Conduct risk: Trends and outlook – is the Indian financial services industry ready for change?

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In an era marked by innovation, business disruptions, social media glare and constant regulatory scrutiny, the significance of customer service, ethical employee behaviour, data privacy and cybersecurity has increased multifold. These critical issues related to conduct, often overlooked by financial institutions in pursuit of short-to-medium-term performance gains, are, in fact, fundamental pillars. Recognising the pivotal role of these pillars in establishing trust among stakeholders and ensuring long-term superior return on investment is imperative for sustained success and gaining the trust of all stakeholders.

Conduct risk refers to the **potential of a financial institution to harm its customers, stakeholders and the overall market through inappropriate behaviours, unethical practices, and inadequate or unfair customer treatment**. These behaviours include misleading information, mis-selling of products, conflict of interest and failure to comply with regulations, thereby undermining stability of the entity and customer confidence and potentially affecting the overall industry's long-term viability.

However, conduct risk needs to be seen together with 'risk 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. Since culture and conduct are interconnected, they also need to be in tandem with each other, as good culture promotes good conduct. Even regulators globally consider poor culture as the main reason for conduct issues within financial institutions.[1]

In recent years, a multitude of incidents involving unethical conduct or poor culture have shaken the faith of investors, customers and the public in financial institutions entrusted with the management of depositors' and investors' money. A few such cases are discussed below.

A leading shadow bank along with two leading private sector banks in India has faced regulatory investigation and potential regulatory penalties due to governance failures.

Tax authorities in India have alleged that insurance companies and their intermediaries have evaded taxes worth INR 30,000 crore by underreporting income and overstating expenditures. The IT authorities are planning to raise demands for the tax along with interest and penalties.2

1. Financial Conduct Authority, 'Transforming culture in financial services', Discussion Paper 18/2, March 2018. Retrieved from https://www.fca.org.uk/publication/discussion/dp18-02.pdf
2. Economic Times, 12 October 2023, 'I-T pegs tax evasion by insurance companies, intermediaries at INR 30,000 Cr'. Retrieved from https://economictimes.indiatimes.com/industry/banking/finance/insure/i-t-pegs-tax-evasion-by-insurance-companies-intermediaries-at-30000-cr/articleshow/104380828.cms

As per the Insurance Regulatory and Development Authority of India (IRDAI) 2021-22 annual report,[3] there were 23,110 cases of mis-selling and 25,716 cases of unfair business practices against Indian life insurers during the year. This constitutes about 14.92% and 16.61% respectively of the total complaints registered against life insurers.

Several mobile app-based loan companies have been found to extend unsolicited loans and then resort to unlawful recovery methods, leading to customer harassment.

A senior fund manager of a leading fund house in India is facing allegations of engaging in front-running over an extended period of time.

The Australian Securities and Investment Commission (ASIC) announced that 11 Australian insurance firms would repay customers a total of USD 550.29 million for failing to honour pricing promises. This came after multiple warnings from the ASIC over pricing misconduct.[4]

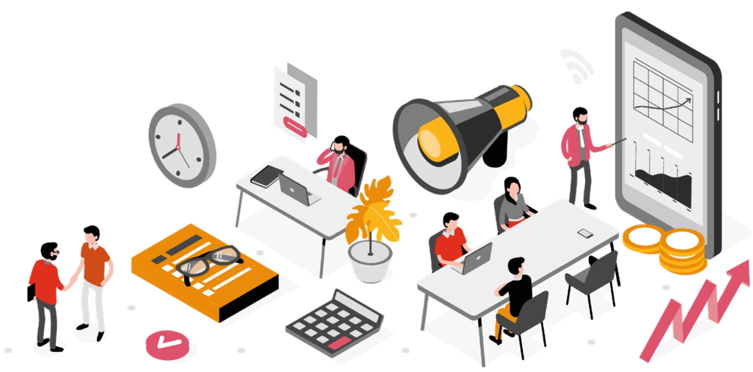
These examples of misconduct within management and even at the board level pose challenges associated with agency risk in corporate governance, leading to strong actions by the regulators.

The Reserve Bank of India (RBI) has now been following a policy of not only holding senior management but also the board accountable for both errors of commission and omission by the management and ensuring personal accountability of management personnel by implementing compensation practices that encourage prudent risk taking and penalise excessive risk taking.

The RBI has recently announced digital lending guidelines for mitigating risks related to digital lending apps (DLA) because of concerns around unbridled engagement of third parties, unfair business conduct, appropriateness of products for public at large, charging of exorbitant interest rates, and unethical recovery practices which are impacting customer confidence. Incidentally, the RBI's 2023 annual report has revealed that the largest number of frauds in India's banking domain are related to digital payments.

The RBI has also issued guidelines for all private sector and foreign banks on compensation to whole-time directors, chief executive officers, material risk takers and control function staff. This is aligned with the Financial Standard Board's (FSB's) principles of sound compensation practices. The primary objective of these guidelines is to ensure that banks' boards adopt principled compensation practices that promote ethical conduct among senior management and encourage prudent risk taking.

The Securities and Exchange Board of India (SEBI) has put in place various measures such as expectations on surveillance systems and frameworks to be implemented by mutual fund houses to deter misconduct, strengthen insider trading regulations, and guidelines around disclosure of material events or information by listed entities under Listing Obligations and Disclosure Requirement (LODR) regulations.



3. https://irdai.gov.in/document-detail?documentId=1632108
4. Reuters, 23 June 2023, 'Australian General insurers to repay $550 million over pricing misconduct'. Retrieved from: https://www.reuters.com/business/finance/australian-general-insurers-repay-550-mln-over-pricing-misconduct-regulator-2023-06-22/

Conduct risk regulatory landscape in India

While the IRDAI, SEBI and RBI play a critical role in overseeing conduct risk and have laid down regulations to ensure fair treatment of customers, none of them have issued any distinct guidelines that specifically address conduct risk – i.e. defining conduct risk, principles for expected conduct and repercussions of not following the regulations. However, a multitude of guidelines and actions from regulators make their expectations from regulated entities on conduct and culture clear.

Some of the prominent regulations on conduct risk in India include:

IRDAI (Protection of Policyholders' Interests) Regulations, 2017, aims to protect the interests of policyholders and contains guidelines to be followed by insurers across sales practices, grievance redressal, policy servicing, etc.

SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, aims to enhance transparency for listed companies in terms of disclosure of material information. Separately, SEBI has mandated a code of conduct for mutual fund houses to ensure fair treatment of investors.

RBI (Fair Practices Code for Lenders) Directions, 2021, includes guidelines and standards around loan pricing, recovery practices, customer communication and addressing of customer grievances.

The Digital Personal Data Protection (DPDP) Act, 2023, aims to safeguard customer data and mandates measures to be put in place by companies around the collection, processing and storage of customer data.

Regulatory approaches to conduct risk in select developed markets

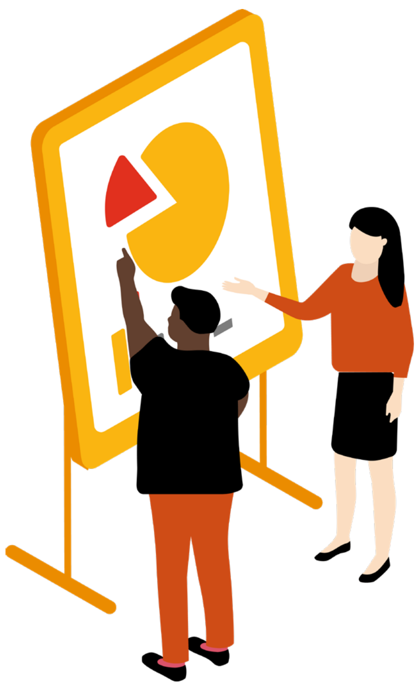
The Financial Conduct Authority (FCA) in the UK and the ASIC in Australia have adopted a principles-based approach on conduct risk management, i.e. a strong emphasis on the outcomes that a financial institution should achieve rather than prescribing specific rules.

Secondly, this is followed by a robust supervisory approach, with close and continuous monitoring of financial institutions to identify and mitigate potential conduct risks proactively. Lastly, there is a rigorous enforcement framework in place, and substantial fines are imposed on firms as a deterrent against wrongdoing.

The ASIC stands out with its 'why not litigate?' approach, indicating a readiness to take legal action when necessary for upholding conduct standards. This differs from the more conservative enforcement strategies of some other nations. Furthermore, the ASIC places significant emphasis on organisational culture, highlighting that a positive corporate culture can prevent misconduct. The ASIC also encourages self-reporting and self-assessment, promoting accountability and transparency within financial institutions.

Notably, the FCA's Senior Managers and Certification Regime (SM&CR) holds senior individuals accountable for conduct within their organisations, establishing clear and unambiguous responsibility for ethical behaviour. The primary aim is to minimise harm to consumers and strengthen market integrity.

The SM&CR rules aim to improve Individual accountability (Individual Conduct Rules and Senior Manager Conduct Rules) and company-wide awareness of conduct issues.



What should institutions be doing?

Role of the board

The board should drive a culture that moves beyond mere compliance with regulatory and legal requirements and strives for best practices to drive an ethical conduct mindset within the organisation. To achieve this, the board must establish a robust policy framework – one that is aligned with the organisation's vision and value, size, composition, strategy, complexity and risk profile. This includes setting clear expectations for risk management and corporate governance, holding management accountable for actions (including remuneration not solely tied to short-term performance), and establishing standards for ethical conduct and integrity.

Senior management

In matters of conduct, the tone at the top is one of the most crucial signals conveying senior management's intention and expectations to employees throughout the organisation. This can be reflected in diverse ways, such as the leadership team's emphasis on fair treatment of customers and other stakeholders, their commitment to serve the shareholder's interest, zero tolerance for compliance breaches (especially concerning customer and stakeholder interests) and, most importantly, behaviour that is either rewarded or penalised on a day-to-day basis and in periodic appraisals.

A leadership characterised by a 'business at any cost' attitude is more likely to be perceived as promoting aggressive behaviour, potentially pushing employees to resort to unethical conduct.

Role of the second line of defence

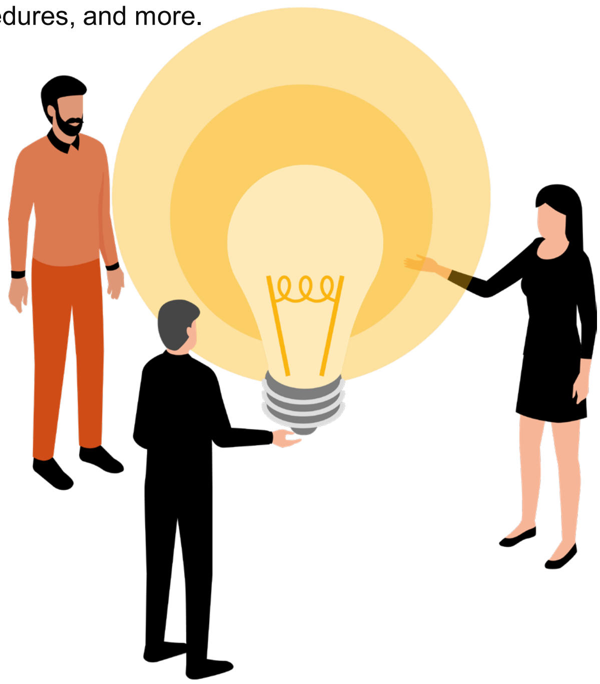
The second line of defence plays a key role in challenging the first line, ensuring effective controls around conduct risk for vulnerable departments and processes, such as sales, operations, investment and trading, customer servicing and claims management. The key responsibilities include:

1. laying down policies, procedures and framework for defining conduct risk for the organisation
2. supporting the first line in development and self-assessment of conduct risk related controls
3. periodic monitoring and assessment of the organisation's conduct risk controls and compliance with regulations, policies and procedures, including employee code of conduct
4. conducting thematic reviews around conduct risk across the organisation, including rolling out behavioural scorecards for the HO/ZO/branches
5. ensuring that employees, as part of the first line, are adequately trained and informed about conduct risk management practices.

Role of the third line of defence

The third line of defence is expected to incorporate conduct risk and sales practices in its annual internal audit plan. The key responsibilities include:

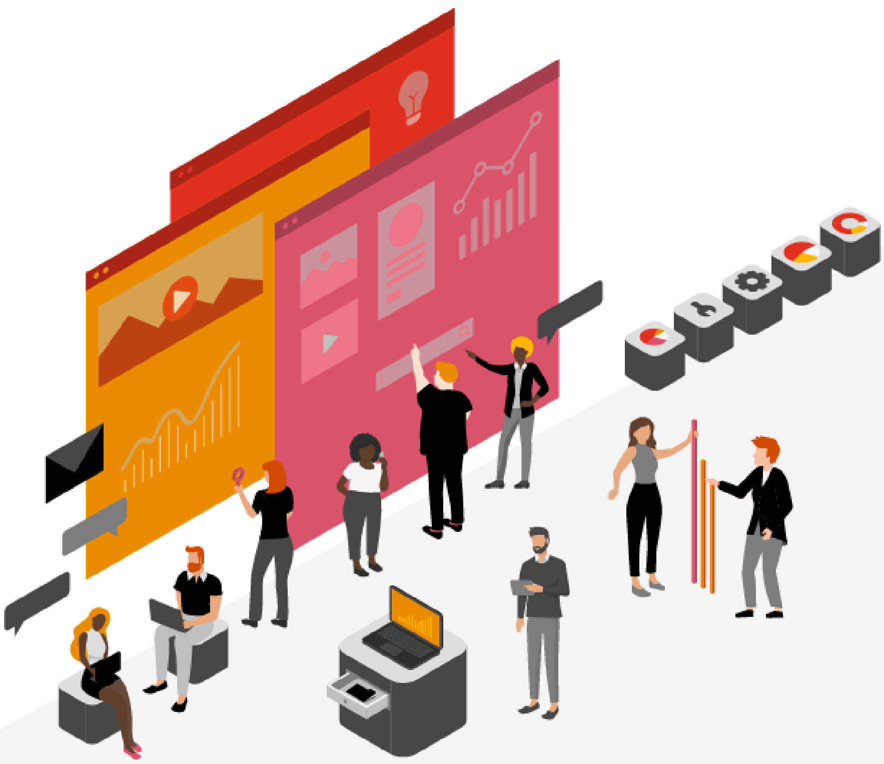
- conducting independent assessments of the adequacy and effectiveness of the first and second line of defences in management of conduct risk
- evaluating key controls around conduct risk management such as governance framework, especially sales governance and practices, and compliance with conduct risk related policies and procedures, and more.



Best practices

In conclusion, effectively managing conduct risk is essential for maintaining integrity and trust in the Regulated Entity (RE). With vigilant regulatory oversight, robust controls and the strategic application of technology, the industry can work towards minimising conduct risk and fostering a culture of ethical behaviour, customer centricity and overall trust on REs. Some of the best practices are listed in the table below:

Leadership	Governance and framework	Compensation, incentives and people management	Accountability and ownership	Risk mindsets and behaviours
Setting of tone from the top by the board and leadership team Monitoring of employee perception and behaviour by leadership to ensure alignment with the desired conduct risk and culture Continuous communication to reinforce banks' values, ethics and behavioral expectation Adhering to a fit and proper regime for senior management	Implementing a staff transaction monitoring and surveillance framework Establishing an escalation protocol framework Implementing an exception tracking framework Establishing a mystery shopping framework Establishing a customer feedback framework Implementing a post-implementation review framework for products and policies Clear delegation of authority policy	Embedment of performance management practices within remuneration for executives and key risk takers Incentivising risk-sensitive behaviour Alignment of talent management strategies with the desired conduct and culture	Well-defined and well-understood roles and responsibilities Accepting accountability and taking ownership for behaviours and decisions	Cleary defined and communicated risk framework, including risk appetite and risk governance Prompt escalation of risk information through the appropriate channels Embracing independence and value addition provided by oversight functions Conducting relevant behavioral surveys to assess the on-ground team understanding of dos and don'ts of conduct while dealing with customers



Group dynamics and decision making	Resilience	Effectiveness of risk management	Policies and procedures	Reporting and monitoring
Setting up an environment wherein individuals feel safe to speak up and raise concerns Within and across groups, individuals effectively communicate and collaborate with one another Decision making involves incorporation and consideration of diverse viewpoints as well as constructive debate	Proactively consider current and potential future circumstances that could result in threats or opportunities Continuous process of improvement of risk culture by learning from near misses, frauds, operational loss, failures to achieve business targets, etc. Encouraging and rewarding innovation	Effective risk appetite framework Sound internal control framework Independence of the oversight functions Processes across the organisation are simple, agile and clearly articulated Leveraging data analytics to understand employee and intermediary conduct. Implementation of automated monitoring systems to identify irregularities in transactions, sales practices and customer interactions	Clearly defining culture and conduct expectations through a segmented code of conduct Implementing a policy on ethical dealing Enforcing a continuous training and awareness Adopting a staff accountability policy Enforcing an insider trading policy Establishing a whistleblower policy Implementing a prevention of sexual harassment (POSH) policy Adhering to a delegation of authority policy Ensuring that compensation policies include a risk and compliance component in individual key result areas (KRAs)	Developing a 'horizontal management information (MI) scorecard' that cuts across individual business and product lines to provide a direction and level of risk on overall conduct and culture risk This will enable the board and senior management to assess how the business is performing against supervisory trends and concerns impacting conduct risk as well as alignment with their vision and values

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