Ensuring Effective Mitigation of Conduct Risk

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Abstract

Conduct of banks and financial institutions and their commitment to fairness in dealings with customers, has attracted intense regulatory scrutiny over the last couple of years. Growing regulatory emphasis on instilling the right corporate culture and institutionalizing consumer protection policies, as well as the slew of penalties imposed for instances of misconduct, have sensitized banks to the need to manage conduct risk. This has, however, proved to be a challenge in the absence of a standard definition of conduct risk. Ever-changing regulatory expectations on managing conflicts of interest adds to the complexity. This paper discusses the key challenges facing the financial services industry with respect to managing and mitigating conduct risk, and suggests an approach that can help banks deal with the issue at hand.

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Introduction

In the wake of the global financial crisis of 2008, regulators focused their attention on reforming the banking and financial services sector to achieve greater stability. Risk management assumed renewed importance and banks established process improvements and correctional measures on priority. Almost six years on, regulatory focus is centered on the conduct of banks and financial institutions, as evidenced by the heavy penalty imposed for poor conduct leading to customer detriment. As a result, the mitigation of conduct risk is increasingly becoming a business imperative, but regulators are yet to issue a universally acceptable standard definition of conduct risk. Hence, banks across the globe have been forced to develop their own definition, and put in place appropriate systems and processes to manage identified risks to meet the evolving regulatory expectations. The absence of prescriptive guidelines to manage conduct risk, coupled with market expectations, has put the onus on banks to define this concept and manage it as part of their overall risk management strategy.

The What and Why of Conduct Risk

Post the economic crisis, risk governance has attracted significant regulatory scrutiny, leading to an increased management focus. Regulations have forced banks to institute sweeping reforms at considerable investment, and embark on a continuous transformation journey encompassing new structures, processes, and tools. However, the spate of conduct scandals over the past couple of years has established that legal reform unaided by cultural change is ineffective in preventing such incidents. As a result, the financial services industry is witnessing a shift in priorities in risk management, with culture emerging as the focal point. Culture is a diverse concept with differing meanings and ultimately revolves around human behavior and conduct. As the activities of banks and financial institutions have far-reaching economy-wide impact, establishing a corporate culture of integrity and commitment to public interest is vital. It serves to prevent manipulation of financial systems and the consequent breakdown of public trust.

Imposition of Penalties

Instances of misconduct over the past couple of years have resulted in substantial customer detriment, significantly damaging public trust in financial institutions. As evidenced from the following, regulators have come down heavily on erring banks:

- A large US financial services firm was fined over $14.8 billion in 2013 for various conduct-related issues including mis-selling of residential mortgage-backed securities in the US.
- A non US bank paid US authorities a fine of $1.9 billion in 2012 on money-laundering charges.
- The ongoing Libor scandal has seen fines totaling $3 billion imposed on various UK banks. Regulators have also instituted legal proceedings against certain former employees.
- In the UK, many banks continue to pay compensation to customers who were mis-sold payment protection insurance. Between 2012 and 2013, this amounted to £11.6 billion, and banks expect to pay an additional £4.3 billion in 2014.

The above incidents are a culmination of a lack of external oversight, defective internal processes, and unacceptable standards of behavior. Spurred by these high profile conduct risk events and the consequent penalties imposed by regulators, banks are taking a fresh look at the culture and code of conduct prevalent across their business units. Bank managements have since come to the conclusion that a shared understanding of risk culture is vital to changing and managing human behavior. Embedding an improved risk culture into every activity across the organization is fast becoming an integral part of the risk management framework of banks.

With consumer protection emerging as a key theme of the ongoing regulatory agenda, banks need to accord this subject the same level of importance as they do to monitoring financial performance. The absence of sound internal policies and frameworks capable of issuing timely alerts to warn against activities reflecting poor conduct has exposed banks to punitive action from regulators. The resultant media scrutiny, public outcry, and associated negative publicity, have adversely impacted their reputation in the marketplace. A holistic solution that addresses all aspects of conduct risk and empowers banks to prevent instances of poor conduct, as well as the resultant penalties, has emerged as the need of the hour.

Clearly, the cost of misconduct is steep, and underscores the need for banks to adopt a conduct risk management strategy with preventive checks and controls besides improving the organizational culture.

Key Unresolved Issues

The financial services industry faces two key issues in managing and mitigating conduct risk:

Absence of a Standard Definition

In a 2011 report, Financial Services Authority (FSA), the regulatory body for the UK financial services industry between 2001 and 2013, defined conduct risk as "the risk that firm behavior will result in poor outcomes for customers"[1]. This is the closest definition of conduct risk that the industry currently has, and financial services institutions are understandably keen to know whether a definition might be forthcoming in the future. Also, in the absence of a clear definition and prescriptive guidelines, banks lack visibility on regulatory expectations in this area.

In the absence of a standard definition, there is a visible disconnect between how firms define and view conduct risk and how regulators perceive this concept. Banks are responding to the increased fines and penalties by developing their own definition and implementing frameworks and controls without adopting a holistic approach to address the issue. These efforts may, however, not match regulators' expectations of effective conduct risk management.

Potential Conflicts of Interest

The ever widening scope of operations has increased the risk of conflicting interests. As banks play multiple roles in the distribution chain—at times acting for multiple clients – it becomes difficult to decide on whose behalf the bank is actually acting. Other examples include acting as an agent for both the customer and the insurer in the same transaction, or acting as an agent and a principal in related cross-sell transactions involving banking and security products. The internal control frameworks and management information systems (MIS) within banks have failed to keep pace with rapid expansions in the size and complexity of their businesses. Banks have traditionally relied on disclosure to address conflicts of interest rather than putting in place effective checks and controls to actively manage them. Disclosures of a generic nature are however inadequate to meet customers' information needs, and often

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[1] Financial Services Authority (FSA), Retail Conduct Risk Outlook (2011), accessed October 1, 2014, http://www.fca.org.uk/your-fca/documents/fsa-rcro-2011

fail to enhance customers' understanding of the product or drive good financial decisions. It has been observed that the multi-product multi-service nature of operations generates conflicts between the banks' interest and the clients' interest, as also between clients' interests. The risk of conflicts is bound to increase in future as banks further expand their offering portfolios.

With consumer financial protection a key theme underlying regulatory activity and the imposition of heavy penalties for instances of poor conduct, mere disclosure is no longer considered an adequate substitute for actively managing conflicts of interest. Banks need to implement appropriate control and monitoring frameworks that can identify areas of potential conflicts, and regularly scale governance and control frameworks to accommodate continuous business expansion and the associated complexities.

A Proposed Resolution Approach

In the absence of a standard definition of conduct risk, one plausible approach for banks is to focus on ensuring desirable customer outcomes, by taking into account the definitions of operational risk, compliance risk, reputational risk, and strategic risk. Adequate controls and procedures for effectively identifying and managing these four areas will help banks to achieve desirable outcomes centered on customers' best interests, and help mitigate conduct risk as well. The Financial Conduct Authority (FCA), a financial regulatory body in the UK, publishes guidelines and highlights instances of misconduct, which could serve as a valuable and reliable source of reference.

Adopting a control framework with monitoring tools can also help manage conflicts of interest. While the first step is to identify potential areas of conflicting interests, some conflicts are self-evident. Examples include capital market firms underwriting securities issues while simultaneously trading in them with or on behalf of clients, providing investment advice on issues while acting as corporate financial adviser or broker, and receiving commission from companies to recommend their products to clients. Senior management should lay down a set of written procedures to manage conflicts. To ensure adherence, adequate operational systems and compliance monitoring tools should be in place. However, banks should foster a corporate culture with the best interests of the customer at its core, and sensitize their personnel to potential conflicts of interest. Compliance based on a 'tick the box' approach will not suffice and banks need to embrace the concept of customer centricity, both in letter and spirit, to regain public trust.

Holistic Conduct Framework

A thorough analysis of the risk control breakdowns that have resulted in the imposition of fines, coupled with data from financial regulators across the globe, will help understand the underlying factors, drivers, and sources of conduct risk, and create a framework to mitigate it. Upon studying the standards of professional conduct adopted by global institutions, we have identified seven key pillars of desirable conduct or code of ethics. Figure 1 shows the seven pillars that should form the core of a holistic conduct framework.

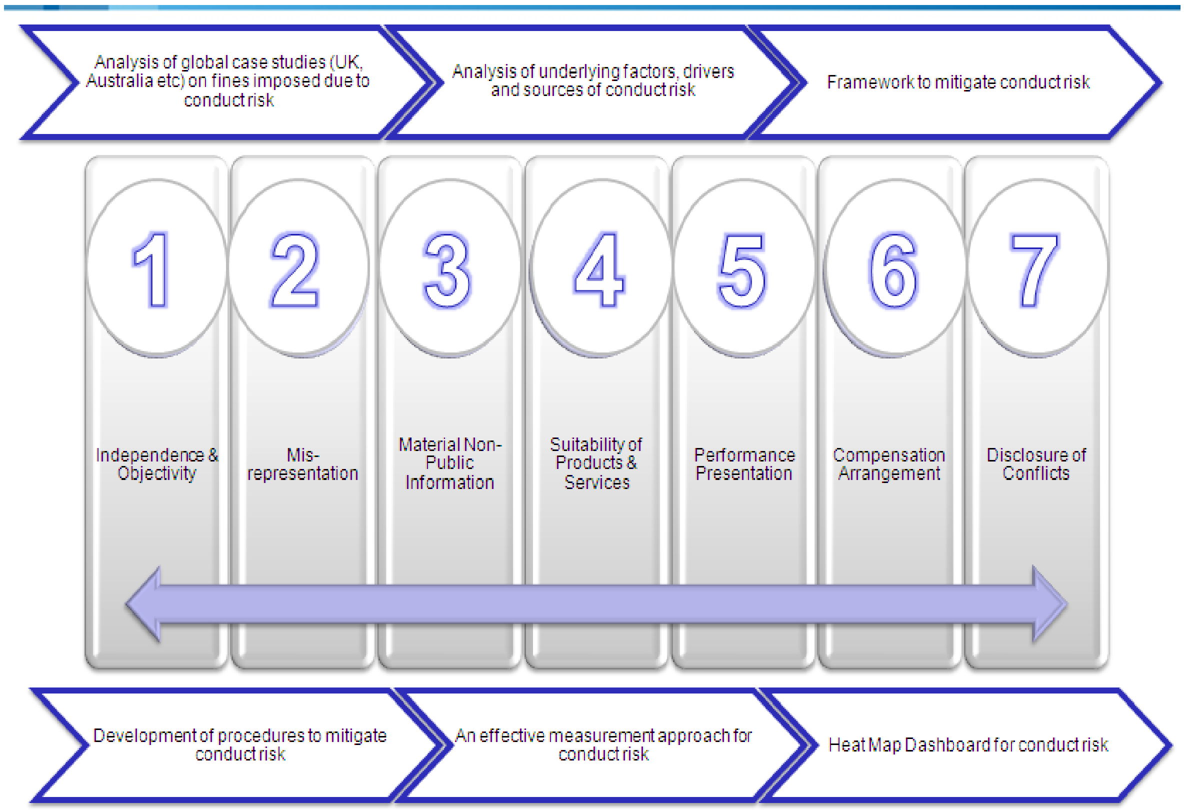

Figure 1: Seven pillars of a holistic conduct framework
Source: Internal Research

Independence and objectivity: Exercise reasonable care to ensure independence and objectivity in professional activities. Activities that can potentially compromise or impair employees' independence and objectivity should be strictly avoided.

Misrepresentation: Avoid knowingly misrepresenting facts related to the bank's offerings or exaggerating their implications.

Material non-public information: Refrain from acting on or causing others to act on material non-public information and strictly avoid disseminating such information within or beyond the organization.

Suitability of products and services: Recommend only those products and services that are appropriate for the customer. Recommendations should be consistent with customers' stated financial objectives and constraints, and suitable to their financial situation.

Performance presentation: Present complete, fair, and accurate investment performance data. Ensure the accuracy of historical performance data and use data appropriate to the target audience.

Compensation arrangement: Avoid accepting compensation that might potentially create a conflict of interest, or impair independence and objectivity.

Disclosure of Conflicts: Ensure complete disclosure of all matters related to the bank's offerings that could create a conflict of interest, compromise independence and objectivity, or impair the ability to discharge duties in a fair manner.

Adhering to and upholding these principles, in letter and spirit, should be made mandatory across the organization workforce and board members. Senior and middle management, as well as customer facing line staff should be included in its ambit. This will go a long way in sensitizing employees to potential conduct hazards, ensure adequate disclosures to and fair treatment of customers, and help improve the overall risk culture in the organization. A holistic framework that encompasses the above principles will pave the way for the development of procedures, methodologies, and models for effective measurement and quantification of conduct risk. The framework should also include heat maps and dashboards to expose and highlight material violations of the seven principles. The solution should also have the capability to direct management attention to areas where violation of the seven principles can potentially occur, and spur remedial action. In addition, putting in place a framework with suitable systems and processes for conduct risk management will help banks convince regulators of their commitment to mitigating conduct risk. Banks can use such a framework as leverage to persuade regulators to waive or reduce the quantum of penalty in case of a lapse or transgression.

Practical Approach to Mitigating Conduct Risk

Establishing a policy incorporating the prerequisites of an effective conduct risk management framework is the first step. The next step is to arrive at a practical approach that details the specific measures to mitigate conduct risk in each of the seven areas, as depicted in Figure 2.

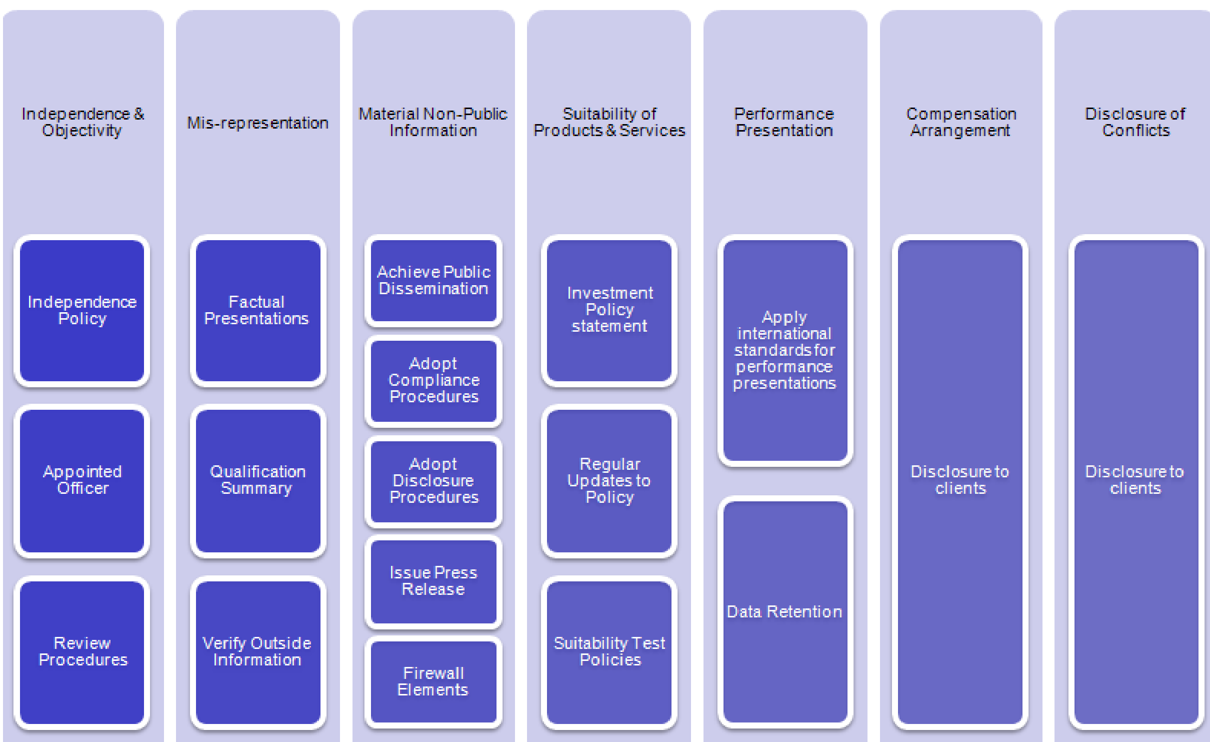

Figure 2: A practical approach to mitigating conduct risk
Source: Internal Research

Based on an extensive research of the control mechanisms adopted by global financial institutions to check professional misconduct, we have arrived at a set of mitigation techniques to reduce exposure to conduct risk (shown in Figure 2). The options include, implementation of an independence policy, appointing and defining the roles of key officers to ensure compliance, putting in place adequate 'need to know' firewalls between departments, disclosure of performance as per globally acceptable standards, and disclosure of conflicts and compensation arrangements.

We recommend that banks initiate the following specific steps to mitigate conduct risk:

Independence and objectivity: Create a holistic independence policy and circulate among all employees to ensure objectivity in decision-making. The policy guidelines should be revised periodically in line with the evolving regulatory framework. Conduct regular reviews and audits with designated officers (internal or external to the organization) overseeing adherence.

Misrepresentation: Publish accurate qualification summary and verify professional credentials of all employees in client advisory roles, to ensure factual accuracy.

Material non-public information: Institute clear procedure and guidelines around information disclosure and ensure organization-wide compliance. Ensure public dissemination of material information via press conferences and press releases. Establish firewalls within the organization to restrict intern-departmental communication and prevent sharing of restricted information.

Suitability: Understand the customer's financial objectives and constraints, and use them as guiding principles while making product propositions. Create an investment objective for each customer and update it periodically. Establish product suitability test policies to validate suitability criteria.

Performance presentation: Apply international standards to data management. Retain data pertaining to research and analysis for future reference and audit purposes.

Compensation arrangements: Ensure full disclosure of compensation arrangements that might create a conflict with the customer's interests, thus improving customer satisfaction and enhancing overall experience.

Disclosure of conflicts: Ensure complete disclosure of all possible conflicts of interest impacting clients

Leveraging Predictive Analytics for Risk Quantification

Some banks are leveraging predictive modeling techniques to quantify conduct risk exposure to complement the existing quantification process based on assessments from experts. The key features of predictive analytics based IT solutions are:

- Analytics capabilities to assign risk weights to potential conduct risk exposures.
- Historical data and knowledge based modeling for detection and assessment of conduct risk exposures.

- Robust business intelligence capabilities for management information and reporting, enabling strategic decision making, performance management, and measurement and monitoring against the risk appetite.
- Performance measurement and back testing to ensure effectiveness of conduct risk quantification based on assessment based approaches.

Traditionally, scoring models have been used to evaluate the credit worthiness of customers; a similar approach can be adopted for conduct risk management as well. Predictive modeling based on data analytics involves assigning of scores to transactions (instead of customers) based on drivers and sources of conduct risk. Such scores will reflect, instead of customer credit worthiness, deviations in employee conduct, and help banks identify violations of the standards of acceptable professional conduct in a particular transaction. By scoring each transaction prior to initiation, banks can identify potential violations before they occur, thereby preventing instances of poor conduct. Such a scoring model would leverage data analytics to provide insights on imminent conduct risk exposures, and serve as an effective alert mechanism to avoid conduct violations.

Recurrent conduct violations resulting in customer detriment can become part of a wider pattern or habit among employees, resulting in a magnified risk. By undertaking link analysis, banks can spot chains of error or malpractice in time and protect themselves. For instance, to boost sales of long-term savings products, staff at a particular branch may be offering these products to customers in their eighties. While increased sales may raise revenues, the product is neither suitable for nor in the best interest of the target customer group. Predictive modeling of conduct risk can help prevent such cases of mis-sell, by assigning a poor score to the transaction and issuing a warning to the erring employees of possible conduct violations. Data analytics can thus pave the way for a seamless conduct risk management framework.

Conclusion

The key to effective conduct risk management lies in embedding a culture of customer centricity within the organization. With increasing emphasis on consumer protection, it is imperative for banks to instill the right corporate culture within the organization. To reduce exposure to conduct risk and prevent the imposition of exorbitant fines, banks need to proactively implement a clearly defined conduct risk strategy with appropriate frameworks and tools to identify and prevent possible instances of misconduct. Banks can achieve this by incorporating a conduct risk management framework into their overall risk management strategy. Leveraging predictive analytics can prove useful in proactive identification of inadequacies or failures in ‘treating customers fairly (TCF)’. A preemptive approach like this one can help a financial institution project a policy-compliant and socially conscious image during reviews and audits by regulatory bodies.