respondents said they would not leave their bank, even if they were dissatisfied with the bank's conduct. Another trend across the sample was that most respondents were either very happy or very unhappy with a specific bank, but the majority were very satisfied. Respondents stated, however, that new disruptors are coming to the market, which will make people switch more frequently. Moreover, not every customer immediately leaves their bank if they are unhappy, and it seems that often customers only threaten to switch banks.

Most individuals thought it possible for a bank to have a good reputation, but bad conduct. Perception is therefore one of the factors to be considered when measuring conduct risk. Most respondents felt strongly that it should be possible for banks to conduct themselves ethically *and* be profitable.

Many individuals understood the gist of what conduct is, and how it is defined, and added safety and customer-centricity to the mix when defining conduct. Interestingly, when asked to provide

examples of good or bad conduct, very few respondents spoke about advice as such, and it appears good service and good conduct are understood as being the same concept. This may link back to the Global Ethics Survey by the Ethics and Compliance Initiative (2016) that has witnessed a move away from a regulatory approach to a more professional business-conduct approach. Many respondents put emphasis on the "hoops you need to jump through" to get anything done in a bank; a very transactional approach. Few respondents felt that banks push products onto the customer or that they oversell, and there was confusion around various banking products and services for some respondents. This suggests that consumers need to be educated in terms of what conduct is and what customers should expect in terms of advice. This point, specifically, could be related to the fact that interviews were held in South Africa, a developing country. Since the average customer is less wealthy than a developed market customer, further investigation would be necessary to ascertain whether the type of product sold in the retail market was a loan product or an investment product.

Respondents stressed that providing their consent to the bank's activities was important. Their perceptions around safety were also discussed. Most respondents noted that the tipping point (to leave the bank) would be if there was a safety issue. There is also a need for clarification with regard to fraud, which was raised as a major concern.

6. The recommended best-practice proposal

6.1 General considerations

One would assume that all banks attempt to minimise conduct risk to avoid paying penalties and losing customers. Some banks entertain certain levels of conduct-risk appetite (Thomson Reuters, 2017). Koletar (2010) argues that zero-tolerance programmes are difficult to enforce in a uniform way. These facts were considered when the suggested best-practice proposal was developed, by working with a potential scenario where some degree of conduct risk might be acceptable.

Although the interviews with bank customers revealed that only half the customers who want to switch banks end up doing so, the conversations showed that certain factors would make customers leave immediately, such as fraud and loss of money. Generally, 50% of the respondents were not sure or would not leave the bank, even if they were dissatisfied with their bank's conduct,

and the other 50% said they would leave. There appears to be a shift of power from the bank to the customer, as more disruptors come to the market and compete with traditional banking services. A survey may indicate that a customer is dissatisfied, but the customer may not necessarily leave the bank. This will not have an immediate effect on the bank's bottom line. However, the customer might speak negatively about the bank and thereby influence perceptions. Perception indicators therefore need to be considered in the proposal.

Koletar (2010) is convinced that making actionable intelligence out of a multitude of data is challenging, and it may therefore make sense to first think about how conduct-risk measurement can be understood and viewed. Based on the earlier, outcome-based definition of conduct risk, the ideal outcome for the regulator (and all other stakeholders) would be the sale of suitable products to all customers, while simultaneously meeting sales targets. In this situation, the probability of fines or losing major customers as a result of inappropriate conduct would be zero. If, on the contrary, conduct risk was higher than zero, there would be some probability that the bank is paying fines or losing major customers, and this would have a negative impact on the profit and sustainability – *ceteris paribus*. For example, if conduct risk is at 20% within a bank, the probability that this specific bank is either going to pay a penalty, with major negative press, or lose major customers would be 20%. Multiple indicators (Thomson Reuters, 2017) that should not be changed or adapted too frequently (Koletar, 2010) will influence this probability, and these need to be measured – as suggested by Koletar (2010) and Taylor (2014) – using careful documentation that cannot be forged, and taking recommended tools into consideration (for example, Miles, 2017 and Thomson Reuters, 2017). Of utmost importance is the forensic nature and free-expression style of the survey for employees, since the choice of words is often very telling (Koletar, 2010 and Pitts and Grouk, 2014). The proposal should therefore work with some open-ended questions, where interviewees must give examples, instead of solely working with quantitative scores.

6.2 *Description of proposal*

For this research, conduct-risk indicators are grouped into the following three areas: behavioural indicators, organisational/procedural indicators and perception indicators. This is based on the findings of the data collection, the literature review (for example, Fitzsimmons and Atkins, 2017) and the fact that conduct risk is rooted in both behaviour and procedures, while perception can play a major role in conduct risk.

The three areas will have to be weighted to produce a combined conduct-risk measurement score (CORIME) on a scale of 1 to 5, with 1 representing a situation where no conduct risk is evident according to the indicators, and 5 where it is at its peak according to the indicators. Weightings could be adjusted, depending on the individual bank or the situation. The score will increase with probability. While, at the overall level, a repeated low score might not be worrying, continuous low scores need to be carefully monitored at the group-indicators' level, according to Koletar (2010). Koletar warns of tipping points that are difficult to manage successfully as an organisation. This argument could influence the shape of the relationship between conduct-risk scores and probability.

The best-practice proposal is illustrated in Figure 2. Take, for example, that the following scores were allocated based on the data gathered and the following weightings applied: perception (10%) = 4, organisational/procedural (60%) = 2, behavioural (30%) = 3. The overall rating would be 2.5, so the conduct risk would be measured at just under 20%, lying between 'manageable' and 'concerning'. This should be a sign for the bank to take action and tackle the different areas of concern. The tipping point could appear at a CORIME score of 3.

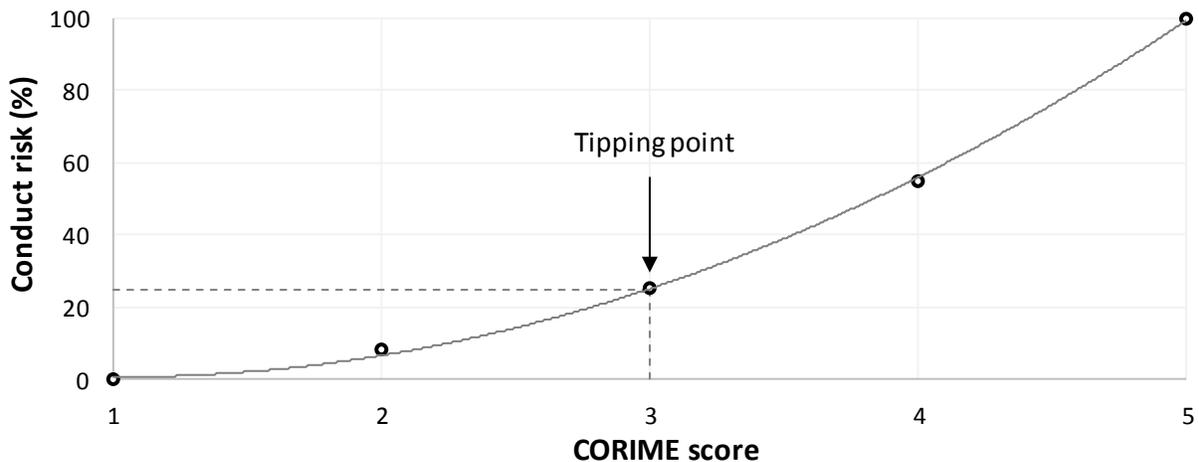


Figure 2: Conduct-risk measurement model.

1 – non-existent, 2 – manageable, 3 – concerning, 4 – high alert, 5 – disastrous

Source: Authors.

A scale of 5 was chosen to allow for various degrees of conduct risk, starting with a situation that is perfect, moving to a situation that might still be manageable, and then going to the tipping point, followed by a high alert and then a situation that is disastrous. A score of 3 does not represent an average score, but indicates to the bank that there is a concern. The goal was to create a measurement tool. The action that should be taken for the different levels of conduct risk, once measured, was therefore not explored.

Below is a more detailed description of the group indicators, with Appendix C providing a detailed example of how surveys, as one of the tools of measurement, could look. The setup of the surveys incorporates the various findings of the literature review, existing surveys and new interviews. The same scale of 5 was chosen for the surveys to link the results for the different categories to the overall score. The naming of the scale was adjusted slightly: 1 – good, 2 – acceptable, 3 – concerning, 4 – high alert, 5 – disastrous. It will be important to interpret different scores within one category, as they cover different themes (as well as staff/employees/other stakeholders), and to compare the overall scores for the three categories. Tools other than surveys were not considered in this research; they may indicate conduct risk, but the focus is not on measuring it. Surveys can be conducted on the phone for customers and other stakeholders, and online with staff members.

Surveys should not take longer than 20 minutes. Unfortunately, to gain the insights required, the surveys cannot be shorter. However, banks can work with samples of customers rather than interviewing all customers. Even though individual customers have their own stories to tell, this study found the results of the interviews based on a relatively small sample fairly representative, in that general trends were easy to detect.

Behavioural indicators: Behavioural indicators need to be categorised according to the behaviour of the organisation and at individual level (Koletar, 2010, Soares, 2013 and Miles, 2017). There must be a distinction between real events and attitudes that can be witnessed. These indicators should be surveyed at staff and customer level, differentiated between different levels and departments of staff (not all staff from all departments have the same interest in scoring low on conduct risk, as voiced by Koletar, 2010) and also retail versus private banking customers – based on the interviews conducted. Behaviour would not only encompass ethical conduct in the legal sense but also in a professional, business-conduct sense. Interviews verified that behaviour is understood in this way.

Organisational/procedural indicators: Since conduct risk is not a pure people risk, organisational/procedural indicators play a role in gauging the level of conduct risk in a bank's system. Existing conduct-risk policies and adherence and attitudes towards them should be surveyed at staff level. Customers should be surveyed about whether they are aware of procedures and have witnessed any process breakdowns. Three lines of defense, as recommended by McCormack *et al.* (2014), must be incorporated at this stage. The survey needs to reveal whether business units, centralised risk function and the internal audit function can manage and mitigate conduct risk from an organisational point of view. Based on the interviews, procedures that ensure safety and deflect fraud are essential to customers. Furthermore, customers believe good administration and good service means good conduct, and vice versa. This suggests that conduct must be tackled from a mis-selling point of view, as well as a service and administration point of view.

Perception indicators: While the first two indicators might show positive results (and hence low CORIME scores), the perception about conduct might be different, or the other way round. Various stakeholders should be surveyed for their pure perception of the bank's and its employees' conduct. Most individuals interviewed believe that a situation is possible where perceptions of a bank are good, but the conduct is unacceptable. The survey would reveal a situation like this if results for the different groups of indicators were compared. Rewards could positively influence customers' perceptions, according to the interviews conducted with bank customers, and thus rewards should form part of the survey. Lastly, interviewees seem to believe that it is possible for a bank to be both ethical and profitable. Whether this was wishful thinking (one of the respondents said: "I have to believe it is possible") or genuine belief was not investigated. A bank may not agree with this perception, but it is a difficult perception to fight. Banks must display ethical behaviour and be profitable, so as not to lose customers.

7. Discussion of results

7.1 Outline of the results

The results of the research indicate that various attempts to measure concepts like conduct in a developed world context are challenging. Interviews with bank customers in South Africa, an example of a developing country, showed that individuals struggle to differentiate between conduct risk as a regulatory issue and conduct in the professional business-conduct sense. The main concerns among bank customers seem to be around fraud and safety, and administrative hassles.

This aside, customers seem uneducated in the vagaries of bank jargon, and hence more vulnerable to mis-selling.

In attempting to answer the research question and fulfil the research objective, this study proposed a best-practice proposal that takes into consideration where stakeholders of South African banks, as well as the regulation, are at, and the difficulty of measuring a concept like conduct.

The proposal partly overcomes the complexity of the concept by breaking it into three categories (behavioural, organisational/procedural and perception indicators) and then further into specific topics of interest, with a survey for different stakeholders suggested for each category. An overall score is achieved per group of indicators, and this score is weighted and added up to a total conduct-risk measurement score. A higher score represents a higher probability of conduct risk existing in the organisation. The so-called tipping point requires careful consideration, since conduct risk will accelerate from this point onwards. Scores within the three categories must be compared on a continual basis if banks want to address the slightly different concerns that developing market customers may have. Also, customers might need to be educated regarding conduct risk.

7.2 *Practical implications*

This best-practice proposal considers the developing market situation in which South African banks find themselves. The proposal could assist them to assess their measurement problems in a time of uncertainty around conduct-risk regulation and to prove to the regulator that they are being proactive and leading by example; it could assist in situations where many customers seem oblivious to conduct risk in the regulatory sense, and are less financially educated than in a developing environment; and it could provide insight to the soon-to-be formed regulator in South Africa (FSCA), and other stakeholders.

The study adds to limited existing knowledge about how to tackle a serious problem that South African banks must confront, given the continuous threat of drastic fines, the call for sustainable business practices and the challenge of financial exclusion.

7.3 *Recommendations, limitations and further research*

It is recommended that South African banks consider the best-practice proposal to conduct-risk measurement as a first point of reference, given the difficulty of measuring this complex concept. It should allow them to formulate an initial idea of what information needs to be collected to gauge the level of conduct risk and will enable them to monitor scores over a certain period, draw necessary conclusions and take action.

The limitations of this study could potentially lie in the researchers having used existing, global surveys for employee data instead of collecting additional, primary data from bank staff in South Africa. This could be solved by using the staff surveys suggested as part of the best-practice proposal to gain a better understanding of local staff issues.

Further research could be conducted on how to interpret the data collected in surveys and on what measures to take within the banking organisation once the data are analysed. More specifically, further studies could be undertaken around how to educate customers and staff in such a way that conduct is understood, lived and appreciated daily, while at the same time meeting customers' concerns around safety and administrative hassles and staying sustainable as a business. Additional measurement tools, like complaint forums and performance management surveys, as suggested by Thomson Reuters (2017), could be examined further.

8. Conclusion

Given the difficulty of measuring a new phenomenon in bank risk management and its seriousness, especially in a developing market context, this study fills a research gap by developing a best-practice proposal for South African banks to measure conduct risk.

The proposal accomplishes this based on existing literature on similar topics and from different (mainly developed) countries, existing global surveys and information from the industry association, BASA, and interviews that were conducted with a sample of bank customers – in the form of primary data collection. This research paves the way for South African banks to measure and mitigate conduct risk, and potentially solve a real-world problem that negatively affects all stakeholders.

More research is necessary with regard to which steps to take once a conduct-risk measurement score (CORIME) has been calculated, especially in the case of a medium to high score. Furthermore, additional measurement tools could be considered and assessed, apart from stakeholder surveys. This additional research would need to offer suggestions on how to incorporate different assessment tools, and how to deal with a situation where conflicting messages are received from the various instruments.

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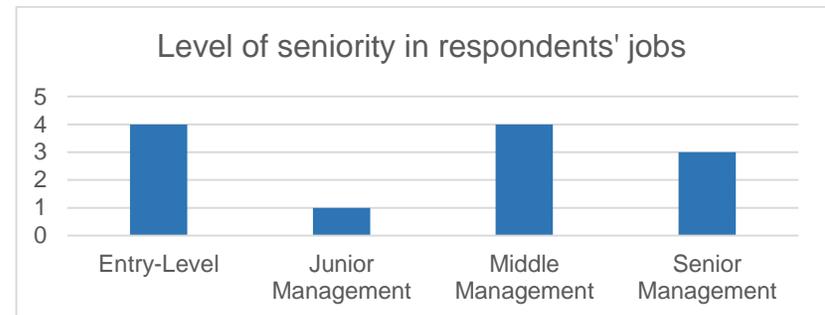
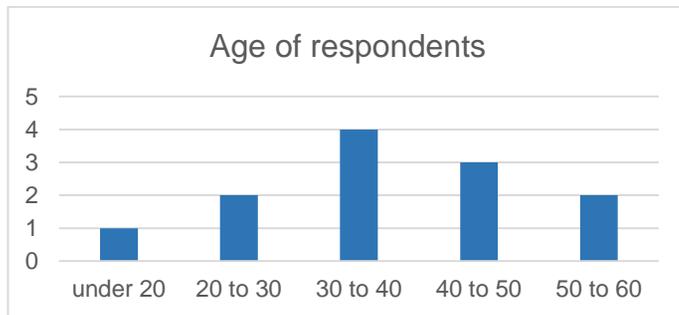
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Appendix A: Interview guide for primary data

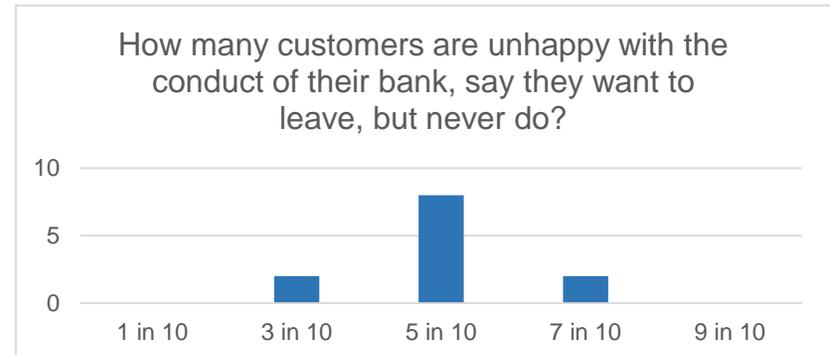
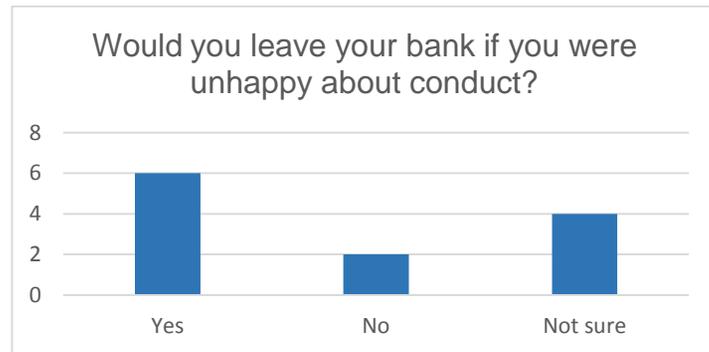
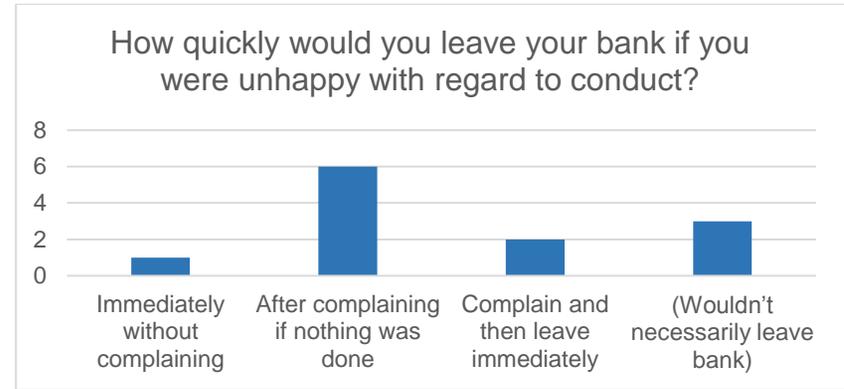
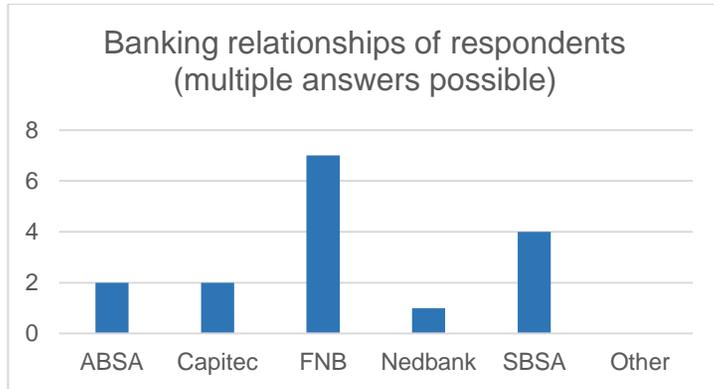
	Question	Feedback	Type of question
0	What is your age?		Closed
	Which financial institution do you bank with?		Closed, but option to explain other
	What is the level of seniority in your job?		Closed
1	What do you understand by <i>conduct</i> in a banking context?		Open
	Can you provide feedback on your banking experience in the last three years, with regard to the conduct of your bank and its employees? Do you feel that the outcome of your interactions was positive?		Open
	If your interaction was positive, how would this influence your bank's (financial) success?		Open
2	If your feedback was negative with regard to conduct, would you switch banks?		Closed
	If not, why not?		Closed, but option to explain other
	How quickly would you leave?		Closed
	If there was a tipping point for you in switching banks, what would it be?		Open
	How many banking customers frequently plan to switch banks because they do not feel they receive a positive outcome, but in actual fact never do? What do you think?		Closed
3	Give two concrete examples of an employee behaviour and/or mishaps of a procedural event that would make you leave your bank as a customer.		Open
			Open
4	Give two concrete examples of employee behaviour and/or policies you would like to see in your bank in order for you to feel that you are in good hands.		Open
			Open
5	Which role do you think perceptions/reputations play in client feedback surveys of banks? For example, is it possible that the perception about a bank is very good, but the actual experience of customers is bad; however because the reputation is good, customers do not complain? Or the other way round?		Open
6	Do you think it is possible for a bank to display acceptable conduct at all times and at the same time be profitable?		Closed
	Can you motivate your answer?		Open

Appendix B: Illustrations from primary data

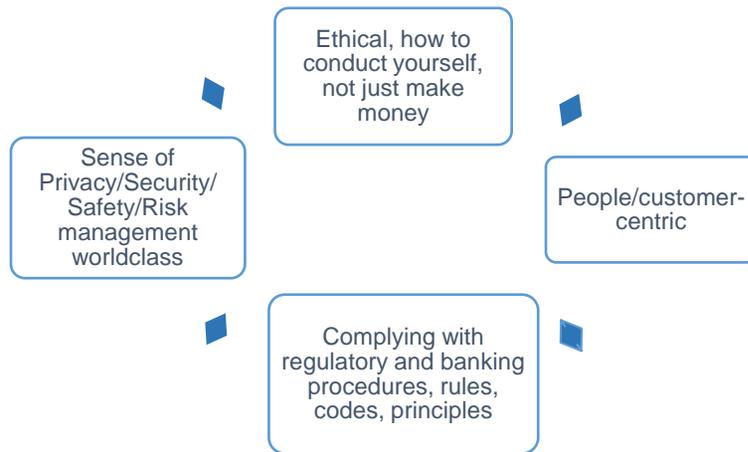
B1: Basic information on respondents



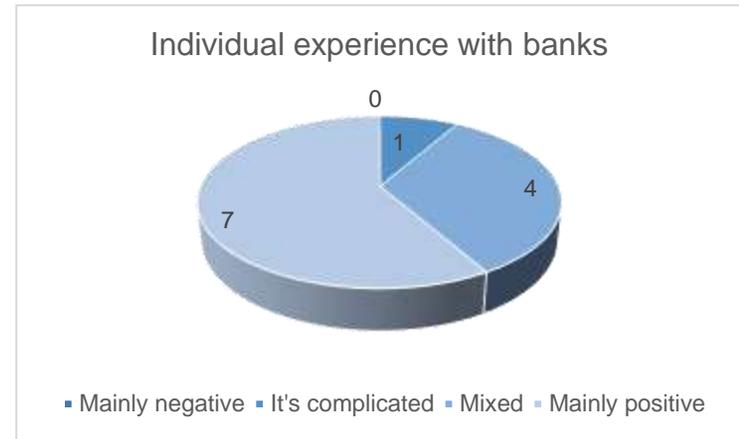
B2: Answers to selected closed questions



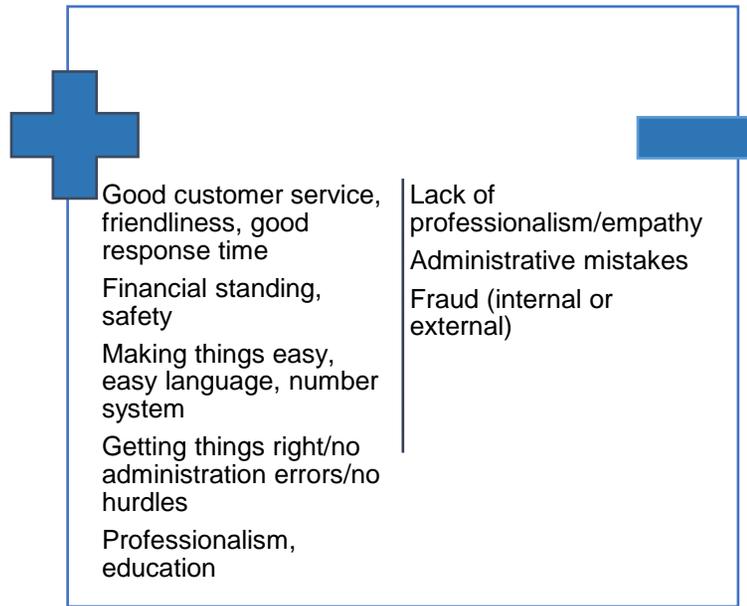
B3: What do you understand by conduct in the banking context? Answers grouped into themes.



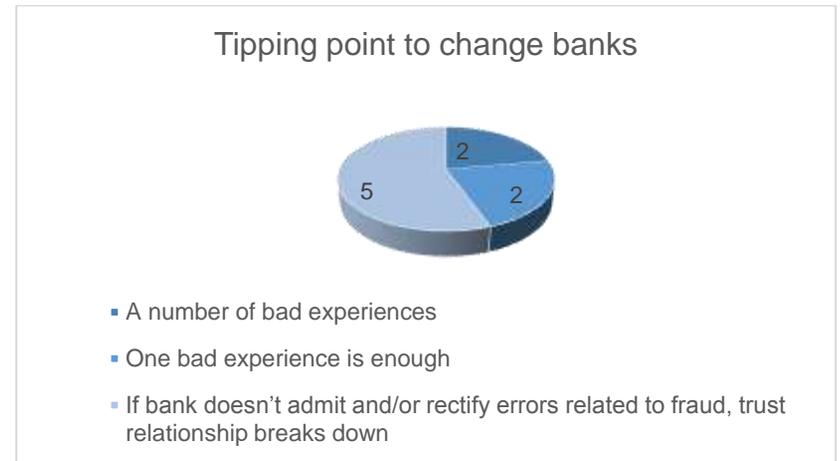
B4: Can you provide feedback on your banking experience in the last three years, with regard to the conduct of your bank and its employees?



B5: Summary of what interviewees understood by good/bad examples of conduct



B6: If there was a tipping point for you in switching banks, what would it be?



Appendix C: Possible survey for conduct-risk measurement

Behavioural category (same questions for staff and customers, but different examples given) Examples given by the bank link back to abbreviations			
Staff (S)	Yes	No	
Department			
Job role			
Customer (C)			
Private banking	Yes	No	
Retail banking	Yes	No	
Score			
Real events	Ethical conduct in terms of conduct-risk legislation	Our example:	The last product that the consultant sold to me was suitable. (C/I)
	Organisation as a whole (O)	<input type="text"/>	Your own example:
	Individual staff members (I)	<input type="text"/>	Your own example:
	Professional business conduct	Our example:	I was treated with respect the last time I came into the bank. (C/I)
	Organisation as a whole (O)	<input type="text"/>	Your own example:
	Individual staff members (I)	<input type="text"/>	Your own example:
Attitudes	Ethical conduct in terms of conduct-risk regulation	Our example:	The consultant is genuinely interested in my needs. (C/I)
	Organisation as a whole (O)	<input type="text"/>	Your own example:
	Individual staff members (I)	<input type="text"/>	Your own example:
	Professional business conduct	Our example:	The consultant has a positive and helpful attitude towards customers. (C/I)
	Organisation as a whole (O)	<input type="text"/>	Your own example:
	Individual staff members (I)	<input type="text"/>	Your own example:
	Overall score	<input type="text"/>	
Organisational/Procedural category (different questions for staff and customers) Examples given by the bank link back to abbreviations indicated below, and represent a suggestion of how the examples could look.			
Staff (S)	Yes	No	
Department			
Job role			
Score			
	Existing conduct-risk policies and procedures (at organisational level)	Our example:	Conduct-risk policies and procedures are available on the share drive, summaries are on the wall and training is conducted once a month. (K)
	Knowledge (K)	<input type="text"/>	Your own example:
	Adherence (Ad)	<input type="text"/>	Your own example:
	Attitude (At)	<input type="text"/>	Your own example:
	Cooperation between three lines of defence – business units, centralised risk function, internal audit	Our example:	A case of unethical conduct was detected last year in one of the business units because the three entities work together very closely. (S)
	Existence (E)	<input type="text"/>	Your own example:
	Success (S)	<input type="text"/>	Your own example:
	Overall score	<input type="text"/>	

Customer (C)		
Private banking	Yes	No
Retail banking	Yes	No

	Score		
Existing conduct-risk policies and procedures		Our example:	I have been made aware of conduct-risk policies and procedures via email, and receive updates every quarter. (Aw)
Awareness (Aw)	<input type="text"/>	Your own example:	<input type="text"/>
Adherence (witnessed breakdowns?) (Ad)	<input type="text"/>	Your own example:	<input type="text"/>
Safety/fraud policies and procedures		Our example:	There was a case of fraud last year on my account, and the bank sorted everything out for me, and all ended well. (Ad)
Awareness (Aw)	<input type="text"/>	Your own example:	<input type="text"/>
Adherence (witnessed breakdowns?) (Ad)	<input type="text"/>	Your own example:	<input type="text"/>
Service/administration policies and procedures		Our example:	I am aware of the service policies and procedures of my bank, especially with regard to turnaround times. (Aw)
Awareness (Aw)	<input type="text"/>	Your own example:	<input type="text"/>
Adherence (witnessed breakdowns?) (Ad)	<input type="text"/>	Your own example:	<input type="text"/>
Overall score	<input type="text"/>		

Perception category (same questions for all)

Examples given by the bank link back to abbreviations indicated below, and represent a suggestion of how the examples could look.

Staff (S)	Yes	No
Department		
Job role		

Customer (C)		
Private banking	Yes	No
Retail banking	Yes	No

Other stakeholder (O)		
Shareholder	Yes	No
Government	Yes	No
Society/NGO	Yes	No

	Score		
Perception of Ethical conduct in terms of conduct-risk legislation		Our example:	The bank comes across as ethical in its Marketing. (C/O)
Organisation as a whole (O)	<input type="text"/>	Your own example:	<input type="text"/>
Individual staff members (I)	<input type="text"/>	Your own example:	<input type="text"/>
Professional business conduct		Our example:	The consultant makes a professional impression on me. (C/I)
Organisation as a whole (O)	<input type="text"/>	Your own example:	<input type="text"/>
Individual staff members (I)	<input type="text"/>	Your own example:	<input type="text"/>
Existing conduct-risk policies and procedures		Our example:	The bank seems very serious about ensuring no mis-selling of products happens. (C/Ad)
Awareness (Aw)	<input type="text"/>	Your own example:	<input type="text"/>
Adherence (witnessed breakdowns?) (Ad)	<input type="text"/>	Your own example:	<input type="text"/>

Reward system		Our example:	The bank's reward systems seem to attract lots of new clients. (C/IP)
In place (IP)	<input type="text"/>	Your own example:	<input type="text"/>
Working well (WW)	<input type="text"/>	Your own example:	<input type="text"/>
Ethical and profitable		Our example:	The bank is ethical and profitable. (C/C)
Banks should be (S)	<input type="text"/>	Your own example:	<input type="text"/>
Banks can (C)	<input type="text"/>	Your own example:	<input type="text"/>
Overall score	<input type="text"/>		

Chapter 5

Conclusions and suggestions for future research

5.1 Summary and conclusions

South African banks are facing a serious challenge: they have to find a way to show they comply with new conduct-risk regulation and, at the same time, maintain a sustainable business, so as not to negatively affect all stakeholders. Literature on the topic is sparse, so three selected studies were undertaken. Primary and secondary data were collected to inform the conclusions for this research. Academia will profit from this research. Subject-matter knowledge is being built on a new and relevant topic (conduct risk), in a developing banking market (like South Africa). This will enable further research by providing direction and suggestions for future studies.

5.1.1 *Article 1*

Article 1 attempts to assemble a conduct-risk regulatory model. The goal was not to create a scientific, mathematical model, but to develop guidance on the influencing factors into such a model and the relationships between those factors. This approach was chosen, because the influencing factors would be crucial in achieving a positive outcome for customers. Given the nature of the topic, the influencing factors are not easily measured and conclusions not easily drawn on a wider basis. This was also not the intention. Nevertheless general trends – especially for emerging markets – could be observed and those added to the subject knowledge. For example, it is suggested that regulators attempt to influence the full conduct-risk situation with all role players.

The regulation of conduct risk is tackled in a unique way, depending on the country in question. For example, in Kenya mobile banking trends are taken into consideration, whereas in South Africa the low savings rate is considered. This means that country specific factors influence regulators' thinking and approach.

However, developing market regulators could gain much by cooperating with other developing countries. Conduct-risk regulation for banks could be driven by common strategies around financial inclusion and education. Collective ideas could be implemented across various developing markets, such as making the study of financial education compulsory for school children or prioritising affordability when extending credit to customers with lower economic profiles.

5.1.2 *Article 2*

Article 2 looks into a framework of how to integrate conduct risk into the general risk framework of a bank – given the situation South African banks find themselves in. The framework is supposed to give direction and influence the strategic thinking of banks, rather than offer a detailed quantitative guideline.

The results of the research show that South African banks should tackle regulatory compliance around conduct risk in tandem with ongoing sustainability efforts, based on a newly developed approach constructed for this study. South African banks have divergent viewpoints in terms of integrating conduct into risk management framework strategies, but have begun to put measures in place via a top-down approach. However, banks expose themselves to considerable conduct risk: the top-down strategy and its values might not always be reflected in the behaviour of employees.

It is recommended that the ‘black box’ between a high-level strategy (top-down) and a measurable result at customer level (bottom-up), with the added difficulty of remaining sustainable as a business, be uncovered through potential strategies from different stakeholders’ perspectives.

5.1.3 *Article 3*

Article 3 explores problems around the measurement of conduct risk. It focusses on which questions would have to be answered in order to understand the phenomenon better. Firstly, there is no perfect solution for measuring conduct risk, and secondly, developing countries have to work with a slightly different and more complex socioeconomic environment. Pointers are given for an approach to the measurement of the new risk and its relationship with compliance using South Africa as an example; the article did not set out to produce a mathematical formula for measurement.

The research found that banks rely on measuring conduct risk with financial needs analysis, and that many customers lack the financial acumen to understand the products and services banks intend to sell. This might be problematic, based on what is at stake. Banks might not realise the importance of being able to demonstrate that conduct risk is under control.

It is recommended that banks formulate an initial idea of what information needs to be collected to gauge the level of conduct risk, enabling them to monitor scores over a certain period, draw necessary conclusions and take action. The information should be collected from various stakeholders, and not only from the customer.

5.2 Contributions

This research paves the way for South African banks to measure and mitigate conduct risk, and potentially solve a real-world problem that negatively affects all stakeholders.

Article 1 found that government and regulators need banks to be able and willing to comply with regulation and fulfil their role in the society and economy. The regulators could also try to influence the customer. If this is successful, customers could be better off and receive a better outcome. The findings provide direction to developing market regulators and enable banks and their shareholders to understand the regulatory landscape. This could influence banks positively in terms of compliance, which will be reassuring for the financial and economic system and all stakeholders.

Article 2 suggests an approach whereby banks can manage conduct and stay sustainable. The implication of this research for South African banks is a greater in-depth-understanding of conduct risk and 'out-of-the-box' and cost-conscious thinking, if the problem can be tackled alongside sustainability. The findings might allow banks to act in an uncertain regulatory environment, instead of approaching the situation using a 'wait-and-see' approach. As a result, customers and other stakeholders of the bank might profit from this.

Article 3 fills a research gap by developing a best-practice proposal for South African banks to measure conduct risk. Given the difficulty of measuring this new qualitative phenomenon in bank risk management, guidance on this matter is desperately needed. The findings will allow banks to demonstrate that conduct risk is under control, and hence enable them to avoid fines. This will positively affect all stakeholders.

5.3 Suggestions for future research

In addition to the particular research in Article 1, more case examples of developing countries in Africa, Asia and South America should be investigated, especially with regard to how financial exclusion and lack of financial education influences conduct failure, and how these problems could be overcome. At a time when some of the regulatory approaches to banking conduct risk are fully implemented, it would make sense to measure their efficiency in more detail. In this context, it would be crucial to explore how banks react to fines, in terms of future approaches to conduct risk, to establish whether the fines are making a difference to the bank's end goal of achieving a positive outcome for the customer.

Further research on the topic for Article 2 could be undertaken to break down the suggested conduct-risk management approach into a more detailed guideline, to ensure a second line of defence, where customer-facing employees feel comfortable speaking up about potential conflicts of interest. This may involve exploring new monitoring technologies. The new research would need to include banking staff members' views, apart from banks' top-management overseeing the topic of conduct in the bank. In addition, the topic of how compensation and remuneration influences employees' behaviour needs to be addressed, specifically in the context of sustainability of banking business models.

Further studies on the topic for Article 3 could be undertaken around how to educate customers and staff in such a way that conduct is understood, lived and appreciated daily, while meeting customers' concerns around safety and administrative hassles and ensuring sustainability as a business. More research is necessary to explore ways of streamlining processes and procedures, to take away hassles that customers experience and that cloud their customer satisfaction and their perception of real conduct issues. Additional measurement tools, like complaint forums and performance management surveys, as suggested by Thomson Reuters (2017), could be examined further. Apart from this, further research could uncover customers' needs more specifically, to ensure that they are implemented throughout the product life cycle, from product design to after-sales.

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