Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

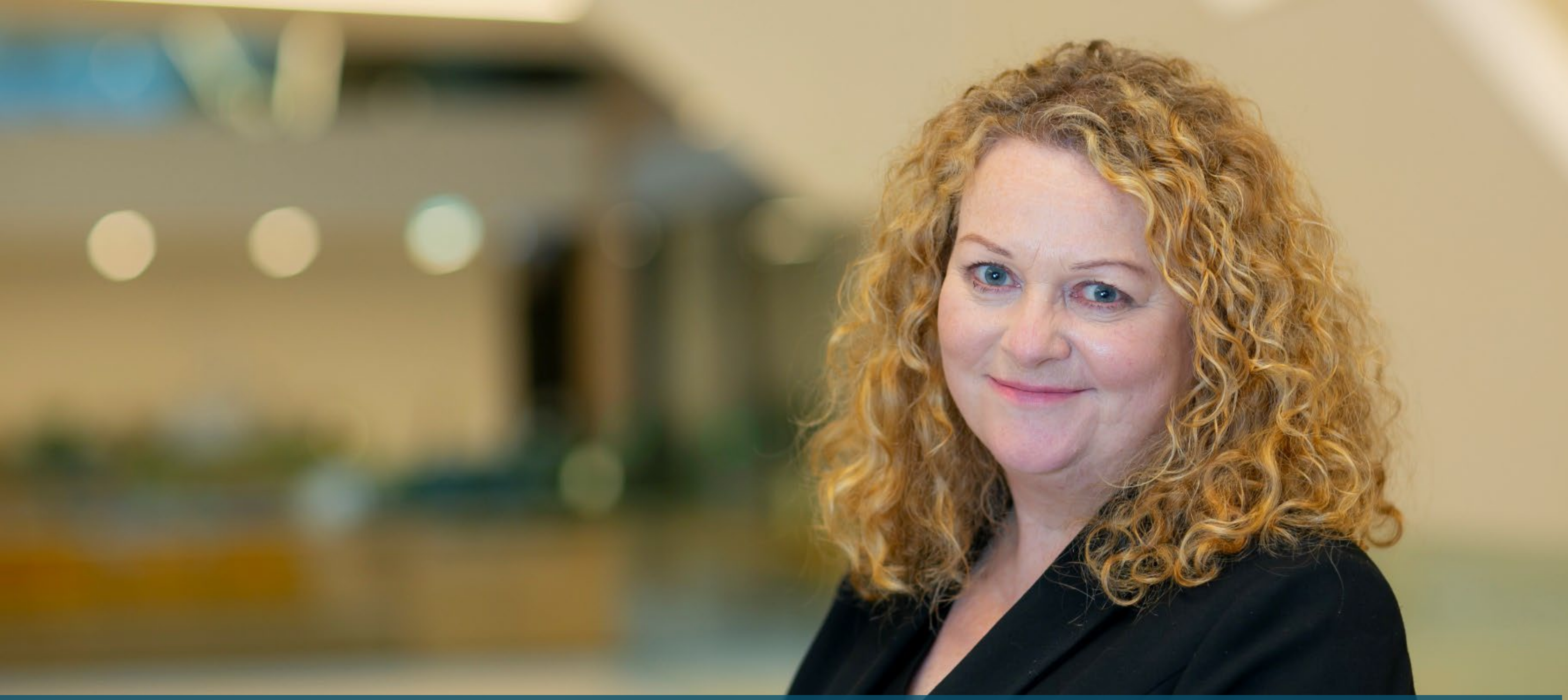
Thematic assessment Embedding an effective conduct-focused culture in wholesale market firms

The role of the Board and senior management in fostering positive conduct and behaviour

June 2023

Contents

Back to "Contents"



Foreword

A strong focus on culture and effective management of market conduct risk is a hugely important feature of a stable, well-governed and trusted wholesale financial market sector. In keeping with our strategic theme of safeguarding, we expect firms to be guided in all their activities by a commitment to a culture of high standards for conduct and market integrity.

Culture is consistently seen as a driving factor in cases of misconduct and conduct risk governance failures in the financial services industry. Having an **effective conduct-focused culture** plays a critical role in minimising opportunities for these risks crystallising.

The term **effective conduct-focused culture** describes a culture that is underpinned by an effective conduct risk management framework which seeks to mitigate the market conduct risks to which a firm is exposed. This framework enables senior management to foster positive conduct and behaviour which ultimately culminates in a culture that has the best interests of investors and the wider securities market at heart.

Overall, this Thematic Assessment found that there is a good recognition in firms of the importance of an effective conduct-

Back to "Contents"

focused culture; Boards and senior management have taken demonstrable steps to set the tone of their own desired firm culture and we observed a number of good practices in how Boards instil this throughout their organisations.

The Thematic Assessment also found that there are a number of further enhancements that can be made to ensure a firm's governance and control framework supports the delivery of an effective conduct-focused culture.

The Central Bank does not prescribe culture for individual firms; it is a matter for each firm's Board and senior management to set an effective culture, including its conduct-focused culture. Whilst this Thematic Assessment focused on wholesale market firms, all regulated entities should review the findings and observations and consider ways in which they can improve their approach to embedding an effective conduct-focused culture in the context of their own business models.

The Central Bank will maintain its focus on driving high standards across industry. We look forward to working with regulated firms and market participants to deliver on our goal of fair, transparent and efficient securities markets, which operate in the best interests of investors.

Patricia Dunne

Director of Securities and Markets Supervision

Back to "Contents"

1. Executive Summary

The Central Bank has completed a Thematic Assessment (the **Assessment**) of the approach taken by firms' Boards and their senior management to foster and embed an effective conduct-focused culture. This included an assessment of firms' market conduct risk management frameworks to support and enable a firm's Board and senior management to deliver an effective conduct–focused culture.

The Assessment focused on a cross sector cohort of firms engaged in MiFID activities, including a range of investment firms, broker-dealers and fund service providers. This report sets out the key findings and observations arising from this Assessment[1].

Overall findings & observations

Across the cohort of firms assessed, there is broad recognition of the importance of an effective conduct-focused culture with each firm having implemented various different measures to set the tone of their desired firm culture within their organisation. While we observed a number of good practices, firms need to do more overall to ensure that this desired culture is effectively embedded into their day-to-day operations, supporting governance arrangements and control frameworks.

Key observations arising from the Assessment include:

- **Board and senior management discussion and challenge of conduct risk and culture requires improvement.** The root cause of this issue is often deficient Management Information (**MI**) and reporting which inhibits the ability of the Board to effectively manage market conduct risk and promote an effective conduct-focused culture. Boards need to be proactive and ensure they are provided with appropriate, timely MI and reporting to ensure they can demonstrate appropriate challenge and oversight of market conduct risk.

[1] Whilst not all of the issues and observations outlined in this report arose in each firm assessed, the key messages in this report are representative of findings across the sample.

Back to "Contents"

- **Responsibilities for managing and mitigating market conduct risk are not consistently articulated in the role profiles and objectives for senior management.** This may potentially inhibit the Board from holding individuals to account and reinforcing expected conduct and behaviour.
- **Boards and senior management should consider what measures, if any, can be implemented to ensure defined culture, values and expected behaviours are being adhered to in a hybrid-working environment.** Firms should consider how effectively their market conduct risk management framework mitigates the particular conduct risks arising from hybrid-working arrangements.
- **Boards and senior management should consider how they can foster an inclusive "speak-up" culture** that fosters and promotes a feeling of psychological safety for staff when raising concerns.

2. Background

The mission of the Central Bank is to serve the public interest by maintaining monetary and financial stability and working to ensure that the financial system operates in the best interest of the consumers and the wider economy.

The Central Bank's Strategy has been designed to ensure we can deliver on this mission and one of the four strategic themes underpinning this strategy is **safeguarding** which reflects the Central Bank's steadfast commitment to the effective regulation of financial services and markets, including the prioritisation of governance, accountability, behaviours and conduct in firms.

Our work in supervising securities markets is a core part of this mission.

We continue to stress the importance of well-governed firms that are guided in all their activities by a commitment to a culture of high standards for investor protection and market integrity.

Back to "Contents"

Regulatory focus on conduct and culture

The Central Bank has consistently stressed its increased focus on conduct risk and culture. For example, in 2019 the Central Bank published the Wholesale Market Conduct Risk Industry Communication setting out our expectation of Boards and senior management of regulated entities to take all necessary steps to identify, manage and mitigate the market conduct risks that firms are exposed *"in order to embed a positive conduct culture within their firm"*.

"We will not prescribe a culture, there is no one size fits all and no two cultures will be precisely the same. We believe that regulators can monitor, assess and influence culture within firms in order to guard against conduct risk and drive better outcomes for consumers and investors".

Derville Rowland, Deputy Governor, Central Bank of Ireland[2]

More recently, the Central Bank set out in the annual Securities Markets Risk Outlook Report 2023 our expectation of what regulated financial service providers and market participants should do to effectively identify, mitigate and manage market conduct risks in the context of their particular business activities[3]. That report set out the Central Bank's expectation of firms to fully embed effective wholesale market conduct risk frameworks that support the ongoing monitoring of conduct risks to which a firm is exposed to enable effective Board and senior management oversight and challenge.

[2] *'Why culture matters'* - Speech by then Director General, Financial Conduct Derville Rowland. Available at: https://www.centralbank.ie/news/article/why-culture-matters-insights-from-the-central-bank-of-ireland-review-of-behaviour-and-culture-in-the-irish-banking-sector---director-general-derville-rowland
[3] Components of this Assessment were completed prior to the publication of the 2023 Central Bank Securities Markets Risk Outlook report.

3. Overview of Findings and Observations

Key findings

The key findings and observations from the Assessment fall within the following themes:

- Leadership and decision-making;
- Governance structures;
- Identification, assessment and monitoring of conduct risk & culture;
- Speak-up culture; and
- Hybrid-working.

3.1 Leadership and decision-making

Risk: Boards and senior management play a critical role in setting an effective culture within their firm. A lack of alignment between a firm's leadership and decision making and its cultural ambition inhibits the delivery of an effective conduct-focused culture throughout their firm.

It is a matter for a firm's Board and senior management in the first instance to set an effective culture.

The concept of *"setting the tone from the top"* and its role in influencing culture is a well-established principal of effective leadership and has been at the forefront of regulatory expectations of a firm's Board and senior management for a number of years. For example, the Central Bank July 2018 report on Behaviour and Culture of the Irish Retail Banks included a particular focus on the key decision-makers in firms who each set the tone from the top.

This Assessment observed that Boards have made positive efforts in setting their firm culture; all firms assessed had defined their desired firm culture and expected behaviours.

However, we noted that a firm's desired culture is often not supported by a defined plan on how the Board will deliver and embed

Back to "Contents"

it. We observed that a number of Boards had not formally considered how their firm's desired culture aligns with strategy, market conduct risk management frameworks and processes. There was also limited evidence of proactive monitoring of whether cultural initiatives are delivering good outcomes.

A **good practice** observed during the Assessment was the development of a Board approved culture strategy designed to formalise how the firm will embed its own desired culture. This includes consideration of how business and strategic decisions align with overall cultural priorities and the wider risk management framework, as well as defined responsibilities and reporting mechanisms to monitor progress on the delivery of a firm's desired culture.

i) Responsibility for delivering an effective conduct-focused culture

The responsibility for delivering the firm's own desired culture permeates to all management within an organisation who should endeavour to lead by example. We observed that a key driver of effective cultural and market conduct practices at certain firms is leaders who act as "*cultural carriers*" and embody a firm's values. Such individuals put the firm's desired culture, values and behaviours into practice in their daily work and demonstrate a commitment to high standards and practices together with values and a mind-set that drive positive behaviours around leadership and decision-making.

- CEOs should lead by example and empower other senior management to foster an effective conduct-focused culture and be seen to embody the firm's values in their day-to-day work and interactions.
- Independent Non-Executive Directors (**INEDs**) play an integral role in helping to foster an effective conduct-focused culture within a firm and can help to challenge where they perceive to be issues. The Central Bank has previously set out its expectations of INEDs to bring an independent viewpoint to the deliberations of the Board, challenge the culture that prevails and to critically evaluate the strategic direction of the firm and the emerging risks to its business model.

Back to "Contents"

- All management have an important role to play in the delivery of an effective conduct-focused culture. Line managers are at the forefront of business operations and staff engagement and need to be seen to live the values and advocate the cultural ambitions set by the Board.

ii) Decision making

Effective decision-making takes into account conduct risk considerations and aligns to the firm's culture and values. One of the Board's key roles is to decide upon the strategy and direction for the firm. We observed that the majority of the firms assessed could not sufficiently evidence how the Board discussed, assessed and considered conduct risk when making strategic decisions, or how such decisions integrate with the firm's desired culture, values and risk appetite statements.

Boards and senior management should consider:

- How they can get assurance that the Board's desired culture is being effectively delivered throughout the firm.
- Individually, how they can set the 'tone from the top' and support and embed an effective conduct-focused culture.
- How the governance framework for the discussion, assessment and consideration of decisions aligns with the firm's culture and values. For example, Boards should challenge senior management conclusions where necessary and be assured that strategic decisions align with the desired culture.

Back to "Contents"

3.2 Governance structures

Risk: Firms must implement robust governance structures for the oversight of market conduct risk that are proportionate to the scale and complexity of the firm in order to deliver an effective conduct-focused culture.

We observed that most firms have implemented governance frameworks that mandate Board responsibility for the oversight of market conduct risk, often including delegated responsibilities for the oversight of market conduct risk to Board sub-committees. The majority of firms evidenced defined reporting lines and escalation channels for conduct risk issues.

Boards and senior management should take active ownership of the governance of market conduct risk, including ensuring the firm has in place effective frameworks for the identification and management of market conduct risk.

3.3 Identification, assessment and monitoring of conduct risk & culture

Risk: Deficiencies in management information and reporting inhibits the effective monitoring of conduct risk to which a firm is exposed, thereby limiting the ability of the Board and senior management to effectively oversee the business, provide challenge and reinforce the firm's desired culture.

Effective management information is critical to enable the firm's Board and senior management to identify, manage and mitigate conduct risk and foster an effective conduct-focused culture.

In the Central Bank Securities Market Risk Outlook Report 2023 the Central Bank set out the requirement for firms to develop and embed governance, control and surveillance frameworks that are sufficiently robust for the management of market conduct risk inherent in their business to enable the development of comprehensive MI for the ongoing monitoring of conduct risk.

Back to "Contents"

We observed that the quality of conduct risk MI and reporting across the cohort of firms assessed varies, with the majority requiring improvement. Deficiencies identified include:

- Reporting to the Board is limited and lacks detail or insightful commentary such as root cause and trend analysis. This may inhibit the ability of the Board and senior management to identify and monitor patterns of conduct and behaviour.
- Often, Board and sub-committee meeting minutes refer to issues simply being "noted", with little further detail on the related discussion and challenge.
- MI is fragmented across multiple reports and updates, inhibiting the Board's ability to fully understand the firm's overall conduct risk profile.
- MI and reporting is not provided in a timely manner. Board packs are voluminous, with Board members not provided with sufficient time to review packs in advance of Board meetings.
- For firms that are part of a global group, we observed a reliance on group data and an overall lack of local entity specific MI and reporting to holistically oversee conduct risks and issues within the local entity.

Boards and senior management should be proactive and ensure they are provided with appropriate, timely MI and reporting to ensure they can demonstrate appropriate challenge and oversight of market conduct risk.

A **good practice** observed is the positive efforts by some firms to extrapolate from existing MI information such as the number of self-reported breaches as a cultural indicator of the willingness of staff to speak up and own errors. Similarly, a number of firms are making positive efforts to consolidate MI and reporting into a dashboard style reporting mechanism to provide senior management with a single view on conduct and culture. This is a positive step by firms towards ensuring Boards and senior management have sufficient insight to make decisions and inform appropriate action.

Back to "Contents"

i) Assessment of patterns of conduct and behaviour as an indicator of culture

Firms in the Assessment acknowledged challenges in measuring or quantifying culture. Some firms are making proactive efforts to design and implement quantitative and qualitative indicators to identify patterns of conduct and behaviour, supported by root cause analysis, from which firms can derive signals of its culture.

The Central Bank set out in the Securities Markets Risk Outlook Report 2023 the importance of considering both quantitative and qualitative metrics, such as acting in clients' best interests or complying with appropriate conduct practices, when determining remuneration decisions.

3.4 Responsibilities and expected behaviours

Risk: Failure to communicate cultural values and expected behaviours in a manner that is systematic, consistent and adopts a top-down approach, gives rise to the risk that staff are unaware of the conduct, cultural and ethical expectations upon them and does not support Boards' cultural ambitions.

All firms assessed have put in place defined values and/or cultural statements setting out the firms individual ethos and expected behaviours. However, some of these are more advanced than others in how these values are being tangibly embedded throughout the firm.

A number of firms were unable to demonstrate how the Board and senior management consistently communicate and reinforce expected behaviours to staff throughout the organisation. We observed:

- A lack of structured, formalised communication plans to communicate to staff the expectations of senior management on an ongoing basis.

Back to "Contents"

- Values that have been defined at group/global level in the first instance but are not disseminated by senior management in the local Irish entity.
- Generic communications that are not purposeful, are not tailored to appropriate audiences and do not link to the firm's own business model and strategy. Often there is no clear linkage to key entity specific market conduct risks.

A number of firms pointed to the delivery of training as a means to cascade cultural values and expected conduct. This can be an effective means in supporting the delivery of an effective conduct-focused culture if this training is tailored to the appropriate audience and correlates to risks inherent in the local entity to ensure values and expected behaviours are well understood.

The frequency of this training is also an important consideration; one-off induction training does not support the ongoing reinforcement of expected conduct and cultural behaviours.

i) Error management

How firms' senior management respond to errors can be indicative of an effective conduct-focused culture; for example, viewing errors as opportunities for learning and ensuring that this learning is communicated to staff.

The Assessment did not observe evidence of Boards and senior management framing errors and breaches as drivers for cultural change and communicating to staff lessons learned in order to foster an effective conduct-focused culture. Firms should consider changing their outlook on error management to re-focus from prevention to utilising errors as opportunities for improvement and to communicate learnings to staff in order to foster an effective conduct-focused culture.

Back to "Contents"

ii) Responsibility for the management of market conduct risk

In the **Securities Markets Conduct Risk January 2020 publication** the Central Bank set out our expectation of regulated entities to *"assess their governance structures on a periodic basis to ensure they have sufficient capacity to manage market conduct risk and this should consider the roles, responsibilities and accountabilities of individuals, management committees, internal functions and any entities engaged on an outsourced basis"*. However, we observed that responsibilities for managing and mitigating market conduct risk are not consistently articulated in the role profiles and objectives for senior management. This may potentially inhibit the Board from holding individuals to account and reinforcing expected conduct and behaviour.[4]

iii) Performance management

We observed that some firms have taken a number of steps to incorporate conduct and culture into performance management frameworks; for example assessing staff against the firm's cultural values in performance appraisal reviews. However, deficiencies persist in respect of the levels of embeddedness and effectiveness of these processes in determining remuneration and individual performance management outcomes. 60% of firms assessed could not evidence how the assessment of conduct has directly impacted on staff remuneration, either positively or negatively.

[4] A key element of the upcoming Central Bank Individual Accountability Framework (**IAF**) will require certain firms to set out clearly and comprehensively where responsibility and decision-making lie in order to achieve transparency as to who is accountable for what within firms. Following enactment of the Central Bank (Individual Accountability Framework) Bill 2022 on 9 March 2023, the Central Bank has launched a three-month consultation on key aspects of the implementation of the IAF, including the publication of draft regulations and guidance. The new framework will underpin sound governance across the financial sector. It will achieve this by setting out clearly the good practices expected of firms and role-holders and their accountability. The framework provides clarity as to standards that must be met by firms and individuals. The Central Bank's approach to implementation of the framework will be founded on the principles of proportionality, predictability and reasonable expectations, underpinned by effective enforcement

Back to "Contents"

3.5 Speak-up culture

Risk: Where conduct-focused culture is not cultivated by 'tone from the top' and reinforced with appropriate frameworks and processes, staff may feel unable or unsafe to speak up regarding issues of concern.

We observed that firms had put in place various mechanisms to encourage and facilitate speaking up, such as the appointment of dedicated whistleblowing champions and regular communications providing information on escalation channels.

We observed a **good practice** whereby some firms in the Assessment gather information through anonymous staff surveys on awareness and understanding of speak-up channels and on how safe staff feel raising a concern. This enables the firm's Board and senior management to measure their individual speak-up culture.

We noted that improvements are required in the depth, quality and local relevance of firms' protected disclosure policies, the supporting management communications and the reinforcement of an environment that promotes psychological safety amongst staff. We observed:

- Firms relying on group protected disclosures policies, with no information on provisions specific to the local Irish entity. This potentially creates confusion amongst staff on the protections afforded to individuals and risks Firms not complying with all local legal obligations in this regard.
- A lack of clear information within protected disclosure policies including (1) the obligations imposed on individuals performing in a Pre-approval Control Function (**PCF**) to disclose certain information to the Central Bank as per the Central Bank Supervision & Enforcement Act 2013 and (2) information on the channels available to staff to raise a concern to the Central Bank, other prescribed persons, and the Protected Disclosures Commissioner.

Psychological safety refers to the degree to which people are able to raise concerns without fear of negative consequences or repercussion.

Back to "Contents"

- Ambiguous language in policies and associated communications which may create uncertainty amongst staff on the protections afforded when making a protected disclosure.

Firms are reminded of the requirement to comply with the provisions of the Protected Disclosures (Amendment) Act 2022[5].

The Central Bank expects firms to have in place protected disclosure policies and frameworks that clearly set out the mechanisms available for raising a concern. Boards should consider how they foster awareness and understanding of these frameworks, and reinforce to staff a culture of psychological safety when speaking up.

3.6 Hybrid-working

Risk: The absence of a formalised approach to managing the potential conduct risks emanating from hybrid-working raises concerns as to how Boards and senior management can gain assurance that their firm's market conduct risk management framework is sufficiently robust.

Firms' approaches to hybrid-working continue to evolve, requiring ongoing review of governance and control frameworks to ensure these are sufficiently robust to manage the market conduct risks emanating. The Assessment noted **good practices** in how some firms have adapted their market conduct risk management frameworks to manage this risk, including:

[5] Directive (EU) 2019/1937 on the protection of persons who report breaches of Union law was transposed into Irish law via the Protected Disclosures (Amendment) Act 2022 (the 2022 Act). The 2022 Act commenced on 1 January 2023. Firms are required to comply with the provisions of the 2022 Act. The Department of Public Expenditure and Reform has published a document containing the details of the key changes of which firms should be aware. Further information from the Department of Public Expenditure and Reform regarding the legislation can be found here. Information is also available on the Central Bank's website on protected disclosures including whistleblowing and infringement reports here.

- Enhanced market conduct risk identification exercises conducted on a regular basis to identify risks or issues impacting the firm's conduct risk profile. The output of these conduct risk identification exercises is actively tracked and discussed at senior management committee level.

However, some of the firms assessed have done little to formalise their approach to managing conduct risk in a hybrid-working environment. We observed:

- The absence of formalised policies and procedures on hybrid-working.
- Poor comprehension and recognition amongst firms of the potential particular conduct risks arising from hybrid-working specific to their own business model.
- Insufficient evidence of communications from Boards and senior management that clearly sets out the expected conduct and behaviour of staff whilst engaged in hybrid-working arrangements.

As set out in the Securities Market Risk Outlook Report 2023 firms are reminded of the Central Bank's expectation of firms operating a hybrid-working model to put in place sufficient arrangements to ensure it can continue to meet their regulatory obligations.

T: +353 (0)1 224 6000
E: wholesaleconduct@centralbank.ie
www.centralbank.ie

Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem