

integrity
behaviour
professional
culture
decisions
professional
culture
decisions

Ethical culture:

Securing an ethical culture in a regulated environment

CII guidance series on ethical culture



CII

Contents

- 3 Part 1:**
Introduction
- 4 Part 2:**
Ethics and regulation
- 10 Part 3:**
Culture, ethics and regulating the firm
- 15 Part 4:**
Behaviour, ethics and regulating individuals
- 18 Part 5:**
Some final thoughts
- 19 Part 6:**
Appendix – checklists

This is the third in a series of guidance documents prepared by the Chartered Insurance Institute. The CII is grateful for Charles Cattell ACII, Chartered Insurance Practitioner, Partner of the Cattellyst Consultancy for developing this paper in the series.

Disclaimer

The guidance set out within this paper is meant to support the thinking of individuals and their firms, and nothing in the guidance should be used by firms to achieve compliance with any statutory and/or regulatory obligations.

Part 1: Introduction

This paper is one in a series on ethical guidance produced by the Chartered Insurance Institute. With the culture of financial services organisations being a key focus of public and regulatory concerns, these papers are intended to provide a helping hand to individuals and firms across insurance and financial services.

The previous papers in this series have looked at how to embed a culture of integrity within organisations and how the ethical side to culture supports professionalism, underpins trust and influences how firms handle the challenges of a changing business environment.

This paper considers how financial services regulation impacts on the development of an ethical culture and highlights pointers from within the regulation which can assist in securing ethical culture and behaviour.

The changes made to the UK's financial services regulatory regime which came into effect in April 2013 transferred responsibility from the Financial Services Authority (FSA) to the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). The separation into two regulatory authorities has brought increased focus to their respective aspects of interest.

Whilst there are inevitable implications for the prudential conduct of firms, issues relating to ethical culture reflect the way that firms and individuals behave. So from a regulatory perspective, ethics are predominantly related to conduct and thus this paper focuses on the requirements of the FCA.

Part 2: Ethics and regulation

What is meant by ethical culture in a regulatory context?

The demand for insurance and financial services stems from the fundamental need for protection against risk. This protection takes many forms. It includes, amongst other things, protection against accidental loss (general insurance), protection against the risk of being unable to look after one's dependents (life assurance), provision against the uncertainties of later life (retirement planning, pensions and annuities), security of assets and access to capital (banking) and stewardship of savings (asset management).

With this range of protection and consequent certainty available to, people to offset risks in their personal and business lives, the industry facilitates commerce, stimulates economic activity and creates wealth for the community at large with all the consequent benefits this brings. These are some of the best possible reasons for the existence of a thriving financial services industry.

However, there is a potential downside. These selfsame activities carry with them temptations for inappropriate behaviour, particularly on the part of individuals from within the industry who should have their clients' best interests at heart and in whom customers place their trust. Such inappropriate behaviour may include taking shortcuts which may put the customer at risk, undertaking activities which are particularly beneficial to the "professionals" concerned (such as giving advice which increases the remuneration paid to those individuals), insider dealing, the misuse of client money or other fraudulent or criminal acts.

These risks are exacerbated because the relationship between most financial services professionals and their clients is asymmetric, in that those working within the industry have a much greater understanding than their clients of financial issues in general and the products and services being offered in particular. This is especially the case in relation to retail customers.

So to secure order and fair treatment, and to protect against the risks of such abuses taking place, rules and regulations are created – and regulators to oversee their application. Whilst the nature of the regulatory regime in the UK is determined by legislation, the detailed design of the regulation is delegated to the regulatory authorities.

The attraction and benefit of regulatory rules is that they offer certainty, by defining (in more or less detail) absolute minimum standards. These then form a minimum level (or threshold) of performance and any regulated firm or individual who fails to meet these standards is deemed to have breached the regulatory requirements. This may in turn lead to regulatory action, ranging from closer supervision, through the requirement for a "Skilled Persons Report" to formal enforcement and sanction in the more extreme cases. By this token, any behaviour which exceeds the threshold standard could be seen to meet the regulatory requirement and therefore deemed to be compliant.

This is fine as far as it goes. However, matters are never quite so straightforward. Although firms need and seek regulatory certainty, this is not always easy to deliver. In many situations some element of judgement has to be applied to determine what is reasonable in the circumstances. This erodes the clarity which might otherwise exist about the regulatory threshold. A similar lack of absolute clarity also applies in those instances where a regulator sets out requirements at a higher level in the form of principles, rather than detailed and prescriptive rules. None the less, even though the perimeter may become blurred in places, the concept remains that a regulatory minimum standard is established below which no firm or professional is permitted to fall.

However, when considered from an ethical perspective the limitations of this approach are clear. The intent behind creating an ethical business culture is to aim to do the right thing all the time as a matter of course. This approach may well lead to performance which exceeds prescribed regulatory thresholds because doing the right thing calls for firms and the individuals within them to rise above the achievement of the minimum permitted standard and instead adhere to the full spirit and intent of the regulation.

As many will recall, there have been siren voices which have encouraged the industry to do no more than meet the regulatory threshold standard, on the premise that, if the regulatory requirements are met, then why should you go further? This view became received wisdom during the boom years because this approach proved to be very profitable— at least for some in the short term. However, as we well know from all that has happened in the recent past, this model is fatally flawed. The combination of the banking crisis and the various other scandals has seriously undermined confidence in financial services generally. This confidence now has to be rebuilt, and the framework within which this will take place needs to go far beyond mere compliance with minimum standards. At the heart of the new model must be the aim of doing the right thing, not just because it is obligatory, but because it is also the right thing to do. Because this is the best approach for our clients and customers, it is also the way to build successful and sustainable businesses.

So far we have focused on problems which can arise from within organisations in the industry. However, we should remember that financial services are built on relationships and it is not only regulated firms and the people employed within them who may behave inappropriately. Not all our clients and customers necessarily act ethically either, especially in times of financial challenge. This exposure to moral hazard can create particular difficulties in maintaining relationships, especially where the need to protect the business from attempts at fraud by the few can result in the implementation of arrangements which may be seen to be obstructive and unhelpful to the many. Although the notion of utmost good faith may be a thing of the past, encouraging ethical behaviour on the part of clients and consumers must be a long term goal.

Compliance as a by-product of doing the right thing (essential vs desirable)

If we are intending to do the right thing because it is the right thing to do, it is helpful to examine regulatory compliance from this perspective. Rather than focusing on the prescribed requirements, what if the primary objective is taken to be securing an ethical business culture? If that is to be the case, how does this impact on regulatory obligations?

There is an immediate attraction in taking this stance, because in seeking to do the right thing, an ethical culture will almost always secure a high degree of regulatory compliance as an automatic by-product. This is certainly true in the realm of principles and high-level rules; it will also go a long way towards ensuring compliance with more detailed rules and guidance. Remember that Handbook guidance is intended to help with achieving compliance with the rules, rather than indicating best practice.

There is a fundamental advantage in this approach since much regulation has been conceived in an attempt to secure fair treatment for clients and customers. So committing to an ethical culture will bring the firm much closer to meeting the spirit and intent of the regulation. In the past this intent has often been promulgated by the regulator in speeches and other pronouncements. It has also tended to feature as part of the consultation process which prefaces changes to the Handbook, even though these aims have not always found their way explicitly into the final version of the rules.

In the past regulators have frequently exhorted firms to do the right thing and have encouraged firms to behave in an ethical way. Yet this has always tended to lie within the realm of good practice. The regulator could only go so far and if firms or individuals were intent on behaving differently, the scope for regulatory enforcement action was to all intents and purposes constrained by the explicit standards contained within the Handbook.

The need to restore confidence in the industry calls for a different approach – a different style of regulation.

Style and focus of conduct regulation

In April 2013 the new regulatory architecture came into effect in the UK with the promise of a distinct change in the nature of regulation compared with that which had gone before. To that end the Financial Conduct Authority (FCA) has been created with the aim of making markets work well to get consumers a fair deal.

To deliver its strategic objective of ensuring that the relevant markets function well, the FCA seeks to:

- secure an appropriate degree of protection for consumers,
- protect and enhance the integrity of the UK financial system, and
- promote effective competition in the interests of consumers.

In endeavouring to deliver these regulatory objectives, the FCA has promised to serve the market better than previous regulators by acting more swiftly and by intervening earlier and more intelligently so as to avoid crises further down the line.

The FCA is talking about a vision of successful, competitive markets in which there is a clear distinction between the best firms, products and services which continue and thrive, whilst the worst performing firms exit the market for good. Consequently, it is challenging firms to go beyond just verifying that products are compliant and tick every legal box. Instead it is seeking assurances that the outcomes are good, that the market is competitive and that the fair treatment of consumers is an inherent element both in the design of financial services products themselves and of the culture of all the firms involved in their creation, distribution and administration.

In support of this the FCA has set out its expectations of firms' ethical culture and behaviour. As Clive Adamson, the FCA's Director of Supervision, has said¹:

“ We don't have direct rules about culture, although our high-level principles for business come close to this in some respects. We don't directly supervise 'culture'. However, as culture and business practices are so important in driving behaviours, we do want to encourage positive culture change in firms. We will therefore increasingly...draw conclusions about a firm's culture and reflect that back to firms. ”

So although the regulator has no explicit powers to regulate the ethical culture of a firm, we can expect these issues to be subject to increasing scrutiny and to become fully integrated into the regulator's supervisory approach. Irrespective of their size, firms which are found to be falling short in this area can expect to receive increased regulatory attention. The challenge for many firms, particularly small firms, is to understand and anticipate what the regulator expects to see in terms of better culture and how firms can demonstrate in regulatory terms that they are doing the 'right thing' for their customers.

¹ Speech made on 19 April 2013. <http://www.fca.org.uk/news/regulation-professionalism>

Implications of a risk-based and judgement-led regulatory environment

In seeking to understand the basis of the FCA's approach, it is helpful to be aware of the Principles of Good Regulation which the FCA is required to consider in carrying out its work².

Principles of good regulation

Efficiency and economy:	The regulator should be efficient and economical in its use of resources.
Proportionality:	The burdens or restrictions imposed on a person or activity should be proportionate to the benefits expected as a result.
Consumer responsibility:	Consumers should take responsibility for their decisions.
Senior management responsibility:	Senior management should be held responsible for their firm's activities and for ensuring that its business complies with regulatory requirements.
Openness and disclosure:	The regulator should publish relevant market information about regulated persons to reinforce market discipline and improve consumers' knowledge.with regulatory requirements.
Transparency:	The regulator should exercise its functions as transparently as possible, providing appropriate information on regulatory decisions and being open and accessible.requirements.

These Principles call for the FCA to adopt a risk-based approach to regulation with greatest regulatory attention being paid to areas which are most likely to go wrong, cause most detriment if they do, or cause most damage to those least able to fend for themselves. In particular, these Principles encourage the regulator to focus on breakdowns in fair dealing and to hold senior management to account when this happens.

In response to these Principles, the regulator has established a framework which seeks to address risk in terms of impact and probability, with firms categorised into one of four categories depending on the extent to which the firm in question poses risks to the regulatory objectives.

This categorisation effectively dictates the nature and closeness of the relationship which the firm can expect to experience with the FCA. As a result, smaller firms which present fewer risks (category C3 and C4 firms) are overseen by specialist teams rather than dedicated supervisors and are likely to have less direct contact with the regulator. Nonetheless, the combination of the review of firms' business models and the information supplied through routine compliance reporting enables the regulator to take a view about each firm's business practices.

² <http://www.fca.org.uk/about/why-we-do-it/our-remit/principles>

Categories are not permanent and a firm’s categorisation can change, depending on the potential impact of changes to its business model. Whilst aggressive growth and expansion plans would typically result in a raised risk category, this could be offset by the firm’s commitment to manage that growth through an ethical culture.

The risk-based approach to regulation reflects the impracticalities of attempting to create detailed rules to cover every situation in which firms may find themselves. Instead, a more general sense of direction needs to be provided to give firms some clarity of regulatory expectation where no detailed rules exist. This is delivered by two mutually supportive sets of principles which have been created, one for firms and the other for key individuals, or Approved Persons.

The principles for businesses

1. Integrity
2. Skill, care and diligence
3. Management and control
4. Financial prudence
5. Market conduct
6. Customers’ interests
7. Communications with clients
8. Conflicts of interest
9. Customers: relationships of trust
10. Clients’ assets
11. Relations with regulators

Approved persons statement of principles

1. Act with integrity
2. Act with due skill, care and diligence
3. Observe proper standards of market conduct
4. Deal with the regulators in an open and cooperative way and disclose information appropriately
5. Ensure that the business is organised so that it can be controlled effectively
6. Exercise due skill, care and diligence in managing the business
7. Take reasonable steps to ensure that the business complies with regulatory requirements and standards

These Principles call for both firms and individuals to act with integrity, apply skill and care in their conduct and to treat customers fairly. It is challenging to present these concepts in narrow “do’s and don’ts” format, which is perhaps why the Statements of Principle for Approved Persons is supported by an evidential Code of Practice.

However these Principles lend themselves to interpretation from an ethical perspective. Essentially these Principles encourage firms to adopt an ethical approach and individuals to behave in an ethical fashion, without prescribing in detail how such outcomes should be achieved. Principles form a core component of most risk-based regulatory regimes and are essential if cost-effective and proportionate regulation is to be delivered.

Relying too heavily on principles alone carries risks for regulators. Indeed the commitment to “principle-based regulation” led to the light-touch regulatory approach during the height of the boom, which is seen as one of the factors which contributed to the financial crisis. Principles can make it challenging to determine the boundary of what is or is not acceptable and consequently to determine precisely what is and is not compliant. This is critical if a minimum level of compliance is being sought; its significance fades if the intent is to behave ethically.

So whilst principles with their inherent flexibility can be very helpful to encourage those inclined to do the right thing, that same flexibility makes enforcement somewhat more difficult for regulators seeking to take action against the intransigent or those determined to behave less honourably.

One of the advantages of principles is that they allow for a more holistic view of what constitutes good practice to be taken between regulators and the community they regulate. The FCA is seeking to take advantage of this by adopting a forward-looking “judgement-based” pre-emptive approach, with a focus on understanding firms’ business models and strategies.

This approach will be particularly evident when firms (irrespective of size) seek initial authorisation, but will also lead to greater challenge subsequently about the reasons for business decisions which have been taken, the extent to which the needs of clients and customers have been taken into account and the proposed future direction of the business. No doubt these challenges will be addressed primarily towards senior management, both individually and collectively, for this is where ultimate accountability rests. This is of course in accordance with the Principles of Good Regulation, which call for senior management to be held responsible for their firm’s activities and for ensuring that the business complies with regulatory requirements.

As the FCA moves forward with its aim to serve the market better by acting more swiftly and by intervening earlier and more intelligently to avoid crises down the line, so we can anticipate that firms will be increasingly challenged to demonstrate that they are behaving ethically and displaying an ethical culture, with the Handbook continuing to provide the regulatory underpin for those who are disinclined to meet the expected norms of good practice.

Part 3: Culture, ethics and regulating the firm

Using the Principles to support the development of an ethical culture

Although the Principles for Businesses were created as part of the foundations of the regulatory requirements, these Principles can also be used as a basis to consider the ethical culture of the firm and to identify opportunities for its further enhancement.

Here are some examples of the Principles:

Principles of good regulation

Principle 1: A firm must conduct its business with integrity

Principle 2: A firm must conduct its business with due skill, care and diligence

Principle 3: A firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems

Principle 6: A firm must pay due regard to the interests of its customers and treat them fairly

Principle 7: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading

Principle 8: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client

Principle 9: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement

Taking these from an ethical perspective, a firm seeking to abide by these Principles is likely to ensure that it:

- treats all its customers (and potential customers) fairly
- ensures it understands and responds to the precise needs of its customers
- makes sure that the services it provides for them are suitable and meet their needs
- keeps customers fully informed about the services being provided
- reviews the performance of its staff to ensure that they are performing routinely to the required standard
- takes criticism and complaints seriously, resolving problems and learning from them to prevent repetition

If you would like to check how well your firm is doing against the Principles for Businesses in more detail, please refer to Checklist (a) in the Appendix at the end of this paper.

Ethics and fairness

Although as we have seen ethical behaviour is not regulated as such, regulators have taken a number of steps in regard to the closely related concept of fairness. Indeed, the notion of the fair treatment of customers has always lain at the heart of regulatory framework and is incorporated in Principle 6 of the Principles for Businesses.

The focus on fairness remains central to the regulation of conduct risk. The FCA has confirmed that the six Consumer Outcomes for Treating Customers Fairly, which were set out originally by FSA, remain core to what it expects of firms. The FCA has also confirmed that it will continue to use the Outcomes as an important factor in guiding regulatory decisions and actions.

The six TCF outcomes

- Outcome 1:** Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- Outcome 2:** Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
- Outcome 3:** Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- Outcome 4:** Where consumers receive advice, the advice is suitable and takes account of their circumstances.
- Outcome 5:** Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.
- Outcome 6:** Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

However, the FCA has made it clear that it sees the concept of fairness as a broader issue and not one which is solely restricted to retail business and those who interact with retail consumers at first hand. There is recognition that the fair treatment of customers may well be impacted significantly by the activities of firms elsewhere in the market, even if they do not interact with retail customers directly. This may arise through the complexities of retail distribution arrangements. It can also come about as a result of risks being transmitted from wholesale markets where the use of products developed in that area may end up being used to meet the needs of retail consumers.

Furthermore, the FCA has acknowledged that not only may different kinds of retail consumers have different levels of expertise and sophistication, but also that asymmetries exist in the relationships between firms and their clients within the wholesale markets. As there is a need for fairness here also, the FCA has stated that it intends to supervise conduct in wholesale markets more assertively, especially where there are risks to market integrity or where wholesale market costs may be passed down to be borne by retail customers.

In addition to the Customer Outcomes, the then Financial Services Authority also created a culture framework as part of its TCF initiative. This framework continues to be relevant and remains core to the FCA's approach to supervising culture and governance. The framework contains six 'key drivers', which have been found to have a significant influence on behaviour in firms. The drivers are illustrated in terms of indicators of good and poor practice.

The drivers for a TCF culture

- Leadership
- Strategy
- Decision making
- Controls
- Recruitment, training and competence
- Reward

With its focus on behaviour, this framework lends itself to being used as a touchstone to examine how far your firm has secured an ethical culture within the regulatory context. By way of example, here are some key questions for you to consider:

- How do you instil the notion of the fair treatment to your staff and ensure that this is integral to the way your firm carries out its business?
- How do you manage and control your business and measure performance and service standards?
- How can you be sure you provide your customers with clear information and suitable advice in all your dealings with them?
- How do you ensure you deal with complaints fairly and that lessons are learned from any adverse feedback to ensure you avoid similar problems in future?
- How do you ensure your recruitment and reward structures complement and support your firm's values?
- How do you educate and train your staff to ensure that your customers always receive a fair deal?

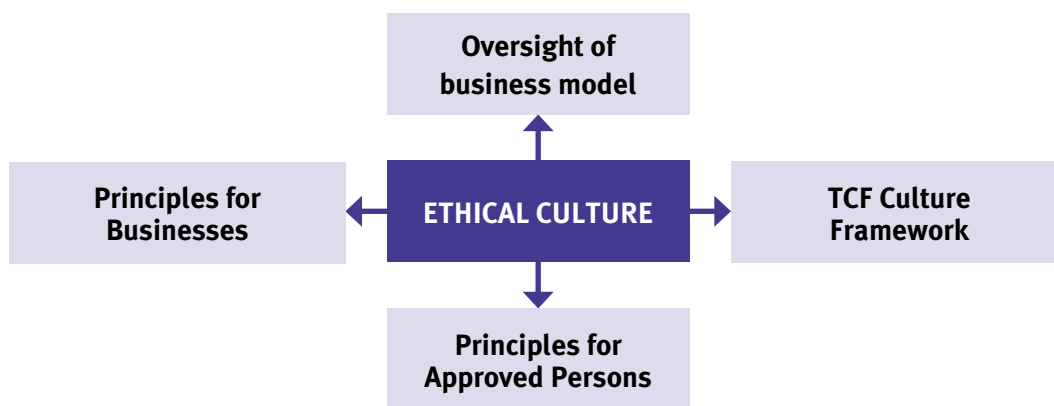
If you would like to check how well your firm is doing in securing an ethical culture you may find it useful to explore each of the drivers in more depth. To do this, please refer to Checklist (b) in the Appendix at the end of this paper.

Regulation of business models

The FCA has stated that it intends to take a much closer interest in firms' business models and strategies, which will include a consideration of the firms' competitive position. This approach will combine analysis of the business model with the firms' culture. It will also embrace product supervision, looking from the perspective of the consumer to secure fair treatment. The aim of this will be to secure product design, governance, sales effectiveness and post-sales handling which ensures that firms' practices are in line with good consumer outcomes. It will also seek to ensure that conflicts of interest are managed appropriately.

Changes to the threshold conditions have given the FCA the requirement to analyse a firm's business model at the time that the firm is authorised to conduct business. This will enable a firm's entire business model (including unregulated business) to be assessed to ensure that the overall business is suitable, there are no fundamentally uncompetitive aspects and it will not put consumers at risk. Firms which seek to behave ethically in all that they do will tend to find it easier to meet these enhanced regulatory expectations.

As can be seen from the diagram below, there are a number of arrows within the regulatory quiver all of which aim to encourage the industry to do the right thing. The regulator can (and no doubt will) select appropriate routes to ensure its views are understood. The surest way to secure compliance across all the various strands is to focus on building an ethical culture and operating ethically as a matter of everyday practice. In the same way that you have to focus on certain key issues in managing your business successfully, so focusing on an ethical approach will simplify most compliance issues.



Regulation, culture and internal controls

Control arrangements need to be in place in every business to ensure that the firm meets its obligations under the regulatory regime. Compliance, along with Risk and Internal Audit, form the core control functions which need to exist in some form within every firm, though the degree of sophistication of each of these inevitably differs depending on the business model and size of the firm in question. For compliance purposes, the control functions provide the infrastructure for monitoring the performance of the firm and its staff against the various regulatory and other requirements.

However, rather more may be required to ensure that an ethical culture is secured and ethical behaviour takes place as matter of routine. Here are some issues for you to think about to help you determine the extent to which you have clarity of these issues and the effectiveness of the controls you have in place:

- How can you demonstrate that your firm’s business model is robust, centred on the needs of your clients and that all risks associated with it have been identified?
- How can you demonstrate that the way you have determined the risk appetite and strategy of the firm is most advantageous from the perspective of your customers?
- How can you demonstrate that your firm’s management arrangements and controls are appropriate to deliver the business model?
- How can you show that your firm’s recruitment, talent management and succession arrangements are designed to secure ethical behaviour and reinforce an ethical culture?
- How can you show that your firm’s remuneration and reward arrangements are designed to secure ethical behaviour and reinforce the ethical culture?

Regulation and enforcement

Despite the best endeavours of all concerned, sometimes mistakes can happen or problems arise and the regulator decides to take disciplinary action. As is well known, firms which have been found to have breached regulatory requirements may find themselves subject to enforcement action (as can individuals in certain circumstances).

However hard a firm tries to secure an ethical culture and to encourage appropriate behaviour, it is always possible for something to go wrong. Whilst effective controls will go a long way towards preventing adverse events from crystallising, there is always the possibility that something or someone will escape the net.

Should firms find themselves subject to enforcement, there will be an immediate cost of fines and rectification. There will also be the need to manage the adverse publicity which will accompany any enforcement action and reprimand. This aspect is highly significant as any immediate costs are likely to be far outweighed by the damage the enforcement action and the surrounding publicity will cause to the firm's reputation and brand value.

This can manifest itself in a number of ways, including the loss of clients and customers as well as increases in the cost of capital. Whilst the circumstances of each case will dictate the action which is taken, there is some anecdotal evidence which indicates that firms which are recognised to have an ethical approach to business find it somewhat easier to recover from this type of set-back.

Part 4: Behaviour, ethics and regulating individuals

The role of individuals in delivering the regulators' objectives

Whilst the concept of culture applies to organisations, expectations about ethical behaviour are centred on individuals. The regulatory system identifies those individuals whose behaviour warrants the closest scrutiny through the framework of Controlled Functions and the provisions of the Approved Persons regime. Essentially there are two types of Approved Person, those in Significant Influence Functions who are involved in the governance and management of the firm at the most senior level and those in Customer-dealing Functions who are involved in giving advice or undertaking specific types of activity on behalf of clients.

As noted earlier, all Approved Persons are required to comply with the Statements of Principle, some of which apply to all Approved Persons and others which apply only to those in Significant Influence Functions. These Statements of Principle are expanded in a Code of Practice. Rather like the TCF Culture Framework, the Code of Practice provides a valuable benchmark against which to determine the extent to which individuals within the firm behave ethically. However, unlike the Culture Framework, the Code of Practice only contains examples of behaviour which would indicate that the requirements of the various Principles have not been attained.

Expectations of those who give advice

If you give advice or are otherwise approved in a Customer-dealing Function, here are some ethical issues raised by the Code of Practice which you might like to consider:

In dealing with clients and customers, Statement of Principle 2 requires you to: Act with due skill, care and diligence.

So from an ethical standpoint:

- How can you demonstrate that you know your customer and fully understand their attitude to risk?
- How can you demonstrate that all the recommendations made to your customers are suitable?
- How can you demonstrate that you understand the risk exposures of each transaction?
- How can you demonstrate that you have paid full regard to the interests of your customer and have put their interests first?

Expectations of senior managers

The FCA places responsibility for the conduct of firms firmly on the shoulders of senior managers. This is because the quality of governance and the tone set by the most senior team will be reflected throughout the organisation. It is essential to secure an ethical approach and behaviour at the highest level if an ethical culture is to be secured more widely. In consequence, directors and senior managers can expect to be subject to increasing levels of scrutiny, both on appointment and subsequently.

If you are a senior manager in a Significant Influence Function, the Code of Practice raises some ethical issues which you might like to consider in relation to how you manage the business:

Statement of Principle 5 requires you to: Ensure that the business is organised so that it can be controlled effectively and **Statement of Principle 6** requires you to: Exercise due skill, care and diligence in managing the business.

So from an ethical standpoint:

- How can you demonstrate that the reporting lines and authorisation levels you implement are fully understood by all concerned?
- How can you demonstrate that you are aware of the skill and competence levels of the staff to whom you delegate?
- How can you demonstrate that decisions you take about the suitability of individual members of staff are not overshadowed by their individual financial performance?
- How can you demonstrate that you fully understand all the risk exposures inherent in the business?
- How can you demonstrate that you fully understand all the risk exposures before entering into new ventures?
- How can you demonstrate that you are confident about the suitability of individuals before delegating responsibilities to them?
- How can you demonstrate that you are kept fully informed about responsibilities which you have delegated and take all appropriate action which may be necessary?

In addition to the Code of Practice, you may find it helpful to consider the following points in your drive to secure an ethical culture.

- How can you demonstrate that the aims and objectives of the senior team are centred on delivering ethical business practices?
- How can you demonstrate that ethical behaviour and values lie at the heart of all senior management activity?
- How can you demonstrate that senior management's attitude to risk seeks to minimise exposure for clients?
- How can you demonstrate that senior management address any conflicts of interest which arise in an appropriate manner?
- How can you demonstrate that senior management drive forward ethical values when leading and communicating with staff?

Expectations of those who manage teams

In securing ethical behaviour from all staff as a matter of routine, there are a number of aspects about the nature of the relationship that individual employees have with the firm and their colleagues which should be considered. These present potential risks to the delivery of ethical behaviour and should be borne in mind by anyone in managerial or supervisory roles who are responsible for others, be they Approved Persons or otherwise. Ask yourself:

- What are the individual team members' values and ethical attitude?
- How do these fit in with the attitudes of peers and colleagues?
- What motivates each individual?
- What recognition, rewards and incentives does each individual receive? How do these underpin ethical behaviour? Are there any elements in these arrangements which could encourage unethical behaviour? What risks are there of any individual becoming demotivated?
- How is each individual's performance monitored and managed?
- What learning and development has been provided in the past and what is planned for the future? How does this reinforce ethical behaviour?

A firm and the individuals within it do not operate in a vacuum. They are subject to pressures and expectations from others who are external to the organisation as well as internally. In seeking to secure an ethical culture it is helpful to examine the following environmental issues and consider the potential impacts of them on members of your team:

- Expectations of shareholders and other stakeholders
- Parent group policies
- Practices and expectations of business partners
- Market practice and competitor behaviour
- Expectations of clients and customers

Appointing new approved persons in significant influence functions

There is increasing clarity about the degree of due diligence which firms are expected to undertake as part of the process of making senior appointments to ensure that candidates for approval to perform Controlled Functions meet the "Fit and Proper" requirements.

If you are making a senior level appointment, here is a checklist of items to address ethical considerations raised by the "Fit and Proper" requirements:

- Are there any issues for concern on the candidate's cv?
- Is the Role Specification and Organisation Chart clear so that the individual's responsibilities and reporting lines are clear?
- Does the recruitment process include examination of evidence of candidates' ethical values and past behaviour?
- Have the candidate's skills been analysed and anything which might have a bearing on the individual's behaviour and performance been capture in a learning and development plan?
- Have you considered the impact the candidate is likely to make on the culture of the firm and the behaviour of the existing senior team?

Part 5: Some final thoughts

What the future holds

At the time of writing (autumn 2013), the new regulatory framework was only a few months old, the new regulators were still becoming established and future expectations were still crystallising. That said, issues raised by the FCA and the responses to the Banking Commission indicate some of the topics which are likely to feature on the ethical agenda during the period ahead. Developments within the next three years may well include:

- Greater emphasis on the personal responsibility of those in senior positions
- The replacement of the Approved Persons regime by more stringent Senior Persons requirements for the most senior staff, at least in some parts of the industry starting with deposit-takers
- A licensing regime supported by defined occupational standards for all other Approved Persons which may well apply, in time, to a broader range of roles than those currently covered
- Increased regulatory focus on firms' business models and the effective delivery of TCF
- Regulatory initiatives driven by a clearer understanding about the underlying reasons for consumer behaviour and how firms develop their culture
- More themed supervisory intervention by the regulator about the fair or ethical treatment of customers
- Continued focus on governance, remuneration and incentives
- Closer scrutiny of culture and behaviour in firms as part of the regulatory risk assessment process
- Closer regulation of individual advisers

This may appear to be a formidable list and no doubt some will find at least some of these issues demanding. However, those who set out to do the right thing and to behave ethically are likely to be best placed to meet these challenges. Practitioners who are members of a professional body and consequently commit to adhering to codes of conduct and aspiring to the expectations of their various professions have a role to play as role models in this new environment, as do the professional bodies themselves in helping to encourage and guide their members.

Part 6: Appendix – checklists

Principles for businesses

To check how well you are doing against the Principles for Businesses, here are some questions to ask yourself about your firm:

Principle 1 says:

A firm must conduct its business with integrity In seeking to secure an ethical culture:

- How can your firm demonstrate that it always seeks to put the principles of ethical and fair dealing into practice?
 - How can your firm show that it does the right thing for its clients and customers as a matter of course?
-

Principle 2 says:

A firm must conduct its business with due skill, care and diligence.

In seeking to secure an ethical culture:

- How can your firm demonstrate that it always takes proper care when acting for its clients?
 - How does your firm ensure your clients are not disadvantaged if something does go wrong?
-

Principle 3 says:

A firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems.

In seeking to secure an ethical culture:

- How can you show that your firm’s managerial arrangements deliver your business model and meet your ethical ambitions?
 - How can you show that your risk management arrangements are sufficiently robust to protect the interests of your clients?
 - How can you show that your firm’s managerial arrangements have taken account of the ethical risks faced by your firm?
-

Principle 6 says:

A firm must pay due regard to the interests of its customers and treat them fairly.

In seeking to secure an ethical culture:

- How can you show that you always put the interests of your customers first?
 - How can you show that the fair treatment of customers lies at the heart of your firm’s business model and is the basis for the way you go about conducting business as usual?
-

Principle 7 says:

A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

In seeking to secure an ethical culture:

- How can you show that you fully understand the information needs of all your clients?
- How can you verify that your clients understand the various communications they receive from you?

Principle 8 says:

A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client

In seeking to secure an ethical culture:

- How can your firm demonstrate that it always seeks to identify and manage fairly potential conflicts of interest?
- How can your firm demonstrate that it manages and resolves fairly any conflicts of interest which do arise?

Principle 9 says:

A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.

In seeking to secure an ethical culture:

- How can your firm demonstrate the suitability of the advice it offers and the services it provides to all its clients?
- How can your firm show that it fully understands the needs of its individual customers?

Drivers of ethical culture (TCF)

To secure an ethical culture you may find it useful to consider the following issues raised by each of the drivers in the TCF culture framework:

Leadership

- What steps have you taken to ensure that the fair and ethical treatment of customers is central to the behaviour and values of everyone in your firm?
- How do ensure that all messages about the fair and ethical treatment of customers are communicated and understood by everyone in the firm?
- How do you demonstrate your personal commitment to the fair and ethical treatment of customers in your own actions and behaviour?

Strategy

- Does your firm have a clear vision which places the fair and ethical treatment of customers at the heart of its strategy?
- How can this be evidenced in the way strategic decisions are reached and implemented?
- How is the fair and ethical treatment of customers reflected in your firm's risk appetite?
- How is the fair and ethical treatment of customers reflected in your firm's outsourcing arrangements (where these exist)?

Decision making

- How does decision making at all levels in your firm reflect the fair and ethical treatment of customers?
- How does your firm use feedback from staff, customers and other sources to secure the fair and ethical treatment of customers?
- How can your firm show that the interests of customers are properly balanced against those of its other stakeholders?

Controls

- What controls exist to ensure that the fair and ethical treatment of customers is delivered?
- How can your firm demonstrate that its controls are integral to the way it manages risk?
- How is management information monitored and used to enhance the fair and ethical treatment of customers?

Recruitment, training and competence

- How are your firm's expectations about positive behaviours and attitudes towards the fair and ethical treatment of customers established and used in the selection of staff?
- How are the fair and ethical treatment of customers and the values of your firm integrated into the training and continuing development of all staff?
- How are the fair and ethical treatment of customers and the values of your firm brought together into your performance management arrangements?
- How can your firm evidence that it recognises desired behaviours and identifies and acts on poor performance when this occurs?

Reward

- How can your firm show that all its reward structures and incentive schemes are transparent, recognise quality and support the fair treatment of customers?
- How can your firm demonstrate that its informal recognition of success reflects the fair and ethical treatment of customers?

The Chartered Insurance Institute 42–48 High Road, South Woodford, London E18 2JP
tel: **+44 (0)20 8989 8464** email: **customer.serv@cii.co.uk** website: **www.cii.co.uk**

© The Chartered Insurance Institute 2013

C13J_8449 (11/13)