The Culture of Risk

The importance of managing conduct risk and maintaining an effective risk culture across the business

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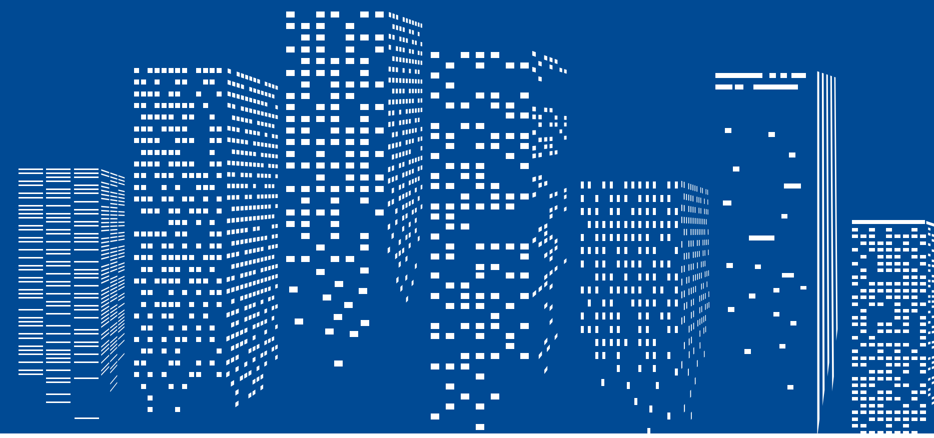
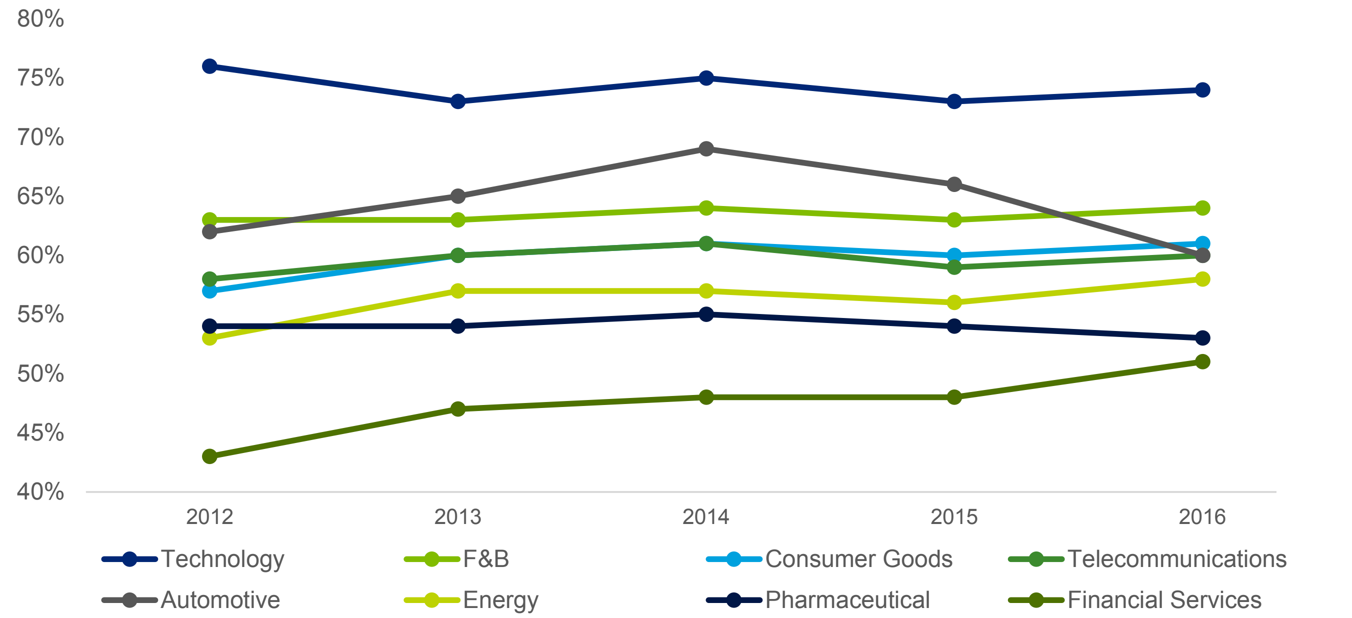
1. Introduction



The emergence of conduct risk and its impact on the financial services sector

Since the financial crisis of 2008-2009, banks and financial institutions across the world have been facing financial and reputational difficulties. The cultural foundation and failure in maintaining an effective risk culture is considered a major driver for the failure of banks. The last few years have highlighted various scandals not just in India, but from around the world – from the recent advance export remittance scandal in India to the LIBOR fixing scandals in the global markets – which highlight how banks are unable to remediate the cultural norms since the financial crisis. This has culminated in reputational damage, regulatory fines, and penalties. Moreover, a major impact on unhealthy cultural norms has led to a loss of public trust. The 2016 Edelman Trust Barometer report illustrated the public's lack of interest in financial service institutions as compared with other institutions from the technology, energy, and pharmaceutical industries respectively. While efforts have been made by the financial services regulators, banks and financial institutions to improve public perception and trust, the financial services industry continues to lag behind its peers from other industries.



Source: 2016 Edelman Trust Barometer – Respondents were asked how much they trust businesses to do what is right. 2016 witnessed an improvement in public trust on financial services however it continues to lag behind other industries

Given the persistent issues around maintaining an effective culture, there have been several global initiatives by financial services regulators and industry bodies to address the issue of 'Conduct Risk' or 'Misconduct Risk'. These are often considered as the risk that a financial institution is not dealing and engaging in fair practices to customers, to the regulator, to market participants, and overall to the global markets. Further, several bodies such as the Group of Thirty, the Financial Stability Board, the IOSCO, the European Systemic Risk Board, and the Basel Committee have recognized conduct risk to be of significant importance to the overall systemic stability of the financial markets. Furthermore, the February 2015 Financial Stability Board's letter to the G20 Finance Ministers and Central Bank Governors highlighted that 'the scale of misconduct in some financial institutions has risen to a level that has the potential to create systemic risks. Fundamentally, it threatens to undermine trust in financial institutions and markets, thereby limiting some of the hard-won benefits of the initial reforms… The FSB will consider reforms to reduce the likelihood of misconduct including by a) assessing reforms to risk governance, compensation structures and benchmarks and, where appropriate, proposing additional measures in these areas and b) considering ways to improve market structure, standards of practice and incentives for good conduct in financial markets more broadly.'

Areas of potential conduct risks across the business and operating model of financial institutions

Conduct risk cannot be pinpointed to a single function or business of a financial institution as it can run deep within the business and operating model if not addressed effectively. A summary of the typical areas where conduct risk arises in a financial institution is given below:

Improper customer on-boarding practices	**Inadequate transparency in fees and charges**	**Fraudulent activities**
Insider trading/ front-running/ rogue trading	**Improper financial advice to customers**	**Collusion with market participants**
Mis-selling financial products	**Tax avoidance**	**Inaccurate financial and regulatory disclosures**

It is therefore imperative for financial institutions to establish a risk culture that not only addresses the risk of misconduct but also highlights clear accountability of actions through a preventive approach.

2. Structuring the conduct risk framework

Conduct risk - A new approach to 'Treat Customers Fairly' ('TCF')

Traditional TCF approach used by global financial services companies		Embedding the TCF into the drivers of 'Conduct Risk' of the company
Confidence of customers when dealing with firms where fair treatment of customers is central to the corporate culture	Marketing and sale of financial products to be designed to meet the needs of the identified customer groups	Inherent factors *Information asymmetries, biases and inadequate financial capacity*
Transparency and appropriateness of information provided to the customer, during point of sale and after sale	Advice provided to the customer takes into account the customer information and circumstances affecting the customer	Structures and behaviour *Ineffective competition, culture and incentives and conflicts of interest*
Financial products sold to customers are expected to perform as expected by the customer and standards of charges are acceptable and expected by the customer	Minimization of post sale barriers imposed by the financial service provider to change product, switch provider, submit a claim or make a complaint	Environmental factors *Economic, regulatory and technological trends*

Integrating stakeholder management with internal conduct risk framework of the firm

The initiative to deal fairly with external stakeholders has existed since the time banks and financial institutions were created. The Financial Conduct Authority ('FCA') of the United Kingdom, in 2006, summarized the six approaches that banks and financial institutions must maintain with their customers and external stakeholders. Similarly, banks and financial institutions in India, too ,maintained similar practices with customers and external stakeholders which were driven either through regulatory directives or self-maintained codes of fair practices.

While these approaches continue to be applicable today, dealing with conduct risk requires a firm to embed it within their internal risk framework so as to bring about a) accountability and, b) monitor it strategically to avoid reputational or financial impact on the business of the firm. Conduct risk forms an essential part of the firm's risk universe whereby the risk factors include the following:

- information asymmetries across various groups within the firm with the external stakeholders
- not dealing with internal conflicts of interest or lack of incentives around doing the right thing, and
- responding to external and environmental change emanating from the economy, the financial markets, technological disruptions, and changing market dynamics

Essential components for addressing conduct risk

1. Defining the conduct risk strategy

- Summarizing the corporate strategy in terms of growth areas, priorities regarding existing customers, distribution model and organization competencies
- Establishing the risks of misconduct which emanate from the strategy
- Clearly specifying the target outcomes in relation to each conduct risk i.e. – what does good look like?
- Measures of whether the conduct risk strategy is successful or not are defined

2. Developing the conduct risk framework

- Framework that clearly references and appropriately covers the conduct risks faced by the firm (i.e. people, process, system and external events)
- Objectively defining the components of the conduct risk framework across the three lines of defense and structuring a defined communication plan
- Roles and responsibilities in relation to the implementation of and compliance with the framework

3. Developing the Conduct Risk Policy

- Comprises:
  - Firm's conduct risk strategy and objectives
  - Firm's conduct risk universe across the operating model
  - Tools and processes for the management of conduct risks
  - Governance arrangements that are in place for oversight of conduct risk and associated reporting framework
  - Board mandate in relation of conduct risk

4. Establishing the conduct risk appetite

- Conduct risk appetite gives consideration to the whole customer lifecycle
- Each statement is specific enough so that it is not open to misinterpretation
- Takes into account the firm's strategy and key output of the conduct risk framework
- Qualitative and quantitative measures for monitoring performance of the risk appetite

Source: Deloitte perspective on Conduct risk – developing and maintaining an effective framework

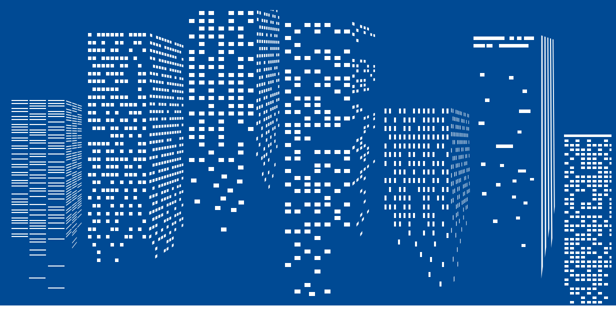
The conduct risk framework remains an essential component of the firm's overall risk management framework – it is the arm that caters to dealing with external stakeholders and embeds in it the manner in which the desired brand recall and reputation of the firm is to be established with the external stakeholders. Various foreign banks today have enhanced their brand and values committee to factor in conduct management and re-establish it as a 'Conduct Risk Committee' so as to constantly monitor reputational vulnerabilities and behaviours expressed by the employees of the firm with the external stakeholders.

Establishing the right manner in dealing with conduct risk requires a consistent approach to address it. An essential component required to cater to the consistency is the 'conduct risk strategy'. This strategy highlights the strategic directives to manage conduct risk and also specifies the governance and oversight or manner in which the 'tone at the top' is established by the Board of Directors and senior management of the financial institution to arrive at; for example – 'What does good behaviour look like for our firm?' and 'What do we need to communicate internally and externally on our tolerance to misconduct and poor behaviour?'. In summary, the conduct risk strategy also establishes the manner in which the conduct risk management framework is to be established within the financial institution.

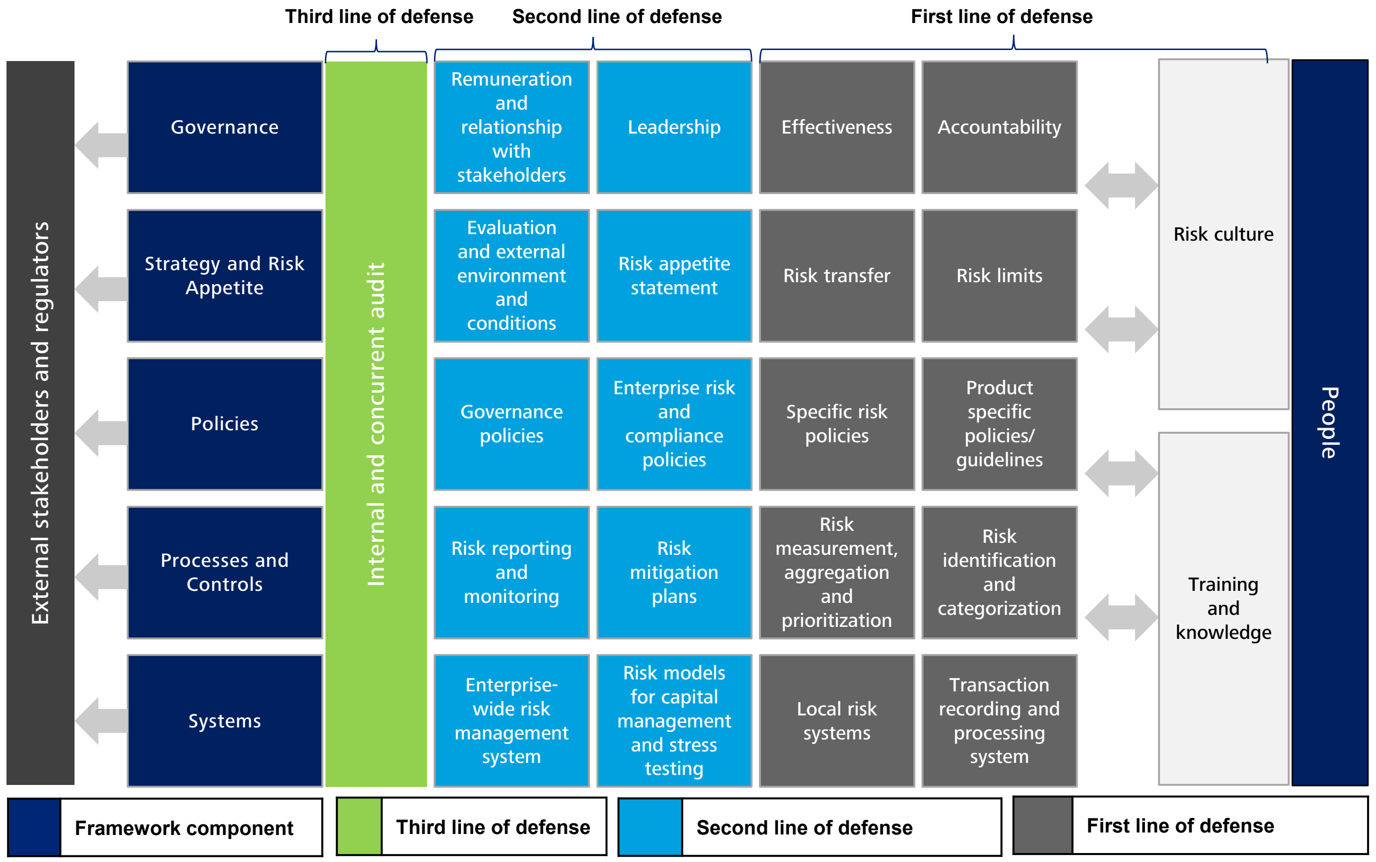
Consequently, developing the conduct risk framework essentially deals with the following things:

- identifying the various exposures to misconduct that the financial institution can express internally and externally,
- the channels and platforms across the three lines of defence of the firm in which poor behaviour can be expressed, and
- the manner in which these risk exposures need to be addressed so as to ensure minimal-to-no form of gap identified across the operating model when dealing with conduct risk.

3. Establishing the risk culture in the operating model



Establishing the components for dealing with conduct risk, structuring roles and responsibilities, and defining compliance measures for stakeholders responsible in managing conduct risk across these tree lines of defence are critical success factors for maintaining an effective conduct risk management framework.



Source: Deloitte's framework for the three-lines of defence model for an effective enterprise risk management framework

Operationalizing the conduct risk management framework can be performed only with the establishment of a conduct risk policy. The policy brings together the following things:

- the mandate from the Board and strategic direction of the firm around managing risks of misconduct,
- the governance framework and components of the conduct risk management framework that are required to be deployed across the three lines of defence
- the operating model of the firm

The policy also covers the kind of tools, metrics and processes required for enabling a consistent approach to address conduct risk throughout the operating model.

Establishing a consistent approach to conduct risk at each area within the operating model can be performed by way of the conduct risk appetite framework. The risk appetite statement demonstrates the manner in which the identified internal stakeholder, for a particular function within the operating model, addresses conduct risk and implements the mandates of the conduct risk policy within their daily operations. This statement allows for consistent deployment and removes any exposure to mis-interpretation around the implementation of the firm's conduct risk strategy. Quantitative and qualitative approaches towards measuring and monitoring the effectiveness of the conduct risk strategy are documented within the risk appetite statement and approved by the Board of Directors of the firm.

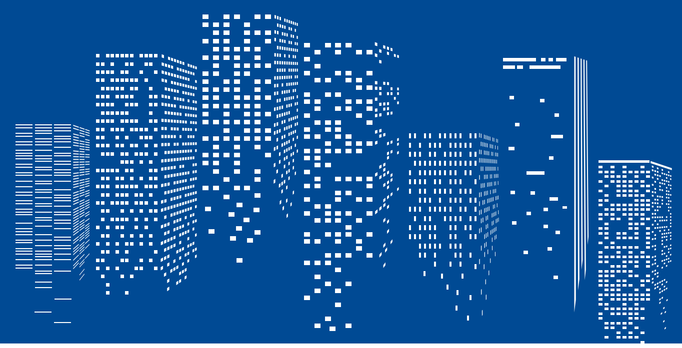
Challenges in maintaining an effective risk culture

When undergoing the risk transformation of the operating model to strengthen the risk culture and governance within the financial institution, it is essential to identify the existing challenges around the current form of risk governance maintained within the firm. Challenges can stem from poor risk governance, management quality, market focus, firm behaviour, effective monitoring, or duplication of efforts across the three lines of defence.

The culture of risk of a financial institution becomes the USP to an external stakeholder and the DNA of the internal stakeholders; establishing the risk culture and governance is thus of paramount importance and must be dealt with in the right manner.

Defining the culture

The November 2015 Group Thirty report on 'Banking Conduct and Culture' defines culture as 'the mechanism that delivers the values and behaviours that shape conduct and contribute to creating trust in banks and a positive reputation for banks among key stakeholders, both internal and external.' Culture is considered as the standardized framework for establishing ethical behaviour and sound business practices. Culture is required to be maintained at the firm, management and individual levels.



Defining the elements required to maintain an effective culture

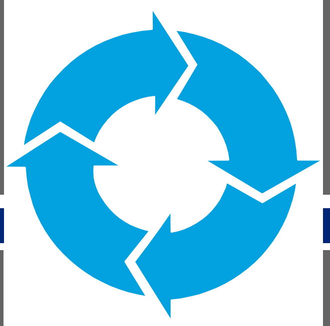
To establish an effective culture within the financial institution, it is important to identify the key elements that would help define the desired culture of the organization. Typically, there are four key elements that help devise the culture of an organization.

Ethics and Behaviour

- Ethics relates to the manner in which the culture is established. An ethical culture highlights cognizance with stakeholder requirements and addressing them in a fair and consistent basis
- Behaviour relates to the approach in which the culture is required to be executed.

Risk Intelligence

- Continuous surveillance of potential exposure to misconduct and non-compliance
- Anticipating and addressing vulnerabilities to fraud and unethical behaviour
- Anticipating and aligning the culture in a dynamic regulatory environment.



Values and Strategy

- Setting the 'tone at the top' with respect to kind of perception that needs to be maintained with the internal and external stakeholders
- Establishing strategies that align with the values of the establishment

Tolerance

- Minimizing tolerance where strategy does not align with the value of the firm
- Highlighting and communication low tolerance to activities that expose the firm to conduct risk
- Penalizing actions that cause the firm to be exposed to conduct risk and negative perception from the stakeholders

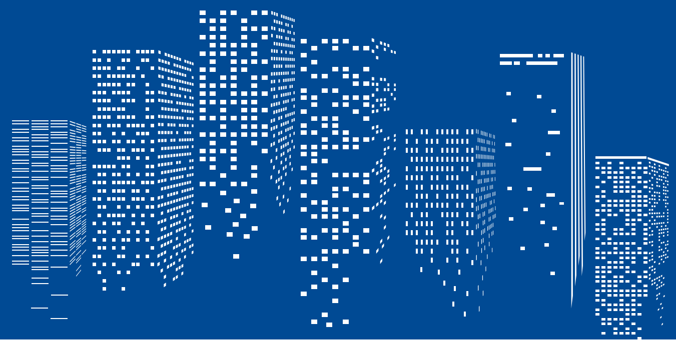
1. Ethics and behaviour – Ethics define the manner in which the desired culture is to be maintained within an organization. This would refer to the ways in dealing with stakeholders, the transparency required to increase trust, and the method in which stakeholder management is to be responded to. The demonstration of action would be the behaviour of the firm with the internal and external stakeholders.
2. Values and strategy – A key requirement for establishing an effective culture within the firm is the manner in which the 'tone at the top' is established. It is the way in which the Board and senior management addresses their firm towards culture and compliance. The manner in which the tone at the top is established typically emerges from the strategic directives of the senior management of the firm.
3. Risk intelligence – It serves as the monitoring or surveillance function for anticipating and addressing risks of misconduct from a preventive basis in order to protect the firm from any vulnerabilities around non-compliance, fraud and general market behaviour.
4. Tolerance – Tolerance demonstrates the acceptance levels of the Board and senior management on demonstrated actions and behaviours that cause misconduct and which may threaten the financial institution from a financial, regulatory or reputational perspective. It is imperative that tolerance be communicated throughout the operating model so as to demonstrate the desired culture to be established within the financial institution.

The importance of a risk-intelligent culture

Prior to the financial crisis, the risk culture of a financial institution was reactive in approach where the rigor and frequency of review was driven by the prevalence of reported risk events and issues. Intervention by compliance and key management stakeholders was only in case of specific issues that were driven either by external events impacting the financial institution or an intimation from the regulator.

Pre 2011 trends		2011 – 2014 trends		2015 onwards	
Limited and sporadic regulatory oversight	Reactive risk and compliance culture	Implementation of compliance technologies and tools	Compliance testing programs	Extensive use of early warning systems	Extensive use of data and analytics to support risk and compliance functions
Silo approach towards risk, compliance and audit	Compliance intervention only in case of specific issues	Embedding compliance within business functions	Automation of regulatory reporting	Close integration between risk, compliance and audit	Transitioning towards a risk based supervision framework
Move towards putting in place compliance frameworks	Move towards robust financial fraud & investigation units	Pre-emptive compliance control embedded in transaction systems	Increased system-based transaction monitoring	Robust transaction and risk surveillance framework	Leveraging GRC tools for efficient self assessment and exception reporting

- The culture of risk and compliance today is expected to transform into a pre-emptive monitoring and surveillance function
- An effective way of transitioning towards a risk-intelligent culture is to become streamlined through increased work-flow based automation



The financial crisis caused banks and financial institutions to to re-think their approach towards compliance and risk where the need to establish it within the first line of defence became a priority. As a result, since the financial crisis, banks and financial institutions have begun to transition towards a risk-intelligent approach where the emphasis on early-warning systems, integration between risk, compliance and audit, automation of reporting and monitoring activities has been integral within the culture of the financial institutions.

Moving across the risk culture maturity levels

Maturity Level I	Maturity Level II	Maturity Level III	
Reactive risk culture	**Institutional risk and compliance**	**Risk-based compliance management**	**Risk-intelligent culture**
▪ Rigor and frequency of review driven by the prevalence of reported risk events/ issues ▪ No central repository of policy/ risk/ regulatory requirements ▪ Unstructured testing framework leading to multiple adhoc reviews ▪ Cost escalation on account of duplication of effort	▪ Framework institutionalized through a governance framework, policy-requirements and standard operating procedures ▪ Repository of regulatory requirements, existing risks and controls and regular gap self-assessments ▪ Existence of governance, risk and compliance infrastructure ('GRC') for ongoing monitoring	▪ High risk, high impact areas identified based on the evaluation of the results from the existing GRC framework ▪ Emphasis on embedding controls within the dealing processes for daily internal/ regulatory compliances ▪ Reliance on a central repository of testing results to optimize the cost of compliance ▪ Continuous updation of the evaluation parameters within the GRC	▪ Systemic risk surveillance framework instituted over and above the existing compliance self-assessments and testing ▪ Compliance evaluation based on inputs from the existing GRC, the central testing data warehouse and the transaction recording platforms ▪ Dynamic updation of risk scenarios and stress on early warning indicators

- **The nature of risk culture among financial institutions in India are currently established within Maturity Level II with the objective towards achieving risk-based compliance.**
- **Creating a risk-intelligent culture within the dealing room by way of leveraging technology for a preventive surveillance system will be the cornerstone of future enhancements**

Transitioning towards a risk-intelligent culture within the operating model of a financial institution

An important feature while moving towards the establishment of a risk-intelligent culture is the manner in which the focus on risk and compliance events transforms—from a reactive basis, towards a policy-driven risk and compliance framework, enhancing the frequency and scope of risk monitoring towards finally arriving at a dynamic risk monitoring culture.

Existing business imperatives and systemic limitations

Complexities in the operating framework
- Legacy system landscape, reliance on manual controls and reconciliations
- Large scale transactional volumes
- Operational complexity and dependencies on documentations

Limitations of the risk management Infrastructure
- Lack of adequate monitoring of operational risks within the dealing room
- Siloed risk management function
- Regulatory expectation of pre-emptive risk and compliance monitoring

Complex Regulatory Environment
- Complex / overlapping regulatory requirements
- Need to monitor all changes to regulations and additions of new regulations
- Assess the impact of changes on the operational activities

Stages of transformation of the risk culture

Reactive risk culture
- Focus on up-front remediation post risk or compliance event
- Multiple adhoc reviews and testing

Institutional risk and compliance culture
- Policy-driven risk and compliance framework
- Warehousing of operational and regulatory requirements/ volume-based testing

Risk enabled compliance management
- Focus enhanced to also cover low-frequency high-impact risk events
- Information ware-housing and static analysis

Risk-intelligent culture
- Dynamic risk monitoring framework
- Real-time data mining and financial surveillance
- Predictive analysis of risk-events

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