Conduct Risk Management: The Journey Ahead

Introduction

Conduct risk (or misconduct risk) refers to the risk arising from inappropriate or unethical behavior of employees with regard to customer welfare or market integrity. In the past, it was treated as part of operational risk, but given its enormous implications, most economies now consider it a standalone risk. UK's Financial Conduct Authority (FCA) monitors the conduct of banks with the twin objectives of protecting consumers and enhancing the integrity of the financial system. In this article, we examine FCA's guidelines on the mitigation of conduct risk and propose an approach to ensure compliance.

Causes and Impact of Conduct Risk

The causes of misconduct risk vary across banks depending on institutions' internal business models, architecture, and governance policies, and cannot be attributed to a particular category of misconduct. However, according to a report on misconduct risk released by the European Systemic Risk Board, mis-selling to customers accounted for 52%of the total misconduct instances reported during 2009-2013.[1]

Aside of attracting wide-ranging punitive actions including disciplinary notices, hefty penalties, suspension, restitution, and insolvency orders from enforcement agencies, conduct risk is highly detrimental to a bank's reputation. It can erode customer confidence and puncture the very fabric of the financial landscape. Systemically Important Banks (SIBs) are no exception. Imposition of hefty penalties on SIBs can cause serious injury to the banking system, which is the backbone of a nation's economy.

Mitigation Strategy

Regulatory directives play a significant role in combating conduct risk and safeguarding customer interests, while restoring public faith in the financial system. The FCA has laid down the basic behavioral standards for banks' staff and has outlined the code of conduct employees are expected to follow[2], other than the internal policies along with the Senior Management regime and Certification regime.[3]

Effective mitigation and management of conduct risk calls for focusing on the following aspects:

Organisational culture and leader's role: The FCA highlights the role of an organisation's culture in mitigating conduct risk. The organizational culture steers individual behaviors and drives stakeholder relationships3.A culture that lays a strong emphasis on individual behavior, risk appetite awareness, and tight governance is vital to minimizing conduct risk.

The backbone of a strong organisational culture is robust communication. The communication channels between managers and staff need to be redefined to enable employees to freely communicate with their supervisors, especially when there is a conflict of interest. Managers should have a clear vision of the ethical standards set by the organisation, and must regularly communicate these to the staff.

A leader's vision plays a major role in building an organisational culture with ethics woven into it. The onus of mitigating conduct risk therefore lies with the bank's leadership.

Ethics training for employees: Most global banks have instituted elaborate ethics training programs for their employees. Introducing employees to the concept and familiarizing them with the expected code of conduct will shape their attitude and behavior, while enabling them to maintain a high level of professionalism and commitment in dealing with customers.

Accountability and supervision: Accountability should be an integral part of a bank's operating model and risk culture. The prerequisite to set accountability norms is to clearly define the roles and responsibilities, and the scope of work for each employee. The FCA's latest guidelines on the certification regime will take us a step closer to achieving total accountability.

Senior managers and supervisors must ensure compliance with conduct norms within their teams. The FCA's latest guidelines, and the Senior Managers and Certification Regime requires banks to regularly assess the fitness and propriety of their senior management.

Whistleblowing: Periodic disclosures by whistleblowers on the unethical practices followed by coworkers instill a sense of fear among employees, acting as a deterrent to misconduct. It is, however, essential to protect whistleblowers' identities to ensure their safety and security. Governments across the world have come up with regulatory guidance on whistleblowing, employers' responsibilities, and codes of practice.

How Technology Can Help

Technology can play a critical role in mitigating conduct risk. Here's how.

Big Data analytics: Post the 2008-09 financial crisis, it was evident that the existing data architecture and IT systems at most banks were not adequate to monitor the entire spectrum of risk. For timely and detailed reporting as required by regulatory agencies, the adoption of sophisticated technology has become an absolute necessity.

Banks also need to have a robust and secure IT system to ensure safe handling of confidential customer information. A strong reporting framework that ensures comprehensive monitoring along with the capability to proactively trigger alerts and automatically generate reports when the bank's risk threshold is breached. We believe that Big Data analytics is the answer here. Big Data analytics can play a vital role in product governance, which can drive down mis-selling to a considerable extent. Advanced analytics can help identify market segments and conduct market analysis. Leveraging elaborate trend analysis, banks can gain insights into product launches, product improvements, and market performance. All this information when made available to the clients can substantially reduce the scope of mis-selling.

Other than analyzing market and customer trends, Big Data can also serve as a checkpoint to monitor employee behavior, which is another major factor for misconduct Risk. Using analytics to assess employees' responses to periodic surveys can help predict their behavior and inclination (or the lack of it) toward resorting to unethical means.

IT resilience and governance: Given the increased dependence of banks on technology, the integrity of the underlying IT infrastructure plays an important role in ensuring operational stability and market integrity. In recent years, banks have incurred significant operational losses due to technical issues and poor conduct4.Delayed or failed payments processes, system errors leading to mismanagement of IPOs, and faulty installation of trading software are some examples of technical issues exposing

banks to conduct risk. Such instances of inadequate IT resilience trigger conduct risk in wholesale markets[4].
To cope up with disruptive technological and operational issues, banks must strengthen IT governance and control frameworks to bridge the gap between key business risk areas, technological issues and operational feasibility and control.

Conclusion

Regulatory pressures, loss of credibility, cutthroat competition, changing economic environment, and emerging technologies are driving banks to better manage their conduct risk through a combination of the right organisational culture, regulatory compliance programs, and technology solutions. We believe that a sound conduct risk mitigation and management strategy is supported by four pillars, which are:

Policy management: The policies of an organization that highlight the expected employee conduct and the consequences of breaching the code. Ethics should be integral to an organisation's overall policies and well aligned with the firm's mission and objectives.

People management: These measures instill a healthy conduct culture in the organization. This aspect includes clearly defining employee roles and responsibilities, designing appropriate remuneration structures, and imparting training on ethics and the expected code of conduct.

Product management: A strong product governance structure that monitors the entire product lifecycle will help firms better manage conduct risk. Products should be designed keeping in mind the demands and needs of end customers and market segments. Before launching a product in the target market, banks should test them to ensure their ability to deliver fair outcomes to target customers. The FCA has outlined guidelines on the governance of structured products while also laying down expectations from firms operating in respectivegeographies[5].

Process review: This is essentially a supervisory review of the code of conduct and process rules followed by the staff. Process review helps determine staff accountability and assess adherence to conduct rules. It involves the documentation of existing conduct risk cases along with their impact, intervention, and mitigation programs.

An integrated approach built through a strong and robust IT governance can enable these four pillars to function cohesively, and provide a strong foundation to effectively manage the overall conduct of an organisation.

References

[1] European Systemic Risk Board, "Report on misconduct risk in the banking sector"(June2015), accessed November 10, 2016, https://www.esrb.europa.eu/pub/pdf/other/150625_report_misconduct_risk.en.pdf

[2] Financial Conduct Authority, "FCA publishes final rules to make those in the banking sector more accountable"(July2015),accessed November 10,2016, https://www.fca.org.uk/news/press-releases/fca-publishes-final-rules-make-those-banking-sector-more-accountable

[3] Financial Conduct Authority, "Culture in banking"(January 2016), accessed November 10,2016, https://www.fca.org.uk/publication/foi/foi4350-information-provided.pdf

[4] Financial Conduct Authority, "FCA Risk Outlook2013"(May2013),accessed November 10,2016, https://www.fca.org.uk/publication/business-plans/fca-risk-outlook-2013.pdf

[5] Financial Conduct Authority, Structured Products: Thematic Review of Product Development and Governance, March2015, accessed Nov10, 2016, https://www.fca.org.uk/publication/thematic-reviews/tr15-02.pdf

About The Author

Anindita De

Anindita De is a Domain Analyst with the Risk Management practice of the Banking and Financial Services (BFS) business unit at Tata Consultancy Services (TCS). She has more than nine years of experience in banking and risk management, with special focus on credit risk and regulatory reporting. Prior to joining TCS, De was a credit manager with an Indian public sector bank. She is responsible for solution development and thought leadership initiatives for the group. De holds a Master's degree in Business Administration from the Indian Institute of Engineering, Science and Technology, West Bengal, India.

Contact

Visit the Banking & Financial Services page on www.tcs.com

Email: bfs.marketing@tcs.com

Blog: Drive Governance

Subscribe to TCS White Papers

TCS.com RSS: http://www.tcs.com/rss_feeds/Pages/feed.aspx?f=w

Feedburner: http://feeds2.feedburner.com/tcswhitepapers

About Tata Consultancy Services Ltd (TCS)

Tata Consultancy Services is an IT services, consulting and business solutions organization that delivers real results to global business, ensuring a level of certainty no other firm can match. TCS offers a consulting-led, integrated portfolio of IT and IT-enabled, infrastructure, engineering and assurance services. This is delivered through its unique Global Network Delivery Model™, recognized as the benchmark of excellence in software development. A part of the Tata Group, India's largest industrial conglomerate, TCS has a global footprint and is listed on the National Stock Exchange and Bombay Stock Exchange in India.

For more information, visit us at www.tcs.com

Experience certainty. IT Services
Business Solutions
Consulting

TCS Design Services I M I 09 I 17