

# Conduct Risk in South African Banks: Aligning Regulatory Compliance with Business Sustainability

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## Abstract

Regulators have imposed heavy penalties on banks for conduct failures since the global financial crisis occurred in 2007/2008. Banks play an important role in the economy, and it is therefore in the interests of both the public and government that banks have an effective conduct-risk approach in place; one that complies with regulation and ensures business sustainability. Current conduct-risk approaches are inadequate, and literature is sparse—especially regarding developing economies. The goal of this research was to explore ways in which banks can manage and mitigate conduct risk, while ensuring sustainability. The qualitative design of this study used South Africa as an example of a developing market; and it employed primary and secondary data. The analysis shows that banks have been focused on developing a suitable high-level strategy but have neglected the lower level (where employees and customers meet). Consequently, they have exposed themselves to conduct risk. Based on these findings, this article suggests that banks' strategies should be tackled in a top-down fashion, while they simultaneously pursue customer outcomes from the bottom-up. This study is crucial, as banks must prepare for new legislation, avoid fines, and strategically position themselves to satisfy clients and remain sustainable. Since the last self-assessment by the (then called) Financial Services Board in 2013, no formal assessment of conduct risk in the South African banking industry has taken place.

**Keywords:** banks; conduct risk; financial regulation; Twin Peaks model

## **Introduction**

Since the global financial crisis, a new risk, namely conduct risk (National Treasury 2011), has been identified. Conduct risk arises when financial institutions sell unsuitable products to clients to meet specific company sales targets (FCA 2013b). According to the Financial Conduct Authority (FCA), “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, and 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 (FSB 2013). Traditional risk-mitigation strategies might be inappropriate for this task.

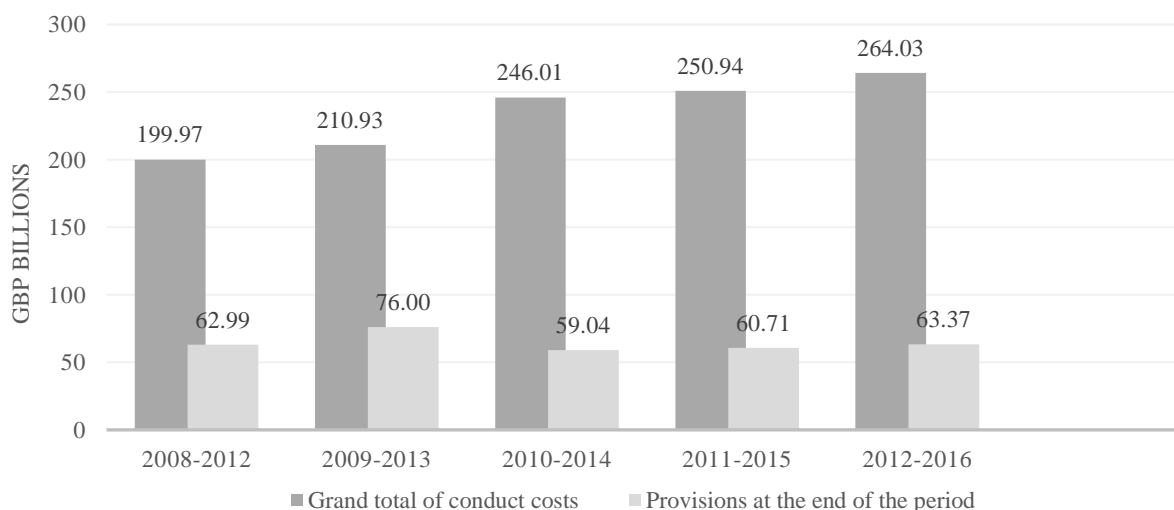
Schaltegger and Wagner (2006) identify risk reduction as one of the drivers that could lead to a sustainable future for businesses because sustainability actively seeks and realises economic success. This could mean that a reduction in conduct risk has a positive influence on improving the competitiveness 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.

## **Background**

To avoid negative consequences for all stakeholders, banks must drive an effective risk management approach, comply with conduct regulations, avoid fines and create positive outcomes for 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 clients appropriately, banks are not addressing these challenges adequately—as shown in Figure 1 (McCormick and Stears 2014; ESRB 2015; CCP Research Foundation 2017).



**Figure 1:** Conduct costs and provisions for banks since 2008

*Source: CCP Research Foundation, 2017—with permission. Banks included in the survey: 20 banks based in the US, Europe and Australia.*

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 all these fines and resulting media reports affect banks’ financial success.

The consistent fines suggest that banks tolerate a level of conduct risk based on the principle that exposure to every business risk 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 consistent fines could also be a sign that banks struggle to control, manage and mitigate conduct risk in a way in which sustainability is secured. Either way, if fines persist and no solutions are forthcoming, serious, undesirable consequences could result for all participants in the relevant country’s economic and financial system (banks and their employees, shareholders, regulators, government and

society and industry) (Baijal 2018). This could arise through a less-sustainable business situation with its own effects and, in turn, banks not fulfilling 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 (i.e. Ali 2014). South Africa presents 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 bank soundness in the 2016/2017 Global Competitiveness Report (World Economic Forum 2017), over-indebtedness is a cause of great concern and 16 per cent (5.7 million) South African adults are still financially excluded from the banking system (BASA 2014). 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 Prudential Authority (PA) and the Financial Services Conduct Authority (FSCA) have been configured as part of a new Twin Peaks model. Until the new Conduct of Financial Institutions Act (CoFI Act) is signed into law (Parliamentary Monitoring Group 2017), the FSCA will work according to existing laws.

## **Literature Review**

Information on conduct risk (in banking) comprises press articles, reports and surveys from consulting companies and other organisations, and bank publications (annual or risk reports) as opposed to formal academic research. Even though the conduct risk situation for banks in developed countries 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), those studies were considered based on the limited information available. We are unaware of any formal academic conduct-risk management studies on South Africa or any other developing country, other than our own published work.

## **Behavioural Aspects**

Miles (2017) concentrates on helping individuals predict specific conduct-risk situations, rather than giving 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 exactly these theories were built into this model, making it difficult to assess its future success and suitability for the

South African market. The study might be useful though for future research. 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. Furthermore, individuals tend to make common rationalisations, which must be managed too. Azis and Shin (2015) also suggest that both employees and bank customers do not behave rationally. Jondle et al. (2013) claim that certain assessment and improvement tools must be used to ensure that the gap between professed values and values in action are 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 (EISA) (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 EISA (2013), three problems are worth 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. The human side of an effective approach for banking conduct risk in South Africa is complex, and detailed explanations of how to tackle it are lacking.

### **Conduct Risk Management Process and Status Quo**

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 per cent said Compliance,

Risk and the Board. Similarly, when asked who was accountable for implementing the conduct-risk policy, 59 per cent said Compliance, Risk and the Board. Furthermore, 69 per cent 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 what 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 found themselves (cf. Thomson Reuters 2016). The results also suggest that conduct is tackled at senior management level but is not necessarily filtered through to all levels. 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. In 2015, the Financial Services Board (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 per cent. Outcome one (corporate culture) attracted the lowest average rating and within this the alignment of reward, remuneration and incentives with TCF objectives was lowest. This suggests that historically, while TCF-readiness was already quite high, corporate culture had not yet been tackled. Also, there is no easy solution for conduct-proof remuneration or incentives (Nicolas and May 2017). Buckley, Avgoileas 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. In this category of the literature, the information available lacks detail, hence the attempt to conduct additional research as part of this study.

### **General Risk Management Angle**

Bessis (2011) questions how the top-down processes (in which *management* initiates, installs 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; not management, who 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 could be important in implementing an appropriate conduct culture, in line with the general risk management approach and framework.

### **Sustainability and Banking Business Models**

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. 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 (Galamadien 2011; Weber and Feltmate 2016). Studies that assess how governance and regulation can be aligned with sustainability focus on generic principles across industries and on the developed world (Doppelt 2017; McNall, Hershauer and Basile 2011). Studies suggest that sustainability is an important matter in the banking world, and that banks are able to be reap reputational and financial rewards based on a suitable sustainability strategy.

## Research Problem

A tangible problem faced by South African banks is that they experience difficulties in both managing conduct risk and preparing for the new regulation: they may face further fines. At the same time, they must continue to lead their businesses in a sustainable way. The problem is serious, imminent 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.

Based on this, the following research question was 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 from interviews with stakeholders in the South African banking industry and secondary data from reports that South African banks have published were consulted from 2015 to 2017.
- The approach is a framework to tackle a specific banking risk, rather than a detailed action plan. Apart from the data collected, there were some lessons from existing studies even if they were not specifically focussed on conduct risk in the South African banking sector. This provided direction, but no exact solutions.
- Keeping the business sustainable is defined for this research as ensuring the business is viable to exist in future and will be profitable. Achieving compliance means that no fines would occur for the past or future.



## **Research Methodology**

### **Research Approach**

The research approach was inductive—the goal being to better understand the nature of the problem and to develop an initial approach. Qualitative primary data and secondary data were collected and analysed. The research strategy was cross-sectional, the phenomenon of conduct risk was examined at a specific time, and exploratory, new insights were sought by interrogating subject-matter experts and conducting interviews/surveys (Saunders, Lewis and Thornhill 2015).

### **Data Sampling**

A sample of subject matter experts was selected for interviews (Terre Blanche et al. 2006). For this study it was decided that a sample of ten specialists would suffice, based on the highly specialised and novel topic (Strauss and Corbin 1990). Firstly, the four major South African banks were selected (ABSA—part of Barclays at the time, Standard Bank, Nedbank and FNB). These banks represent 83 per cent of total banking assets (BASA 2014) and are actively tackling conduct risk, as communicated in 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, 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 South African conduct risk, in this case one representative from KPMG was chosen; one independent consultant who was recommended as a regulatory and risk management specialist from the World Bank, as well as the head of market conduct at the (then called) FSB; and two specialists from the most acknowledged sustainability or ethics institutes in South Africa (the Stellenbosch-based Sustainability Institute and the Pretoria-based Ethics Institute), since those concepts are related to conduct. Further interviews were considered, but saturation was reached after the first ten (Strauss and Corbin 1990). Secondary data (reports) were also limited to the four major banks.

## **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 was used (based on the link between conduct risk and sustainability management), 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. Data collected from interviewees were transcribed into text documents during interviews. Secondary data were collected via the internet.

Both primary and secondary data collection—linked to the research question—focused on:

- a) difference between conduct and sustainability,
- b) current approach for both, and
- c) common thread going forward.

## **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 was 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; and 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).

### **Validity, Credibility, Dependability, Conformability of Data**

Qualitative researchers believe in validating their studies according to whether it is credible, which is questioned throughout the research process (Terre Blanche et al., 2006). This was ensured by engaging with a wide audience and sources (bank employees, specialists, published reports), and by following an interpretative approach. Bryman and Bell (2007) recommend that dependability and conformability of data are ensured. The findings are likely to apply at other times, but since the topic is currently relevant, the South African banking sector's response to it might change over time (as expected for a cross-sectional study). We have allowed our own values to influence the research to a limited extent by letting interviewees guide interviews and by listening carefully to responses.

### **Ethical Considerations**

Ethical clearance for primary data collection was received from the affiliated university. Additionally, 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 were assembled by bank staff members, who may have a particular view.

### **Results/Findings**

We allowed the interviewees to guide the conversation and then formulated themes based on this:

#### **Conduct/Sustainability vs. Profitability**

There was no agreement about the relationship between conduct/sustainability and profitability. While one person insisted that "Conflict does not exist between profit and sustainability," another asked: "Will it be possible to innovate, comply fully and be profitable at the same time?" One interviewee commented: "Ethics is the relationship between sustainability and conduct risk management" and "Organic growth is sustainable growth." Clearly, many opinions exist regarding the measurement of sustainability.

## **Conduct Regulation**

Comments by interviewees were cautionary: banks are apprehensive about future regulation and associated implementation costs. Most individuals commented that banks have a conduct code and other rules in place for staff already. Literature is sparse on the status quo of the new regulation; National Treasury is engaging with stakeholders around the legislation (National Treasury 2018).

## **Reporting**

Interviewees stated that most banks are waiting to hear which reports regulators will demand, they have a wait and see attitude; some have started working on reports deemed suitable. Most respondents said that sustainability is already reported.

## **Demonstration/Measurement of Conduct**

Some made the point that financial needs analysis has been in place for a long time; this will enable banks to demonstrate conduct in the form of trustworthiness and respect. Others realised that one of the most difficult tasks might be to demonstrate conduct. One person said: “Financial institutions think they know what the client needs.” One respondent commented on banks needing to know “what matters to customers.”

## **Conduct and Company Strategy**

Most respondents believe there should be alignment between the commercial strategy and conduct: many banks used the new conduct regulation discussions to review their strategies and build a competitive advantage. Most respondents were confident and made positive comments about this theme.

## **Conduct-risk Management Approach**

Interviewees confirm that banks tasked individuals with and implemented committees to review conduct risk management but are still unsure of how to address the issue. Respondents seemed wary about tackling the issue given current uncertainty around the new regulation. Content analysis of the secondary data is summarised in Table 2.

**Table 2: Summary of analysis of annual/risk reports of four sampled South African Banks**

|  |
|--|
| <p><b>Barclays Africa Group (2015a and 2015b):</b></p> <p>The <b>Risk Management Report 2015</b> mentions conduct risk as a separate risk and lists the following key themes:</p> <ul style="list-style-type: none"><li>- Resilience of technology</li><li>- Continued levels of regulatory change</li></ul> <p>The report also provides an example of certain activities (i.e. 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.</p> <p>One of the goals is: “Enhance controls and key performance indicators to track and manage conduct risk.”</p> <p>The <b>2015 Integrated Report</b> mentions balanced scorecard items and relates these to how sustainability is measured:</p> <ul style="list-style-type: none"><li>- Conduct is listed as a separate issue, described as: “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.”</li></ul> <p>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).</p> |
| <p><b>Nedbank Group (2015):</b></p> <p>The <b>Integrated Annual Report 2015</b> mentions the Conduct and Consumer Protection under “Engagement with Regulators.”</p> <p>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.</p> <p>Nedbank speaks about a forward-looking approach to conduct and they place emphasis on the RDR.</p> <p><b>Risk Reporting 2015</b> mentions conduct risk as a separate risk in the group’s Enterprise Wide Risk Management Framework (ERMF).</p>  |
| <p><b>First Rand Group (2015):</b></p> <p>The <b>Integrated Annual Report 2015:</b></p> <ul style="list-style-type: none"><li>- Mentions conduct under insurance control functions only</li><li>- Mentions regulatory and legal risk</li><li>- Reputational risk is mentioned under strategic and business risks</li></ul> <p>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.</p> <p>The 2013 Annual Integrated Report had a Social and Ethics Committee Report.</p> <p>Environmental and social risks included in Banking and Equator Principles Report.</p>  |
| <p><b>Standard Bank Group (2015a and 2015b):</b></p> <p><b>Standard Bank’s Report to Society 2015</b> states that:</p>   |

- 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 put in place.
- 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*

## **Discussion and Analysis**

### **Behavioural Aspects**

One of the most interesting findings of the primary and secondary data is that banks are confident they are already conducting themselves appropriately and are more concerned with how to demonstrate this. 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. Based on this, 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 individuals and that their end goal is achieved, banks are exposing themselves to considerable conduct risk, and it appears that they are unaware of this problem. The process of convincing staff members to adopt from top-down prescribed values is challenging, as described by various studies (i.e. EISA 2013; Jondle et al. 2013). Although training employees may be the correct approach, training must be conducted in a way in which experiences are created: behaviours must become natural. Customers also need to be trained and educated; no evidence suggests this is occurring. The effectiveness of the training would also have to be measured, as changing behaviour can be difficult and lengthy.

## **Conduct Risk Management Process and Status Quo**

Primary data suggest that banks seem wary about more regulation. Banks seem to not want to implement too many activities/reports around conduct risk, based on the regulatory uncertainty. They seem to think all is in order, as they have always used financial needs analysis. Secondary data show that banks are beginning to assess themselves or are being assessed. They are also exploring how to measure conduct risk. Lastly, banks are training employees, establishing various committees and engaging with relevant authorities.

In answer to the research question and based on the findings, the conclusion is that there is a “black box” between a suggested, communicated and partly implemented high-level strategy that claims to incorporate ethical conduct as well as 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 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. Besides, the negative influence of remuneration on conduct has not been tackled (i.e. FSB 2013; Thomson Reuters 2016) and this can affect compliance with the regulation.

## **General Risk Management Angle**

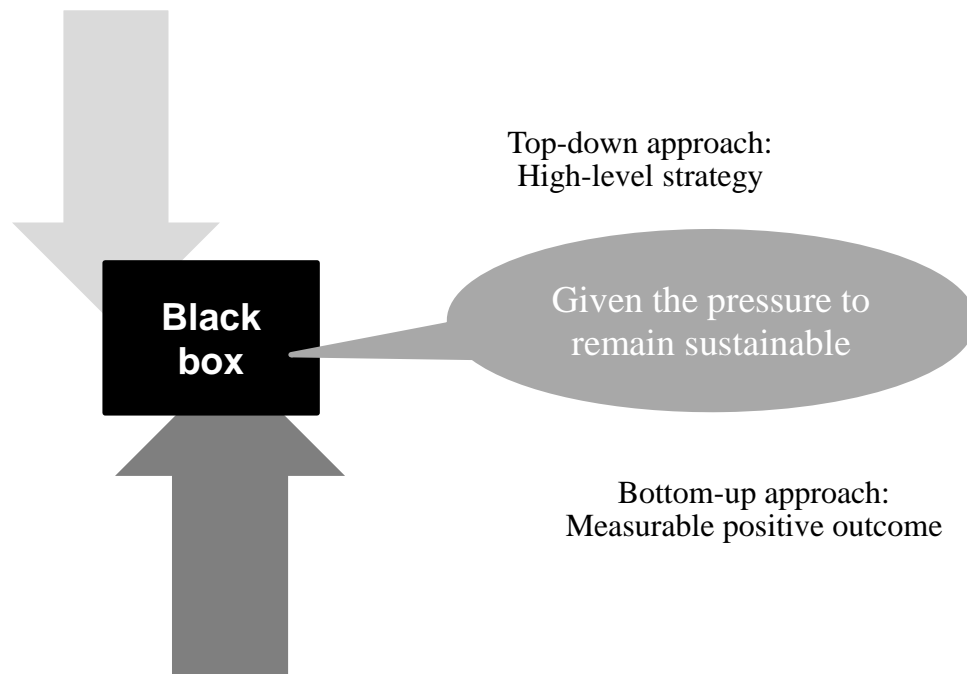
Overall, based on primary and secondary data, South African banks (measured by the “big four” banks) have acknowledged conduct risk and the regulatory changes that will affect them—but mainly from a top-down level. They have used the opportunity to review their strategies. Each bank is at a different stage of preparation and has adopted a slightly different method for how to incorporate conduct into their strategy and risk management framework, as well as sustainability strategy (see, for example, Raj and Sindhu 2013). 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 uncertain regulatory situation. Such an approach may help banks overcome their “wait-and-see” approach and to work proactively towards finding a solution specific to their customer base, with the possibility of gaining an extensive competitive advantage and making their businesses even more sustainable.

## Sustainability and Bank Business Models

Primary data indicate that banks disagree on the relationship between sustainability and appropriate conduct. Secondary data illustrate that banks are reporting on sustainability, but not in tandem with conduct risk in every case. The literature suggests that banks can and should tackle sustainability by reviewing their business models and that this can have a positive effect for stakeholders and profits alike (Galamadien 2011; Chen, Danbolt and Holland 2014; Weber and Feltmate 2016).

## Potential New Approach for the South African Banking Sector

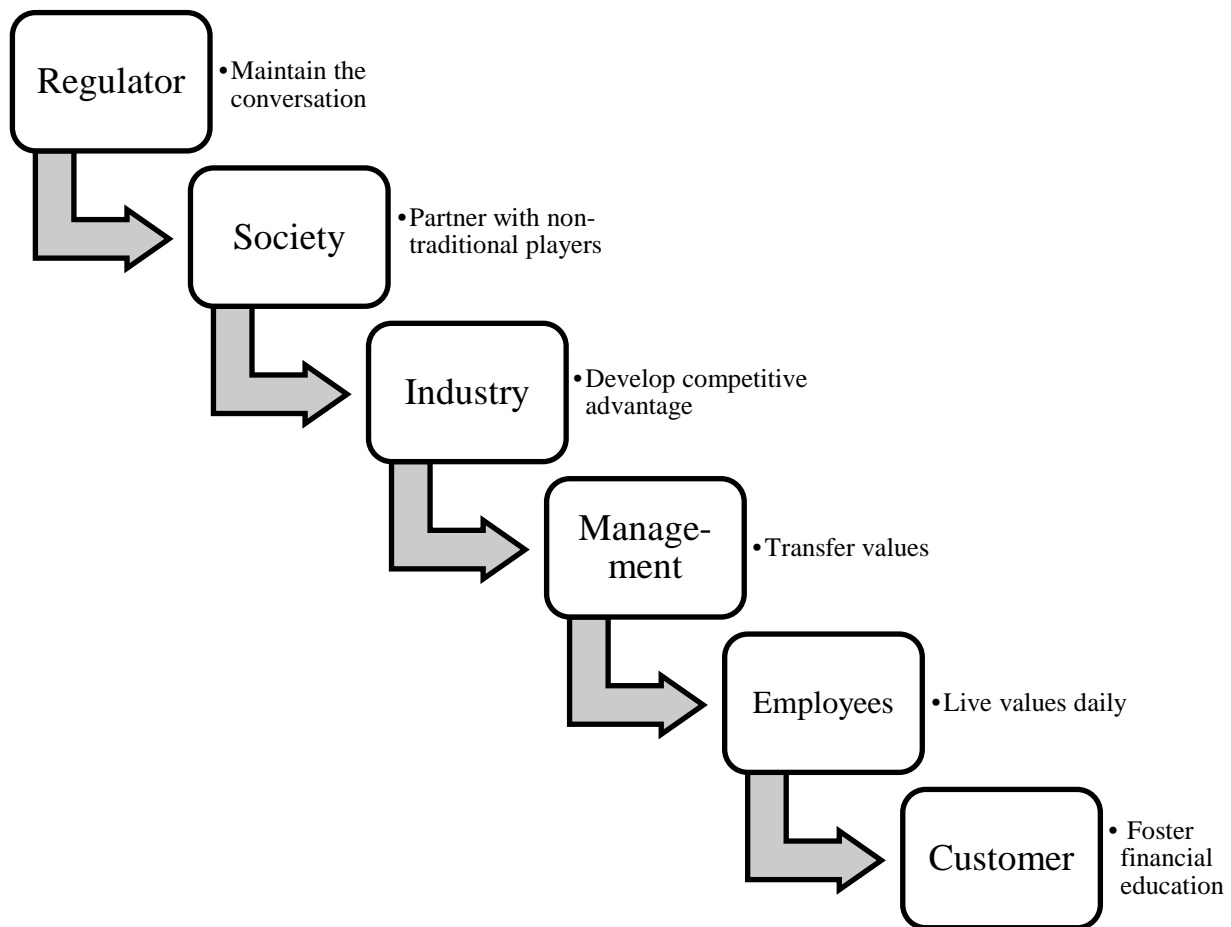
The new approach needs to recommend a way to bring light to the “black box,” while focusing on the South African situation. The approach used information from primary and secondary data analysis. For some of the more detailed and specific suggestions, selected findings from the literature review were used. For example, Bessis (2011) recognises that risk management needs to be tackled from top-down and from bottom-up. We also developed some of the specific ideas ourselves. Figure 2 below illustrates the new approach, while Figure 3 shows how the “black box” can be uncovered.



**Figure 2:** “Black box”

*Source: Authors*





**Figure 3:** Uncovering the “black box”

*Source: Authors*

Including these stakeholders and by asking the right questions, the “black box” can be uncovered, and sustainable solutions found (Schaltegger and Wagner 2006, AON 2007, and UNEP 2015).

### *Regulator*

The CoFI Act will be passed in 2019 (Murray and Phelan 2017), so banks must work with the existing regulation for now, including the Financial Advisory and Intermediary Services (FAIS) Act and TCF. Most banks already comply with these Acts, which is positive. If regulators are driving an outcomes-based approach, as they are in South Africa, they must influence the outcome for the customer indirectly—which is difficult (Hargarter and van Vuuren 2017). A risk exists that the new regulator will try to regulate at product level in future. Banks are apprehensive about this and about more regulation causing higher implementation costs; they

also are proactive in engaging with the regulator about the new regulation and should maintain this.

### *Industry, Investors and Society*

Banks that confront the aforementioned issues 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 need to use resources efficiently and build trust to ensure a continued sustainable future business (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 ideal strategy are defined, banks must prioritise one important aspect: to guarantee that employees, and not only management, work towards making their dedication to conduct a reality (i.e. 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 are more positive about the new conduct-risk approach than their employees. Management must empower employees to fulfil their roles and employees must "live" their values more meaningfully. 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 (Chen, Danbolt and Holland 2014). Furthermore, the bank must 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 clients, with emphasis on action-based learning rather than only on policies and procedures. Blacker and McConnell (2015) assert that people-risk is best managed by allowing staff to take personal accountability for decisions and 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 (Galamadien 2011), but this can be expensive and in developing economies bank customers struggle to fully understand their financial needs (National Treasury 2014). This could influence client 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: increased financial competence of households and small businesses has seen greater demands for better-suited financial services (Ali 2014). However, not all South African banks are convinced that it is possible to be profitable and ethical, given the socioeconomic situation. Banks could offer free financial education online courses in partnership with educational institutions, instead of only capturing the status quo of their customer's financial knowledge. Conduct risk could thus be reduced by fostering a reputation for sustainability and ensuring client loyalty.

### **Conclusion**

South African banks face a serious challenge in that they must comply with new conduct-risk regulation and simultaneously retain sustainable businesses, otherwise all stakeholders would be negatively impacted. South African banks should tackle regulatory compliance and conduct risk in tandem with ongoing sustainability efforts, but the literature is sparse.

South African banks are in different stages of preparation and have divergent viewpoints regarding integrating conduct into risk management framework strategies. Legislation uncertainty has prompted them to install top-down approaches. By not ensuring that the strategy filters through to the juncture between customers and employees, banks expose themselves to considerable conduct risk. The “black box” between a high-level strategy (top-down) and a measurable result at customer level (bottom-up), with the added difficulty to remain sustainable as a business, was uncovered through a suggestion of possible strategies from different stakeholders' angles.

### **Recommendations**

Banks should focus on people-risk management and avoid thinking that the only risk they need to manage is failure to demonstrate their good behaviour. Conduct risk is ubiquitous since every

employee's behaviour 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 experience 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.

## **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 first knowledge is 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 is only able to provide 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, apart from banks' top management overseeing the topic of conduct in the bank.

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