Tany

One of the
RSM team

White Paper

Conduct Risk

White Paper - Conduct Risk

For Circulation

11th September 2024

1.0 Background

The purpose of the paper is to understand the meaning and emergence of conduct risk, the behaviours which contribute to conduct risk in the BFSI sector and its mitigation. The paper also endeavours to assess the evolving regulatory environment and the approach towards auditing conduct risk. Conduct risk can be of a financial as well as non-financial nature. The paper focusses on the financial aspect of conduct risk. Though the regulatory focus is on BFSI, the core principles would be applicable to several industries.

2.0 What is Conduct Risk?

Conduct risk defined as any action of a firm or individual that leads to consumer / investor detriment or has an adverse effect on market stability or competition. The Financial Service Authority's (FSA)'s Retail Conduct Risk Outlook of 2011, defines Conduct Risk as 'the risk that firm behaviour will result in poor outcomes for customers. In FCA's 5 question conduct report participants in the survey generally identified at least a few of the following areas of conduct risk: material non-public information, conflicts of interest, treating customers fairly, suitability, diversity & inclusion and personal misbehaviour (non-financial misconduct).

Conduct risk arises out of mis-selling of products, poor financial advice, non-disclosure of conflict of interest, inadequate regulatory compliance, incomplete disclosures, market manipulation and unsuitable product design. Banks, financial institutions and intermediaries are most vulnerable to conduct risk in customer interactions, sales practices and product design.

3.0 Emergence of Conduct Risk in the financial services sector:

The increased focus on conduct risk especially within the financial services industry, has its origins in the global financial meltdown of 2008-09. As the financial world recovered from the crisis, it emerged that ethical behaviour, transparency and customer centricity had been compromised in the quest for earning higher incentives and bigger profit margins. The events of 2008-09 led to increased regulatory scrutiny through the establishment of new laws and strengthening of provisions in the existing legal framework.

The US established the Dodd Frank Act (DFA) in July 2011, which ushered sweeping reforms to the U.S. financial sector including the creation of Consumer Financial Protection Bureau (CFPB), with the objective of monitoring and protecting the financial interests of the consumers and the Financial Stability Oversight Council (FSOC) tasked with monitoring designated systemically important financial institutions (SIFIs) including banks, insurance companies, or other financial institutions deemed “too big to fail." Additionally, DFA introduced the Volcker rule, designed to limit speculative investments and amended provisions of Securities Act, 1933 and 1934, Investment Advisers Act, 1940 and Sarbanes-Oxley Act of 2002 with the objective of bringing in more transparency, reducing conflict of interest and enhanced consumer protection.

The UK established the Financial Conduct Authority or the FCA in 2012 by abolishing the existing regulator FSA. FCA was established to focus on the regulation of conduct by both retail and wholesale financial services firms.

In Europe the establishment of the Markets in Financial Instruments Directive 2014 or MIFID 2 provided a legal framework for securities markets, investment intermediaries, in addition to trading venues. The regulations set guidelines for assessing product and client suitability in financial products, market conduct and preventing mis-selling.

The Australian Securities and Investments Commission (ASIC) introduced more stringent actions on firms for financial advice misconducts, stronger surveillance to counter market misconduct, jail terms and fines for market misconduct including insider trading. The Financial (FOFA) reforms of the government banned commission fees for advisors of superannuation and insurance products, defined more clarity on best interests of customers and introduced disclosure of fees structure for advisors to client. Similarly, Securities Finance Commission (SFC) and the Hong Kong Monetary Authority (HKMA) in Hong Kong and the Monetary Authority of Singapore (MAS) brought in regulations in the areas of suitability, best execution, disclosure and market misconduct.

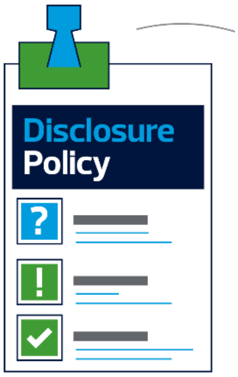
Conduct risk arises out of behaviour or actions of organizations. Some of the key instances of poor behaviours leading to conduct risk are:

(i) **Poor/unsuitable Financial Advice:** Firms may provide poor or unsuitable advice or make unsuitable discretionary decisions on behalf of clients that could result in customer detriment. Hong Kong regulator SFC fined the broking arm of a leading multinational US$1.2 million for misconduct in bond sales as the firm failed to conduct sufficient due diligence on bond products, before recommending to customers in 2015 and 2016.

(ii) **Conflict of Interest:** It could arise when an individual’s actions are contrary to the firm’s interests. It may be that situation in which a firm’s interests are contrary to that of the customers. In 2023, SEBI banned 3 individuals for a period of 3 years from the securities market and fined them INR 90 lakhs for trading in securities, of which they had access to unaudited results prior to publication. A leading multinational bank was fined $250 million by OCC for “deficient” risk management controls leading to a failure in avoiding “conflicts of interest” in the wealth and asset management business.

(iii) **Mis-selling:** It may include the deliberate omission of key information, the communication of misleading advice, or the sale of products not aligned with customer's expressed needs and preferences. An investment arm of major UK based bank was fined approximately £80 million in 2013 for mis-selling complex structured products as simple and low risk between 2008 and 2010.

(iv) **Market Misconduct:** This covers behaviours/ conduct designed to deceive investors by controlling the price of securities and indices. This includes misrepresentation and or making false statements with the objective of misleading other market participants. The LIBOR benchmark rate fixing scandal is one of the foremost examples of several institutions colluding to manipulate the rates. One of the other most common instances of market misconduct is insider trading. The SEC in the US booked 43 offenders for misconduct related to insider trading in 2023.



(v) **Non-disclosure**: Lack of transparency particularly in the fee structure of products results in bad outcomes to customers. In 2012, the Swiss Federal Supreme Court directed Wealth Managers to return retrocession fees received from banks, custodians or funds to specifically promote certain products to customers and further required them to make full disclosure of the retrocession fees and seek a waiver from customers.

(vi) **Treating customers unfairly:** An unfair practice is one that harms consumers financially and that consumers cannot reasonably avoid. The CFPB ordered three subsidiaries of a card services company in the US to refund about $85 million to around 250,000 customers in October 2012. The agency determined the subsidiaries harmed consumers in interactions ranging from advertising credit cards to accepting payments to collecting debts. The applicants were treated differently based on their age, among other charges.

(vii) **Overcharging fees:** Regulators have been taking a serious view of overcharging customers without prior notice. In 2023, OCC fined a leading multinational bank $ 250 million for charging customers "junk fees" for not maintaining a minimum balance and SEC fined a large US bank $35 million for allegedly overcharging clients a total of $26.8m in advisory fees, despite advisors having agreed to charge lower fees.

(viii) **Unsuitable product design:** OECD G20/OECD High-Level Principles on Financial Consumer Protection describe unsuitable product design as arising out of the lack of adequate product governance within firms in designing, approving, marketing and managing retail financial products. This could manifest itself in building products that may meet the financial objectives of the firm, but may not consider customer perspective or products that are complex, opaque and high risk in nature which the customer is unable to comprehend.

4.0 Regulatory framework in India:

The key regulations governing conduct risk across the BFSI industry are as under:

(i) SEBI IA Regulations, 2013
(ii) AMFI Code of Conduct for Intermediaries
(iii) IRDAI (Protection of Policyholders' Interests and Allied Matters of Insurers Regulations, 2024)
(iv) RBI Fair Lending Practices Directions, 2023
(v) SEBI Stockbrokers Regulations, 1992

The ensuing table summarizes the key provisions of the above regulations relative to behaviours that contribute to conduct risk.

Conduct Risk Behaviours	SEBI IA Regulations, 2013	AMFI Code of Conduct for Intermediaries	IRDAI (Protection of Policyholders' Interests and Allied Matters of Insurers Regulations,2024)	RBI Fair Lending Practices Directions, 2023	SEBI Stock Brokers Regulations, 1992
Poor/unsuitable Financial Advice	Reg 15 (7) 17 (a) to (e) III Schedule	Code 9a & 13	Regs 8(b), 9(iv) 26(3)(i)(c) , 26(6)		Reg 9B (7)
Conflict of Interest	15(1), 15(3),15(5), 22A III Schedule	Codes 9b & 9c			Reg 9B(4)&(6)
Mis-selling	15 (7), 17 (a) to (e) III Schedule	Codes 27	Regs 8(1)(iv), 11(4)(c), 30(2), 34		Reg 9B (7)
Market Misconduct		Code 27			Regs 9A(3)&(4)
Non-disclosure	Reg 18	Codes 4,5, 27	Regs 9(1)(i),10(1)(2), 11(1) &(2), 34	Secs 3(iv),(v)	Reg 9B (7A)
Treating customers unfairly	III Schedule		Regs 26(3)(i)(a),30(2)	Sec 3(iv)	Reg 9B(4)&(6)
Overcharging fees	III Schedule, Reg 22A	Code 9b	Regs23(1)(iii),24, 26(6)	Secs 3(i) to (v)	
Unsuitable product design			Reg 34(4)(c)		

In December 2014 the RBI released a Charter of Customer Rights, which enunciated the 'five' basic rights of bank customers. These are: (i) Right to Fair Treatment; (ii) Right to Transparency; Fair and Honest Dealing; (iii) Right to Suitability; (iv) Right to Privacy; and (v) Right to Grievance Redress and Compensation. The Reserve Bank also advised the Indian Banks' Association (IBA) and the Banking Codes and Standards Board of India (BCSBI) to formulate a "Model Customer Rights Policy" encapsulating the principles enshrined in the Charter.

5.0 Key Drivers of Good Conduct:

Conduct risk is inextricably linked to the organizational culture. Culture can be understood to be organisational values and mindsets that influence employee behaviour in an organisation. As a subset of the organisational culture, risk culture focuses on shared values and behaviour with respect to understanding of risk, its management and overall risk-taking willingness within the organisation. Organizations must build a customer-centric culture, where customer interests assume the highest priority throughout the product lifecycle.

In its letter to market intermediaries dated November 2020, the Australian Securities and Investments Commission (ASIC) identified the following drivers of good conduct:

- Leadership and Professionalism
- Governance and Individual Accountability
- Performance and Consequence Management
- Conduct and Culture training

These are briefly explained below:

5.1 Leadership and Professionalism

The board of directors and senior management play a crucial role in creating and driving a positive culture setting the "tone from the top", the senior management puts in place a framework for monitoring conduct risk and creates a culture for making employees for adherence to policies driving conduct.

5.2 Governance and Individual Accountability

The firm uses risk appetite statements, drives conduct risk across all three lines of defence, there's a defined approach for raising and addressing breaches and Compliance function has a say in the performance and consequent management.

5.3 Performance and Consequence Management

Organizations should have performance management systems which include key indicators for managing good conduct. Career progression is also driven by good conduct and compliance which is publicly acknowledged outside the performance review cycles as well. Similarly, poor conduct leads to disciplinary action including impact on remuneration

5.4 Conduct and Culture training

Firms organise training on conduct and culture for new employees as well as tenured employees on an ongoing basis including real-life examples. In multinational organizations training may be tailored to include local regulatory nuances, as required.

A strong conduct risk management culture and framework results in driving good control behaviour which would translate into the following positive actions:

(i) **Transparency in customer interactions:** Customers of financial entities with a strong conduct management culture will consistently receive sufficient, accurate, consistent and unambiguous information which will equip them to make informed financial decisions. In alignment with regulatory requirements, such entities make a complete disclosure of their fee structures, their products and the risks governing these products.

(ii) **Appropriate pricing:** A stronger control environment ensures that customer fees and charges are devoid of hidden costs, there is no pricing differential to customers in the same market segment and the firm considers the benefit accruing to the customers relative of the price.

(iii) **Responsible selling practices:** Selling practices of organizations with a strong control culture are free from conflicts of interest and inducements to buy financial products.

(iv) **Strong complaint management:** Entities with a strongly prevalent conduct culture place a greater emphasis on the customer feedback. They build strong and easily accessible complaint resolution mechanisms for timely redressal of customer complaints.

(v) **Customer and Product Suitability:** Customer suitability i.e. offering the appropriate products to customers in line with their investment objectives, financial ability, time horizon and their maturity is of paramount importance. Similarly, such organizations have a mechanism in place to offer and develop products that align with their organizational objectives and investment philosophy and is aligned to customers financial interests.

(vi) **Easy availability of Information to Customers:** The firms should provide all the information to customers enable them to make informed and appropriate financial decisions.

6.0 Approach to Auditing Conduct Risk

The Institute of Internal Auditors (IIA) in its paper on “Auditing Culture” prescribed that the internal audit activity should determine whether the organization has a conduct risk management framework that states its values, expectations, and the mechanisms that measure how well employees are performing against those criteria. Internal auditors should also conduct inquiries across the organization to ascertain the level of employee understanding of conduct requirements and expectations. Internal auditors should discern whether the employees are aware of the potential consequences of noncompliance.

Culture assessment can still rely on both hard data points and a subjective testing method. depending on the organisation, a number of hard data points can be sourced from HR, Compliance and other relevant departments. These can include:

- Disciplinary records
- Internal fraud records
- Personal trading validations
- Length of employment
- Retention/turnover rates
- Employee engagement scores
- Employee exit interview records
- Customer service scores
- Legal dispute/court actions
- Senior executive media coverage

Data sensitivity issues and various legal requirements in different jurisdictions, may make it difficult for auditors to obtain this information. Hence, this is complemented by obtaining self-assessments through surveys, interviews and discussions with employees and managers. Auditors need to be mindful that the self-assessment may not be the most objective means of evaluating culture as this may be based on the individuals perception of conduct culture. Moreover, employees may not be upfront about surfacing issues due to fear of retribution. They may also harbour apprehensions that surfacing concerns may usher in enhanced controls and thus add to their workload. It is therefore imperative that auditors administer surveys anonymously to employees and maintain confidentiality to prevent any influence or backlash. Additionally, to bring in objectivity auditors, should cross check the results of survey with objective evidence, records and data points. Audit approach should also build in checkpoints to identify the conduct related behaviours in audits of specific businesses and processes.

7.0 Conclusion:

Conduct risk will continue to remain a major focus area in a highly regulated environment in the banking and financial services sector. The foundation of good conduct culture needs to be "the tone from the top" driven by the board and senior management. In auditing conduct risk, auditors should employ objective and traditional audit techniques in combination with self-assessment of the conduct culture through surveys and interviews.

THE POWER OF BEING UNDERSTOOD

RSM

For further information please contact:

RSM Astute Consulting Pvt. Ltd.

8th Floor, Bakhtawar, 229, Nariman Point, Mumbai - 400021.

T: (91-22) 6108 5555/ 6121 4444
F: (91-22) 6108 5556/ 2287 5771

E: emails@rsmindia.in

W: www.rsmindia.in

Offices: Mumbai, New Delhi - NCR, Chennai, Kolkata, Bengaluru, Navi Mumbai, Surat, Hyderabad, Ahmedabad, Pune, Gandhidham, Jaipur and Vijayanagar.

facebook.com/RSMinIndia

twitter.com/RSM_India

linkedin.com/company/rsm-india

Youtube.com/c/RSMIndia

11th September 2024