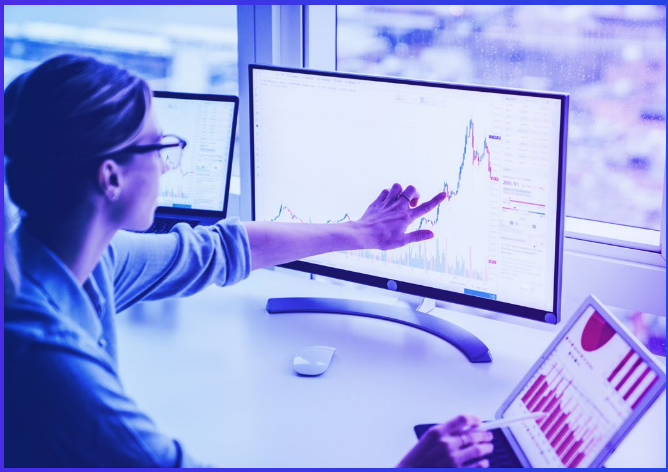
Conduct risk and its bigger impact

Navigating through the risk of misconduct

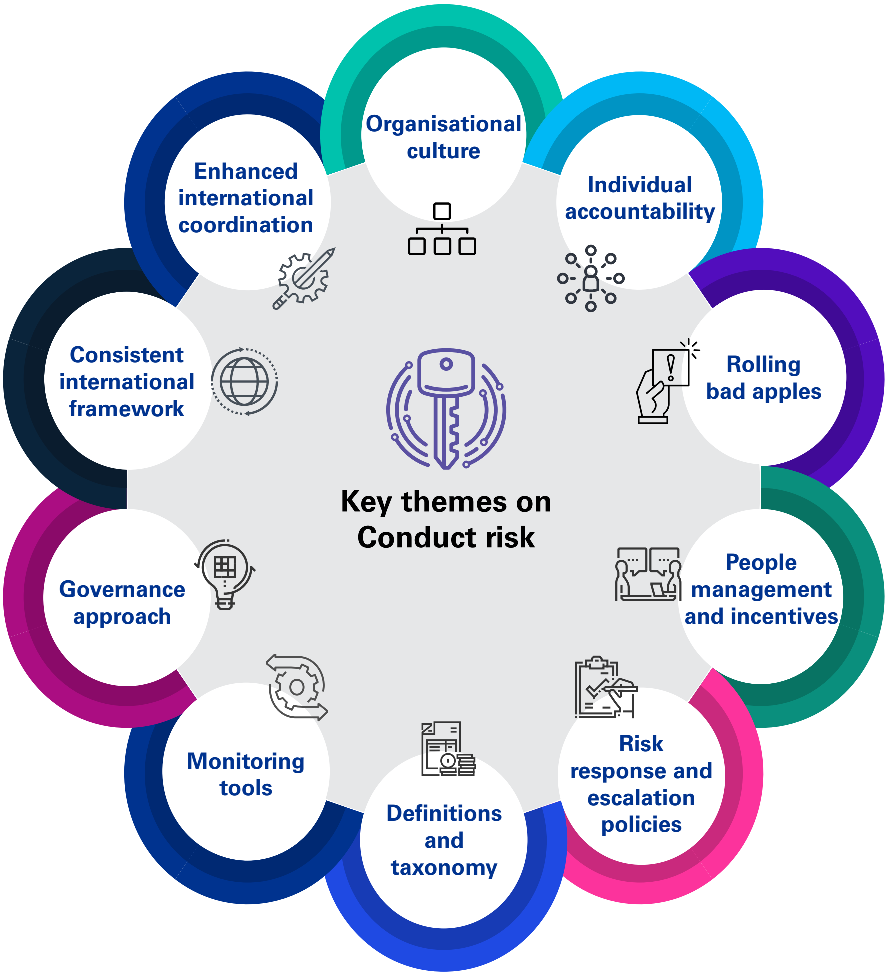
Board Leadership Center (India)



The radical and fast paced innovation and disruption in business model have enabled organisations to take wider risks. The innovation techniques, if leveraged appropriately, open various horizons to manage these risks effectively. Recent events such as market abuse, non-performing assets (NPA) related incidents and digital frauds highlight the risk of misconduct. Widespread misconduct in financial sector creates mistrust, weakening the ability of markets to allocate capital to real economy and in turn give rise to systematic risk. Thus in order to protect the stability of market and interest of customer, it is more important than ever to proactively embed fair customer treatment into all aspects of firm's activities.

Financial Stability Board's 10 key themes on conduct risk

As per the research conducted by the Financial Stability Board (FSB) in May 2017[1], on the efforts taken by international bodies, national authorities, industry associations and firms for use of governance frameworks to mitigate conduct risk, 10 key themes on conduct risk were identified, which are as below:



[1] Source: Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors | FSB ORG

In the Indian context, though the regulator has focus on customer protection to ensure appropriate transparency into the business dealings, some of the current industry challenges from our vantage points related to conduct risk are:

1. **Lack of a homogeneous definition:** It is imperative to have a guidance/ definition of conduct risk by respective regulator, which may encompass conduct aspects for customers, market and overall governance
2. **Structured mechanism for identification:** Limited mechanisms for identification of scope of conduct risk at firms, thus resulting into lack of alignment between the firm and its customers' best interests
3. **Implementation of an appropriate culture:** Lack of understanding of 'good and bad conduct' and implementation of appropriate culture in the organisation leads to difficulty in identification of misconduct during the normal course of business
4. **Culture of impunity:** Existence of impunity and disciplinary inconsistency wherein employee's impact and familiarity in the organisation leads to difficulty in actionable
5. **Preventive vigilance:** Firms operate responsively but not proactively and limited investments in preventive vigilance for aspects relating to employee behaviour become hurdle for effective risk management
6. **Rolling bad apples:** Situation wherein employees leave one institution following misconduct allegations and later hide the same by getting into another firm. Currently, there is no mechanism for exchange of information among firms for misconduct by employee, thus it enhances the risk of rolling of bad apples
7. **Mis-selling of product:** Soliciting customers by mis-selling the product, leading to gain of employee/company by jeopardising the interest of the customers thereby leading to emergence of 'conduct risk'
8. **Extended workplace:** Given the widespread usage of social media where users and customers identify themselves with the organisation they work with or are associated, may expose an organisation's reputation due to irresponsible behaviour and at times may have legal consequences.

Possible solutions for mitigation of Conduct risk

Conduct risk across the firms can be mitigated basis joint effort of regulatory authorities and firms. Few of the possible action points that can be initiated by both regulatory authorities and firms are outlined in the subsequent section.

Key considerations for board members:

- Take steps to identify the conduct risks inherent within your organisation
- Emphasise on encouraging and empowering the employees to be responsible for managing the conduct risks of the business
- Constitution of a specific committee maybe explored with periodic reporting to the board as per governance standard
- On identification of events exposing organisation to conduct risk, ensuring zero tolerance for breaches.

Potential actions a firm may explore from a framework perspective

01

Defining risk-based approach by senior leadership that evaluates and prioritises the most significant cultural drivers of misconduct

02

Senior leadership to promote **training of staff for identification of significant cultural drivers of misconduct** that are in conflict with firm's cultural vision

03

Defining formal measure for mitigating drivers of misconduct, like enhanced whistle blower protection, escalation procedure, effective compensation, etc.

04

Identifying key responsibilities, including mitigation of the risk of misconduct, **and assigning them to the holders of various positions within the firm**

05

Hold individual accountable for misconduct through combination of regulatory provisions; firm's internal processes; supervisory action and regulatory enforcement

06

Undertake assessment of suitability **of individual** who have been **assigned key responsibilities** on periodical basis

07

Firm to **promote culture of preventive vigilance**, to identify the cases of misconduct at an early stage

08

Firm to conduct appropriate due diligence to identify instances of misconduct by employee at previous firm

09

Firm to define formal measure of **reporting of misconduct to relevant committees within firm and regulators.**

Possible actions regulators may consider to assess manifestation of Conduct risk in respective entities

Developing mechanism for **defining misconduct and risk based supervisory review of culture** at various firms	**Dialogue between firm's leadership and regulator** will bolster firm's proposed actions to strengthen culture and to mitigate misconduct risk	**Regulators to assess the implementation of firm's framework** for responsibility and accountability on periodic basis
National authorities to coordinate with other (regional) authorities for supervising the implementation of firm's framework	Regulators to **develop mechanism for exchange of information on employees between firms** to identify instance of rolling bad apples	**Assessment of firm's employment and disciplinary policies and practices** to be embedded in supervisory process of regulators.

We would like to extend our gratitude towards the FS council members for their valuable time, insights and perspectives that have contributed towards the development of this document.

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30 years and beyond