

***Conduct Risk framework:  
Industry trends and challenges***

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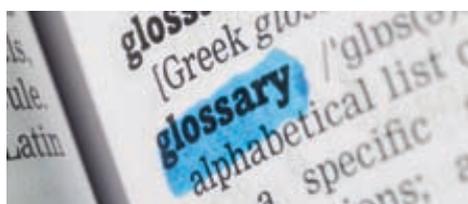
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# Executive Summary

*Remember, upon the conduct of each depends the fate of all.*  
Alexander the Great



Financial institutions have become quite advanced in dealing with classical risks, controlling losses and protecting their balance sheet. But contrary to any of the classical risks, Conduct Risk forces a complete change in paradigm, since it requires financial institutions to put themselves in the shoes of their customers or stakeholders, and protect their customers' balance sheets (in some cases against the financial institution's own short term interests). Financial institutions now need to concentrate on protecting their indirect assets, i.e. their customers.

Bank structures, technology, organisation and governance were not established and refined to deal with this new paradigm, with this being one of the reasons why the adaptation process is still in its infancy.

This document intends to provide an overview of the main components of a successful Conduct Risk management framework, as well as the agents that shape them.

- ▶ Section 2 contains an overview of those components and how they are related to one another. A more descriptive summary is then provided for some elements, including

Conduct Risk definition, organisational structure and functions, policies and procedures, risk appetite, etc.

- ▶ Section 3 provides a more in-depth review of one of the factors that is proving especially difficult to tackle, i.e. that of Conduct Risk effective identification and measurement. This section explores the classical approach to Risk measurement, adapted to Conduct Risk (Risk Appetite, Control model, Risk and Control Self-Assessment, Risk Metrics etc...). In addition, it provides insight on how new technology and new techniques (including Big Data and Advanced Data Analytics) can be used to explore non-obvious potential Conduct Risks in a forward looking, proactive way.

Developing a robust framework for managing Conduct Risk should be a key component of the executives' agenda. In the words of Tracey McDermott, then acting as Chief Executive of the FCA (2015), "the cost of failing to identify risks to clients, market integrity or fair competition is material. It makes good commercial sense – indeed I would say there is a commercial imperative – to manage these risks as effectively as any other risk on your balance sheet".



# Introduction

*Circumstances are beyond human control, but  
our conduct is in our own power.*

*Benjamin Disraeli*



The concept of Conduct Risk has evolved in recent years from being a relatively unexplored and underestimated risk, to being one of the major risks faced by financial institutions. Although there is some diversity in the way that Conduct Risk is defined by different institutions, it is generally accepted that Conduct Risk refers to losses for an organisation emanating from its poor conduct. The European Systemic Risk Board refers to Conduct Risk as the “risks attached to the way in which a firm and its staff conduct themselves. As such, it includes how customers and investors are treated, mis-selling of financial products, violation of rules and manipulation of markets”<sup>1</sup>.

As in many other aspects of the Financial Industry’s ethos, the financial crisis and other transformation forces have in recent years shaken up the status quo in the relationship model between financial institutions and their customers and investors:

- ▶ **Bail-outs:** The need for certain banks to be bailed out by governments across the world led to an increased pressure from public opinion, urging governments and regulators to act on behalf of the general public and make financial institutions accountable.
- ▶ **Macro environment:** The cyclical changes and deep depression of macroeconomic indicators caused some investment products to move out of the money (e.g. structured products referenced to index) and triggered the activation of certain protection products (Payment Protection Insurance being the flagship). Those two aspects helped to surface a large number of cases of product mis-selling, reinforcing the perception of lack of customer protection. Moreover, the same economic depression brought higher unemployment rates, which at the same time increased public discontent and increased pressure on legislators to make banks pay their part of the bill as agents in the crisis.
- ▶ **Poor culture** of customer protection. Some financial institutions had led a culture of short-termism, oriented toward financial results rather than fair customer outcomes. This is supported by the UK Parliamentary Commission on Banking Standards, which stated that “[incentive schemes] are likely to have encouraged mis-selling and misconduct”<sup>2</sup>. Thus, in some instances, inadequate incentives schemes were at the heart of such poor culture and behaviour. As Andrew Bailey, then Chief Executive of the UK’s Prudential Regulation Authority

postulated, “my assessment of recent history is that there has not been a case of a major prudential or conduct failing in a firm which did not have among its root causes a failure of culture.”

- ▶ **Technological developments** continue to transform not only the way banks distribute products but also the relationship model between banks and customers. New technologies started to allow such relationships to evolve from being reactive and bank-led to being proactive and customer-led: meaning that any interaction occurs precisely when and how the customer requires. Clients across different ages and levels of wealth had become accustomed to the distribution models used by large technological and goods companies, in which the relationship between client and provider is more automated, and started demanding the same from banks.

Given the above, Conduct Risk analysis and active management is thus quickly spreading across borders and industries. In some regions, this progress is being fuelled and encouraged by very active regulatory intervention, where public authorities stress the impact of misconduct on the broader financial system. As Mark Carney, then Governor of the Bank of England, outlined in 2014, “the scale of misconduct in some financial institutions has risen to a level that has the potential to create systemic risks”. The corresponding intervention has come in the form of issuing standards, guidelines and best practices, as well as imposing large fines and mandating remediation programmes to financial institutions.

<sup>1</sup> European Systemic Risk Board (2013)  
<sup>2</sup> PCBS Final Report – Changing Banking for Good (2013)



## Facts and Figures

The emergence of scandals around the world (such as the LIBOR manipulation, seen in Case Study 1, and the FX probe), coupled with the resulting consumer mistrust towards financial institutions, prompted regulators worldwide to closely examine the root causes of 'bad behaviours' in banks, as well as the potential drivers, consequences, and remediation requirements that such scandals encompass. As a result, the past few years have seen a rapid development in Conduct Risk focus, both from the organisations exposed to it and the institutions responsible for safeguarding the public against it (e.g. regulators). Naturally, this increased focus has not been homogenous across the world's various regions; rather, geographies with more advanced financial services industries tend to be the ones where Conduct Risk receives greater attention.

Some geographical and global indicators<sup>3</sup> provide a hint of the exponential growth in the level of awareness of and regulatory focus on Conduct Risk in the financial services industry:

- ▶ **Fines:** The aggregated amount of fines imposed on financial institutions operating in the UK since 2007 can be seen in the table below. These are essentially the financial penalties that the UK regulator (FCA) imposes on firms within its scope as a result of their misconduct. Furthermore, such fines may be applicable at both the firm and the individual level.
- ▶ **Redress:** In general, redress is understood as returning the customer to the position they would have been in had the regulatory failings not occurred, including any consequential loss. In the UK, the FCA has published redress data on a half-yearly basis since H2 2009, the evolution of which is displayed at Fig. 2.

As the graph shows, recent years have seen financial services providers compensating consumers in much larger quantities than before. It should also be noted that the steep increase in redress amounts observed in H2 2011 is largely due to the PPI<sup>4</sup> scandal (see case study 2).

Both the fines data and the redress data signal the increased regulatory focus and the raised standards that have been imposed on banks' conduct during the past few years.

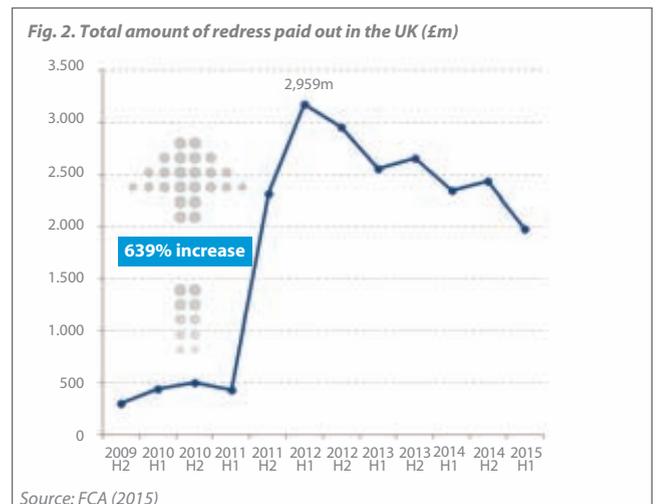
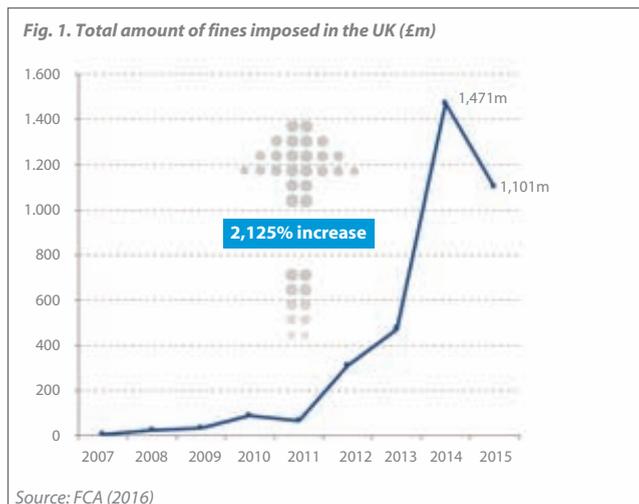
- ▶ **Complaints:** The increased scrutiny on banks' behaviour also manifests in the number of complaints they receive from customers. Looking at complaints data from the past nine years, there has been a general upward trend, which at times increases dramatically due to various events:

In 2007, following the 'Treating Customers Fairly' (TCF) initiative from the FSA<sup>5</sup>, consumers became more active in pursuing fair treatment from their financial services providers, leading to an increase in the number of complaints filed.

<sup>3</sup> Public information is used to illustrate these aspects. In this sense, there is a natural bias in the figure towards those geographies where Conduct Risk is more evolved and regulators and financial institutions have been working for a longer time.

<sup>4</sup> Payment Protection Insurance

<sup>5</sup> Financial Services Authority (2007)



## Case Study 1: LIBOR Manipulation (Worldwide)

Many of the world's largest financial institutions have recently found themselves in the media spotlight for engaging in practices that led to adverse outcomes for their customers as well as the industry as a whole. Perhaps the most famous of these is the 'LIBOR Scandal', referring to actions from various banks aimed at influencing the LIBOR in order to profit from various trades.

To provide some context, LIBOR refers to the "London Inter-Bank Offered Rate", representing the average interest rate estimated by banks in London, which the average bank would be charged if borrowing from another bank. It constitutes one of the most important benchmarks for short-term interest rates around the world, and is linked to at least \$350 trillion in derivatives and other financial products worldwide.

Initial reports regarding a potential LIBOR manipulation were published as early as 2008; however, it was in 2011 that regulators started their inquiries into the manipulation of the rate, and in 2012, the US Department of Justice started conducting a criminal investigation into the LIBOR abuse.

Following these investigations, it was proven that several banks were issuing false LIBOR submissions, in an attempt to both

manipulate the rate and give the impression of a stronger credit position than their actual one. Some banks were also colluding with each other in order to fix their LIBOR submissions.

These actions affected individuals worldwide in a number of ways: an increase in the LIBOR can lead to higher monthly interest rate payments on a loan, whilst a lower LIBOR implies lower interest rates. However, a lower LIBOR would have adverse effects on mutual funds and pensions with investments in Libor-based securities, which would consequently earn less in interest.

As such, it is evident that the actions of the banks involved had negative implications on various stakeholders worldwide, and regulators had to respond accordingly. So far, several institutions have been fined by regulators in relation to the LIBOR manipulation, with total fines exceeding \$8.5 billion.

In addition, this scandal was marked with the criminal investigation of many individuals involved, as well as the resignation of several senior executives.

## Case Study 2: PPI Mis-selling (UK)

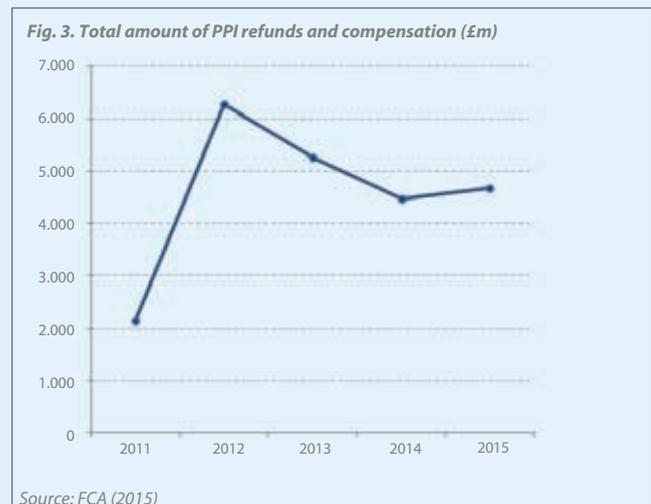
Payment Protection Insurance (PPI) is an insurance product that enables consumers to cover loan or debt repayments, in the event that they are unable to meet them, provided that certain circumstances, such as being made redundant or becoming ill or disabled, are present.

However, this type of product has been the subject of much controversy (especially in the UK), as consumers were often sold the product without having understood its features; banks and other lenders sold PPI to their customers without fully explaining what it covered. Furthermore, in the worst case scenarios, the lenders misinformed their customers by telling them it was a compulsory element of a loan; in other cases, lenders simply added PPI without the borrowers' consent. In the financial year 2010-11, the Financial Ombudsman Service (FOS) in the UK received a record number of formal customer complaints, with over half of those (51%) being attributed to PPI. These complaints mainly concerned cases where a claim on a payment protection policy was turned down, or cases where PPI was sold without the customer's consent, as well as cases involving disputes about refunds of premiums.

In late 2010, the Financial Services Authority (FSA, the predecessor of the current regulator for conduct matters in the UK – the FCA) introduced rules to stop the mis-selling of PPI. However, banks, represented by the British Bankers Association, opposed these rules. The case went to the High Court, which

ruled in favour of the FSA's rules, thus opening the door to a series of claims for PPI mis-selling as well as large amounts of redress to consumers.

The evolution of PPI refunds and compensation is shown in the Fig. 3: overall, in the past 4 years, more than £20bn has been paid out to consumers in the UK in relation to PPI.





In 2009, growing consumer frustration regarding unauthorised overdraft charges resulted in more complaints. The case went on to the UK Supreme Court, which led to the Court overturning previous rulings, allowing the Office of Fair Trading to investigate the fairness of charges for unauthorised overdrafts.

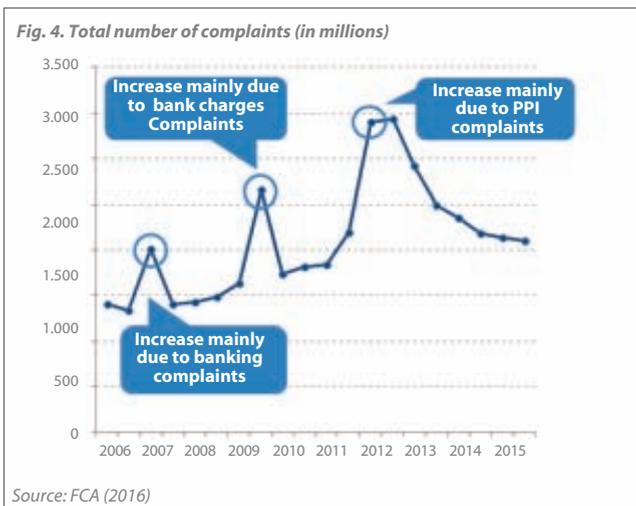
Most recently, in 2011, a dramatic growth in PPI complaints accounted for the majority of complaints filed against banks, as was previously mentioned.

The steady increase in the average number of complaints, even once outliers have been removed, seems counterintuitive considering the extensive human efforts and investments that banks and regulators have devoted to improving the levels of customer service. Undoubtedly, Fig. 4

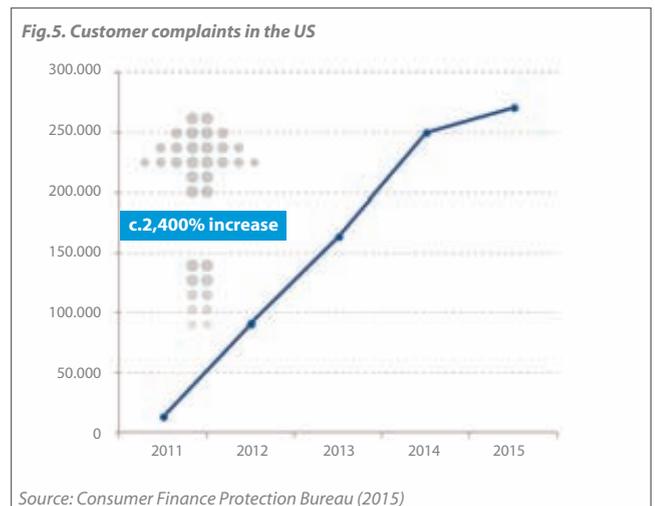
reflects one of the underlying factors behind the rise of Conduct Risk, namely the increased awareness and higher expectations from customers and regulators when it comes to financial services.

However, for each of the above indicators (fines, redress and complaints), the most recent time interval shown on each graph appears to illustrate an overall improvement or at least a stabilisation.

Furthermore, the increase in volume of conduct indicators has been evidenced in other regions as well. Although materiality of the actual numbers may differ significantly across individual countries, an upward trend can be noticed in different geographies. The Fig. 5, 6 and 7 demonstrate the increase in customer complaints in the US, Brazil and Spain:



<sup>5</sup> Financial Services Authority (2007)





## Regulatory environment

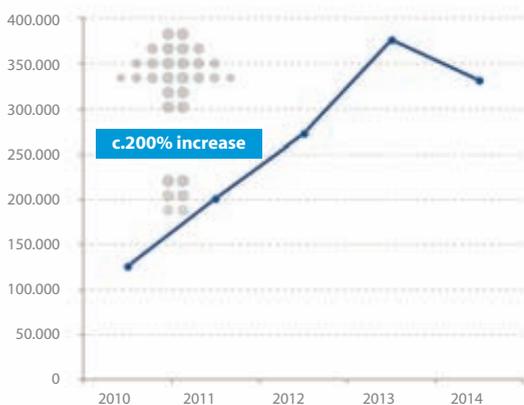
Since the financial crisis emerged, regulation in the more advanced geographies has increasingly included elements relating to Conduct Risk. For example, the Capital Requirements Directive IV (CRD IV), although focused on capital standards and measurement, also includes a cap on bankers' bonuses. Moreover, regulations such as the European Market Infrastructure Regulation (EMIR), which aims to reduce the risks associated with the derivatives markets, helps to protect customers against large scale failures. In addition, there are many other regulations that include large sections dedicated to conduct requirements or that are exclusively focused on Conduct Risk.

The following pages provide a summary, organised by geography, of the regulations that focus most explicitly on

Conduct Risk and that are most relevant in the current landscape. Some regulations are still in the draft stage and therefore may be subject to change. Where multiple compliance deadlines exist, the most relevant has been selected.

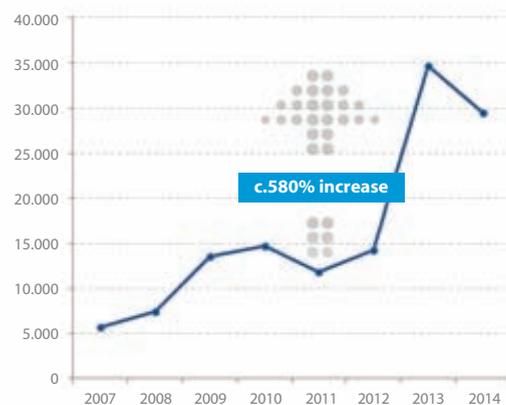
Some geographies, including the US and the UK, have taken the lead by issuing specific Conduct Risk related regulation. In the case of the UK, a specific Regulatory Body (Financial Conduct Authority) was created in 2013. However, both Conduct Risk regulation and supervisory activity is spreading quickly to other geographies including Continental Europe, Asia-Pacific, Australia or Latin America, with large commonalities across regions.

Fig. 6. Customer complaints in Brazil



Source: Central Bank of Brazil (2014)

Fig. 7. Customer complaints in Spain



Source: Bank of Spain (2014)

<b>Europe<sup>6</sup></b>		
<i>Regulation</i>	<i>Description</i>	<i>Compliance Deadline</i>
Alternative Investment Fund Managers Directive (AIFMD)	<ul style="list-style-type: none"> <li>▶ Requirements for minimum standards for conduct in business, safekeeping of investments and authorisation of fund managers</li> </ul>	Q3 2014
Mortgage Credit Directive	<ul style="list-style-type: none"> <li>▶ EU-wide framework of conduct rules for banks offering first and second charge mortgages</li> <li>▶ Requirement for banks to implement new pre-contract disclosures and withdrawal/reflection periods</li> <li>▶ Requirement for regulators to implement an admissions regime for intermediaries</li> </ul>	Q1 2016
Undertakings for Collective Investment in Transferable Securities (UCITS) V Directive	<ul style="list-style-type: none"> <li>▶ Harmonises rules across the EU regarding depository duties, eligibility and liabilities</li> <li>▶ Aligns UCITS framework to AIFMD procedures in force for non-UCITS funds</li> </ul>	Q1 2016
Payment Accounts Directive	<ul style="list-style-type: none"> <li>▶ Requirement that all customers have access to basic accounts</li> <li>▶ Increased transparency of payment accounts fees</li> <li>▶ Establishment of minimum standards for switching</li> </ul>	Q3 2016
Market Abuse Directive/Regulation (MAD II / MAR)	<ul style="list-style-type: none"> <li>▶ Prohibition of any attempt of insider dealing and market manipulation</li> <li>▶ Minimum criminal sanctions for market abuse and requirements for cross border cooperation between all EU member states</li> </ul>	Q3 2016
Key Information Documents for packaged retail and insurance-based investment products (KIDs for PRIIPs)	<ul style="list-style-type: none"> <li>▶ Requirement to provide a key information document for packaged retail investment and insurance products</li> </ul>	Q4 2016
Markets in Financial Instruments Directive/Regulation (MiFID II / MiFIR)	<ul style="list-style-type: none"> <li>▶ New investment protection/distribution measures, increased transparency and stricter controls on market processes</li> </ul>	Q1 2018
Benchmark Rules (drafted)	<ul style="list-style-type: none"> <li>▶ Standards for authorisation and supervision of benchmark contributors</li> <li>▶ Improves transparency and governance of the production of benchmarks</li> <li>▶ Ensures appropriate supervision of benchmarks</li> </ul>	TBC <sup>9</sup>
Securities Financing Transactions Regulation (drafted)	<ul style="list-style-type: none"> <li>▶ Disclosure requirements such as providing clients with information on the effects of re-hypothecation and the use of SFTs</li> </ul>	TBC <sup>9</sup>
Insurance Distribution Directive (drafted)	<ul style="list-style-type: none"> <li>▶ Rules on knowledge and competence of employees and intermediaries</li> <li>▶ Introduction of two conduct principles that banks must act honestly, fairly and professionally and that all information must be fair, clear and not misleading</li> </ul>	TBC <sup>9</sup>
Structural Reform of EU Banking (drafted)	<ul style="list-style-type: none"> <li>▶ Ban on proprietary trading for all EU states</li> <li>▶ Power for supervisors to require ring-fencing of deposits (allowing derogation to individual states where proposals are underway)</li> </ul>	TBC <sup>9</sup>

<b>United States</b>		
<i>Regulation</i>	<i>Description</i>	<i>Compliance Deadline</i>
Dodd – Frank <sup>7</sup>	<ul style="list-style-type: none"> <li>▶ Internal conduct rules on conflicts of interest, record keeping risk management etc.</li> <li>▶ Enhancement of customer protection with external business conduct rules</li> <li>▶ Increased transparency through real time trade reporting</li> </ul>	Q2 2013
Self-Trading Rules <sup>8</sup>	<ul style="list-style-type: none"> <li>▶ Requirement to have policies and procedures in place to review trading activity and stop patterns of self-trades from the same origin (e.g. trading desk)</li> </ul>	Q3 2014
Sanction Guidelines <sup>8</sup>	<ul style="list-style-type: none"> <li>▶ Enhancement of sanctions against those who commit fraud or make unsuitable recommendations to customers</li> </ul>	Q2 2015
Volcker Rule (under the Dodd –Frank) <sup>8</sup>	<ul style="list-style-type: none"> <li>▶ Ban on proprietary trading by commercial banks – whereby deposits are used to trade on the bank's own accounts (includes bypassing the rule via hedge/private equity funds)</li> </ul>	Q3 2015
ERISA Proposed Scope Redefinition <sup>7</sup>	<ul style="list-style-type: none"> <li>▶ Proposed redefinition of a fiduciary to include investment 'recommendations'</li> <li>▶ Investment advice fiduciaries banned from receiving sales commission and participating in revenue sharing arrangements (if they do not meet the 'best interest contract' exemption)</li> </ul>	TBC <sup>9</sup>

<sup>6</sup> European Commission

<sup>7</sup> US Congress

<sup>8</sup> FINRA

<sup>9</sup> Compliance deadline to be confirmed

## United Kingdom

Regulation	Description	Compliance Deadline
Retail Distribution Review <sup>10</sup>	<ul style="list-style-type: none"> <li>▶ Requirement to clearly describe the service offered and properly disclose charges</li> <li>▶ Enhancement of professional standards for advisors including a code of ethics</li> </ul>	Q1 2013
Mortgage Market Review <sup>10</sup>	<ul style="list-style-type: none"> <li>▶ Reform of practices to make the mortgage market more robust and customer focused</li> <li>▶ Enhanced practices including more comprehensive affordability checks, stricter conditions over interest only mortgages and the requirement for most interactive sales to be advised</li> </ul>	Q2 2014
Peer to Peer /Crowdfunding Regulation <sup>10</sup>	<ul style="list-style-type: none"> <li>▶ Further consumer protection measures including increased transparency of how and where money is invested</li> <li>▶ Additional review expected in 2016</li> </ul>	Q2 2014
Consumer Credit Rules & Price Cap <sup>10</sup>	<ul style="list-style-type: none"> <li>▶ Enhancement of the Consumer Credit Act</li> <li>▶ Higher standards particularly for High-Cost Short-Term Credit (HCSTC)</li> <li>▶ Price cap to ensure customers do not face excessive charges when taking out HCSTC</li> </ul>	Q1 2015
Client Assets Review <sup>10</sup>	<ul style="list-style-type: none"> <li>▶ Additional documentation requirements</li> <li>▶ New client money segregation requirements ensuring compliance with the Client Assets Sourcebook</li> </ul>	Q2 2015
Senior Management Remuneration <sup>10</sup>	<ul style="list-style-type: none"> <li>▶ New rules aimed at discouraging irresponsible risk-taking and short-termism in senior management</li> <li>▶ Includes the introduction of clawback rules and the extension of deferral periods</li> </ul>	Q3 2015
Consumer Rights Act <sup>11</sup>	<ul style="list-style-type: none"> <li>▶ Clarifies standards for purchasing goods/services and remediation options</li> <li>▶ Revised requirements over unfair contract terms</li> <li>▶ Other industry specific provisions</li> </ul>	Q4 2015
Senior Managers Regime and Certification Regime (SMR & CR) <sup>12</sup>	<ul style="list-style-type: none"> <li>▶ Senior Managers Regime (SMR) to ensure more structured accountability</li> <li>▶ Certification Regime (CR) to hold all individuals to appropriate standards of conduct</li> </ul>	Q1 2016
Complaints Handling <sup>10</sup>	<ul style="list-style-type: none"> <li>▶ New rules for how to manage and report customer complaints</li> <li>▶ Rules include an extension of time for dealing informally with a complaint, requirement for banks to send written communication and report/publish all complaints</li> </ul>	Q2 2016
New Rules on Whistleblowing <sup>10</sup>	<ul style="list-style-type: none"> <li>▶ Rules on how to build an effective whistleblowing network</li> <li>▶ For example the introduction of whistleblowing champions</li> </ul>	Q3 2016
Banking Reform Act <sup>11</sup>	<ul style="list-style-type: none"> <li>▶ Ban on proprietary trading</li> <li>▶ Introduction of a ring fence around retail deposits</li> <li>▶ Depositor preference introduced</li> </ul>	Q1 2019
Fair and Effective Markets Review (FEMR) Proposals <sup>12</sup>	<ul style="list-style-type: none"> <li>▶ Raises the conduct standards of individuals</li> <li>▶ Improves the quality, clarity and fairness of FICC trading practices</li> <li>▶ Promotes forward looking Conduct Risk identification</li> <li>▶ Strengthens domestic and international governance</li> </ul>	N/A

## Other

Regulation	Description	Compliance Deadline
Future of Financial Advice (FOFA) Reforms - Australia <sup>13</sup>	<ul style="list-style-type: none"> <li>▶ Ban on remuneration structures (incl. commission) in relation to distribution and advice of retail investment products</li> <li>▶ Standards requiring financial advisors to act in the best interest of clients</li> <li>▶ Increased visibility of fees</li> </ul>	Q3 2013
Amendments to the Financial Instruments and Exchange Act (FIEA) - Japan <sup>14</sup>	<ul style="list-style-type: none"> <li>▶ Enhancement of investor protection and disclosure requirements for financial institutions</li> <li>▶ Ensures appropriate management of self-regulatory operations</li> <li>▶ Imposes strict counter measures against unfair trading</li> </ul>	Ongoing

<sup>10</sup> FCA

<sup>11</sup> UK Act of Parliament

<sup>12</sup> PRA

<sup>13</sup> ASIC

<sup>14</sup> Financial Services Agency

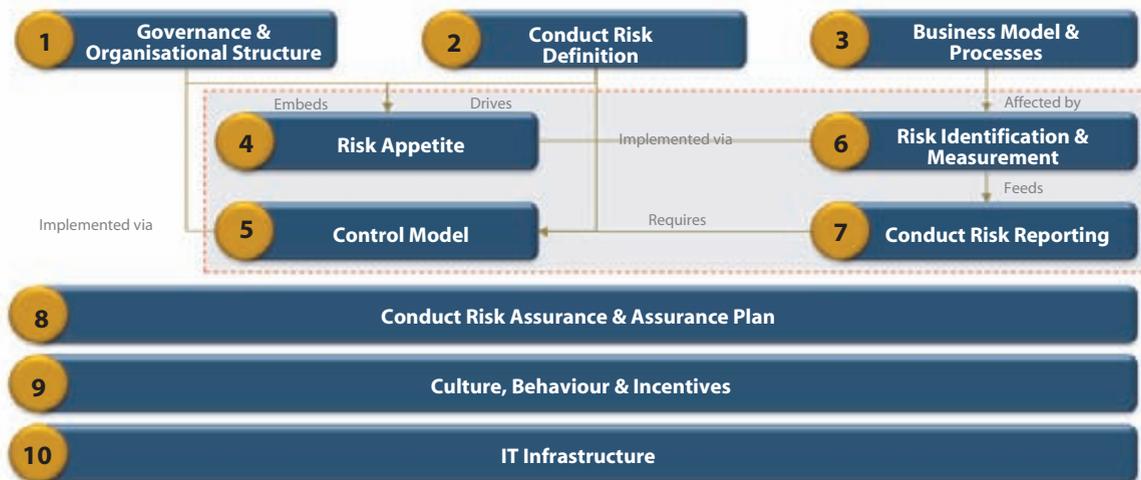
# Conduct Risk management framework components

*Initiative is doing the right thing  
without being told.*

*Victor Hugo*



Fig. 8. Conduct Risk Framework Components



Source: Management Solutions, 2016

A Conduct Risk management framework may be developed around the business model and value proposition of the financial institution, and within the boundaries established by the regulatory landscape.

A financial Institution usually starts by providing a definition of what Conduct Risk means for its organisation. This effort sets the scope of the risk, and therefore of the framework itself. This definition is usually influenced both by the regulatory environment as well as by the financial institution's own business model. The Conduct Risk framework is supported by an organisational structure and governance model that establishes clear accountabilities across the first and second lines of defence.

The business model of a financial institution is articulated through a collection of business processes that provide the fabric of its commercial operating model. These range from customer onboarding, to product design, product marketing, product sales / advice, product post-sales, product monitoring, customer servicing, complaints handling, collection and recovery, etc. and span across all channels, customer segments and geographies.

Those business processes are being reshaped by the new regulatory landscape, which imposes constraints such as what products can be commercialised, to whom, by whom, etc. These regulatory requirements are usually translated into internal policies, procedures and standards, which dictate how those business processes need to be designed, executed and controlled.

As in the case of any other risk, an organisation will define a Conduct Risk appetite. This appetite is translated into specific risk policies (with appetite sub-statements) that set further constraints on the business model. The business model in turn needs to ensure that the risks originated in the pursuit of the

commercial strategy and targets are within the limits defined in the appetite.

In order to ensure alignment with internal policies, a financial institution usually defines a control framework for Conduct Risk, with different types of controls across the front-to-back product lifecycle that are executed with a defined frequency, are assigned owners, etc.

Additionally, as with any other risk, a bank's second line of defence uses a set of tools to provide assurance that the risks do not exceed the appetite defined. These include a framework for identifying the emerging risks and measuring the risk exposure and a framework for gathering and reporting management information. The efforts to gain assurance usually involve the creation of Assurance teams specialised in Conduct Risk that, using all available information, provide an independent assessment of the level of compliance with the internal standards, using a Conduct Risk assurance plan.

The last element of a successful framework is a strong technological infrastructure that allows the implementation of the policies and standards in a systematic, automated and controlled way.

The above framework should be permeated, influenced, and in fact driven by a strong cultural and behavioural component. In all aspects of the operating model, in all the business processes that articulate the commercial activity, and in all the supporting functions in the second and third lines of defence, there needs to be a strong culture of fair service to and treatment of customers and other stakeholders. This is usually supported by a carefully designed remuneration and incentives scheme that ensures alignment of incentives with the bank's strategy.

## Definition and sources of Conduct Risk

The definition of Conduct Risk allows financial institutions to set the boundaries of the framework, and provides the basis for the remaining components. In its current level of maturity, there are still discrepancies across the industry in relation to the scope of Conduct Risk. In recent years, however, as financial institutions and regulators have devoted time and effort to the understanding of this risk, there has been a broadening of the scope of this definition, as well as improved levels of alignment across the industry.

As a reference, the list below provides various definitions of Conduct Risk created by industry associations and international regulators.

Best practices formulate the definition of Conduct Risk across different dimensions, including:

- ▶ An inclusive view of who can potentially commit misconduct (not only employees, but also senior management or third parties or representatives acting on behalf of the bank).
- ▶ An inclusive view on who can be on the receiving end of misconduct, including individual customers, institutional clients, market counterparties, competitors, shareholders, and the broader society (including regulators, government bodies, etc.).
- ▶ An inclusive view on the business processes where Conduct Risk can originate from. These allow for a categorisation of Conduct Risk into sub-types:
  - ▶ **Retail conduct**, originated in business processes such as product design, product marketing, sales and advice, post-sales servicing, complaints handling, collections and recovery, as well as treatment of vulnerable customers.
  - ▶ **Wholesale conduct**, originated in the business transactions with wholesale counterparties and including insider dealing, information barriers, handling of conflicts of interest, practices of market abuse, whistleblowing, etc.
  - ▶ **Corporate conduct**, originated in the business processes around cross-border activities, management of confidential data, etc. In some cases, the definition of Conduct also includes Financial Crime (Anti-Money Laundering, Anti-Bribery and Corruption, Sanctions and anti-Terrorist Financing activities).

A complementary approach to defining Conduct Risk is that of identifying the fundamental drivers that originate the risk. Such a fundamental analysis has been pursued by some

regulators: in a foundational paper back in 2013<sup>15</sup>, the Financial Conduct Authority identified nine drivers of Conduct Risk, which could be classified across three families. A summary is provided:

### *Inherent factors*

- ▶ **Information asymmetries:** where one party in a transaction has additional or superior information compared to the other party. According to the FCA, this is the root of most of the conduct issues in financial organisations. The most relevant example is consumers not understanding the details of sophisticated products or services or being unable to compare products. Another common example is insider trading, whereby players in the market gain an unfair advantage over the competition by using non-public information to inform their trading decisions.
- ▶ **Biases, rules of thumb and mental shortcuts:** consumers can make poor financial decisions and advisers can give unsuitable advice. Rules of thumb and mental shortcuts in decision making can lead to poor decisions being made when consumers do not pay sufficient attention to the most important product terms or features. These behaviours can be particularly problematic in financial markets, because of their complexity, and because financial decisions often involve risk, time and predictions about the future, which are especially susceptible to consumer bias. Examples of misconduct arising from this factor are cases where banks take advantage of consumer biases through the way in which they choose to present their products and by overstating their value to the customer.
- ▶ **The growing importance of financial capability:** financial capability is the ability to understand information on financial products and services. This is generally weak among consumers. Financial institutions often assume that their customers are financially informed enough to understand all of a product's features, when in reality that is not always the case.

### *Structures and business conduct*

- ▶ **Conflicts of interest:** At the root of many Conduct Risks are conflicts of interest which over time have been built into financial sector structures, processes and management. Conflicts of interest are particularly pertinent to wholesale markets, where banks sometimes put the interests of a more profitable customer over those of a customer bringing in less profit.
- ▶ **Culture and incentives:** Culture drives behaviour; it reflects the underlying values and 'mind-set' of an

<sup>15</sup> FCA Risk Outlook (2013)

## Definitions of Conduct Risk

“Misconduct risk refers to the risks attached to the way in which a firm and its staff conduct themselves. As such, it includes how customers and investors are treated, mis-selling of financial products, violation of rules and manipulation of markets.”

European Systemic Risk Board (2015), “Report on misconduct risk in the banking sector”

“Conduct risk is the risk of inappropriate, unethical or unlawful behaviour on the part of an organisation’s management or employees. Such conduct can be caused by deliberate actions or may be inadvertent and caused by inadequacies in an organisation’s practices, frameworks or education programs.”

Australian Securities and Investments Commission (2014), “Market Supervision Update Issue 57”

“Market conduct risk is the risk of loss or harm to consumers and counterparties arising from undesirable market conduct practices by an institution, and/or its representatives, and/or their inability or unwillingness to comply with the requisite market and business conduct requirements.”

Monetary Authority of Singapore (2015), “MAS’ framework for impact and risk assessment of financial institutions”

Conduct risk is understood as the risk of “consumer detriment arising from the wrong products ending up in the wrong hands, and the detriment to society of people not being able to get access to the right products”

Financial Conduct Authority (2013), “FCA Risk Outlook 2013”

“Conduct risk means the current or prospective risk of losses to an institution arising from inappropriate supply of financial services including wilful or negligent misconduct.”

European Banking Authority (2014), “Draft Guidelines for common procedures and methodologies for SREP”

“Conduct risk is derived from the business actions taken and the conduct which is shown at each stage of the product and which might have harmful impacts such as negative outcome for the clients.”

Bank of Spain

organisation. Incentives structures are another important way of motivating behaviours and they can reflect the kinds of behaviour that the bank’s senior management values and rewards. For example, a heavily bonus-driven sales policy may lead to sales employees selling products to clients who do not need them or for whom they are not suitable, for the purpose of maximising their personal earnings.

- ▶ **Market structures:** This is the key element of well-functioning markets, referring to how different market characteristics affect the way in which products are valued or costs implemented. For example, ineffective competition may very well result in financial institutions exploiting their advantageous position in the market to charge excessive prices without the risk of losing their customers.

### Changes in environmental conditions

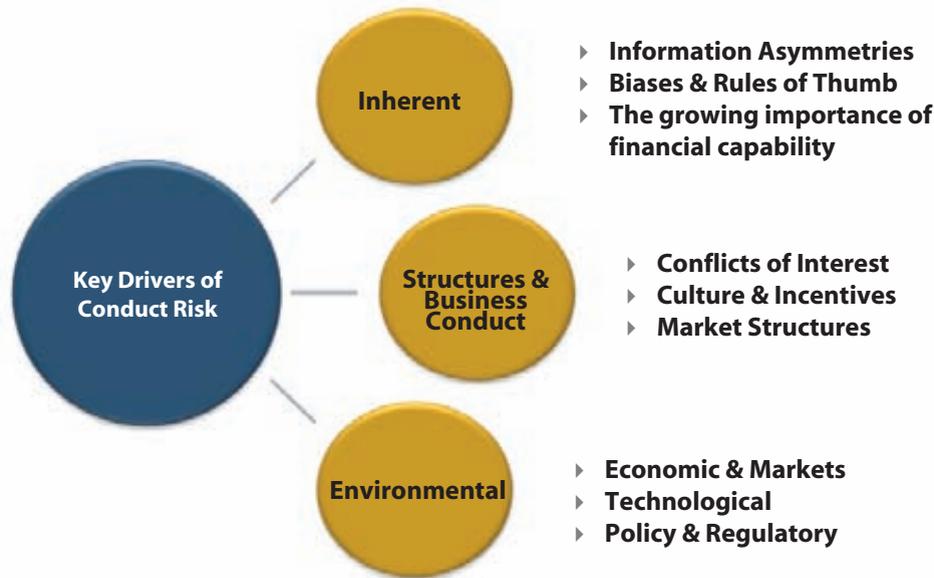
- ▶ **Economic and market:** Developments in the economy and financial markets influence the products and services that financial institutions are willing to offer, the needs and demands of consumers and the profitability and

volume of financial products sold. For example, the recent economic crisis led to the inability of many consumers to repay a mortgage that was of greater value than the now devalued collateral (i.e. the house).

- ▶ **Technological:** Technology continues to grow in importance as increased dependence on digital connectivity affects both the way many consumers engage with financial services and the way products and services are distributed. Consumers can benefit in many ways from having quicker interactions, which are cheaper and, in general, simpler to use. Furthermore, consumers are able to access new channels for advice and information. This will encourage competition and create more market information for consumers. However, this use of technology also brings vulnerabilities. Financial institutions and consumers are more exposed to technology’s disruptive capabilities, such as misunderstanding, complexity, reliance on systems, etc.

- ▶ **The policy and regulatory environment:** The regulatory reform agenda, both in the UK and globally, is bringing changes to the structure of markets and support for the financial sector aimed at achieving better outcomes for

Fig. 9. Conduct Risk Drivers



Source: FCA Risk Outlook, 2013

consumers by changing the way banks conduct business. This is an important driver of how financial institutions are looking to develop and reorient their business models. The policy environment over the last year has continued to focus on strengthening public finances, restoring economic growth and ensuring financial stability in the UK.

'Clients, Products & Business Practices' events, defined as "losses arising from an unintentional or negligent failure to meet a professional obligation to specific clients, or from the nature or design of a product"<sup>16</sup>. This is allowing some financial institutions and regulators to use the databases of historical events for this sub-type to calibrate potential capital charges in the Capital assessment processes<sup>17</sup>.

Most sections throughout the remainder of this document are applicable to all Conduct Risk subtypes. However, some elements (e.g. risk measurement and some the examples used) have, for clarity and illustration purposes, been restricted to retail conduct (i.e. the Conduct Risk originated in the design, distribution and post-sale management of financial products and services to Retail customers).

This section on the definition of Conduct Risk concludes with two final remarks:

- ▶ The drivers that can trigger a Conduct Risk event are very broad. A Conduct Risk event can be triggered because of a product that was poorly designed (e.g. inadequate stress testing that makes the product underperform in certain conditions), poorly distributed (sold to customers not in the original target market, across different age ranges, etc.), or due to deliberate malpractice of a financial institution's employees and agents. Moreover, these drivers are not always independent, but in general can be highly correlated and interrelated. This makes the identification of root causes and the isolation of effects (for measurement and prediction purposes) difficult.
- ▶ Some of the Conduct Risk subtypes are already part of the Operational Risk discipline (under the Basel category of

### **Business Model, Processes, Policies and Standards**

Upon determining the role of business processes across a Conduct Risk management framework, it is important to take into consideration the following points:

- ▶ The business model of a financial institution, i.e. the way it serves its clients and pursues its commercial strategy and aspirations, is all articulated through a collection of business processes that provide the fabric of the commercial operating model of the bank.
- ▶ Those business processes are reshaped by the new regulatory landscape, which imposes constraints upon the products that can be commercialised, to whom, by whom, etc. These regulatory requirements are usually translated to internal policies, procedures and standards, which dictate how those business processes need to be designed, executed and controlled.

When reviewing the regulations specified earlier (and focusing, for the sake of clarity, on the Retail business), we find that financial institutions are currently subject to a set of constraints or boundaries, some of which are specified below:

<sup>16</sup> Bank for International Settlements (2001)

<sup>17</sup> EBA EU-Wide Stress Test 2016 – Draft Methodological Note

## Product Design

- ▶ Offer basic bank accounts to customers and ensure the opening process does not take an excessive amount of time
- ▶ Design responsible products for the mortgage market avoiding 'toxic combinations' (for example high loan-to-value combined with customers with poor credit or an unstable income)
- ▶ When designing short term products, ensure interest rates and charges are not excessive, paying close attention to any caps on high cost credit

## Product Marketing

- ▶ Ensure advertisements used are fair and not misleading to customers
- ▶ Provide transparent marketing materials, clearly representing all charges and other features. For example:
  - ▶ Offer Key Information Documents (KIDs) when marketing relevant funds (e.g. PRIIPs, UCITSs, MMFs)
  - ▶ Provide simple 'key messages' upon set trigger points when disclosing information on mortgages to customers
  - ▶ Disclose all associated risks when marketing investment products and all default rates, likely returns etc. when promoting a P2P loan service
- ▶ Uphold the same conduct standards when using social media or other recently developed channels as when using the more traditional methods
- ▶ Incorporate risk warnings into any advertisements for short term credit

## Sales

- ▶ Interact with customers in a transparent way by:
  - ▶ Ensuring transparent and prominent contract terms (in plain and intelligible language)
  - ▶ Clearly representing the cost of advice allowing investors to make informed decisions before they accept the service
  - ▶ Informing customers as to whether or not additional services/products have to be bought when packaging accounts/products and being transparent on costs

- ▶ Act in the clients best interest by:
  - ▶ Ensuring any independent advice is unbiased and unrestricted and where restricted advice takes place, clearly disclosing the nature of the restriction
  - ▶ Advising on the full range of products regardless of the panel/platform the bank uses, referring to a third party when the staff do not hold the required permissions/expertise
- ▶ Advise on mortgage sales (with limited exceptions such as the customer being high net worth) in a way that ensures the customer receives the most suitable product by:
  - ▶ Offering interest only products when there is a credible strategy for the repayment of capital
  - ▶ Providing pre-contract disclosures in simple formats including a breakdown of all charges without undue delay and allowing a pre-contract 'cooling-off' period

## Post Sales

- ▶ Upon the resolution of a complaint, send a summary communication to the customer including information on an ombudsman service if available
- ▶ Make account switching available to customers in a simple and time efficient way
- ▶ Provide an annual statement of fees in a standardised format to customers
- ▶ Treat any pre-contractual information given as a binding term if it is a factor in the customer entering into the contract
- ▶ Provide greater flexibility to consumers in repaying what they owe before the expiry of the credit agreement
- ▶ For more complex products, provide regular and more detailed information (e.g. fund rules, objectives, asset types)

## Vulnerable Customers and Debt Management

- ▶ Exercise reasonable forbearance towards customers with repayment difficulties before initiating repossession proceedings
- ▶ Reduce or eliminate charging arrears when a borrower is in the process of repaying
- ▶ Charge reasonable fees for breaches of the terms and conditions on basic accounts
- ▶ Restrict the number of times high-cost short-term credit can be rolled over



## Risk Management

- ▶ Perform adequate affordability and income checks on customers (irrespective of whether third party channels have been used)
- ▶ Perform routine interest rate stress tests
- ▶ Implement a greater degree of monitoring on trading patterns and behaviour
- ▶ Increase separation of the risk management function from other operating units
- ▶ Impose tighter controls on proprietary trading (due to high VAR and volatility)

The regulatory requirements influencing these processes (together with additional constraints coming from the risk appetite of the organisation) are usually translated into internal policies, procedures and standards, that dictate how those business processes need to be designed and executed. It is important to highlight that although these processes are largely impacted by regulatory requirements, financial institutions ought to complement regulatory change with a mind-set of continuous improvement in customer treatment.

## Risk appetite

Given the nature of Conduct Risk, and its relation to the protection of the customer's interest, there is usually no formal appetite for any Conduct Risk exposure. However, a large and complex organisation with a variety of products and services, distributed across different geographies, channels, and customer segments, works under the assumption that completely eradicating the potential to mistreat customers might be an aspiration, but is not realisable from a business

perspective. As highlighted in by the European Systemic Risk Board<sup>18</sup>, tackling conduct risk is especially challenging in large banks, where senior management could be unaware of emerging misconduct issues.

This adds to the inherent difficulties associated to identifying and measuring the exposure to Conduct Risk. In this sense, financial institutions usually articulate their appetite as a set of Risk Appetite Statements and Sub-statements that specify the ambition of the organisation in relation to Conduct Risk across the product lifecycle and across customer segments, channels, products and services. This appetite also translates into specific risk policies (that develop the appetite sub-statements), which set further constraints on the business model (that needs to ensure that the risks originated in the pursuit of the commercial strategy and targets are within the limits defined in the appetite).

The Risk Identification and Measurement section contains further details and specific examples as to how this Risk appetite is articulated, and how it is associated with the difficulties in measuring Conduct Risk exposure in relation to appetite.

## Control Model

Both the regulatory landscape and the risk appetite impose a series of constraints on the business model and on the business processes involved in the front-to-back product lifecycle. In order to ensure that those business processes are executed in alignment with internal policies, a bank will usually define a control framework for Conduct Risk, with different types of controls across the front-to-back product lifecycle that are executed with a defined frequency, have owners, are planned, tested for effectiveness, etc.

<sup>18</sup> ESRB, Report on misconduct risk in the banking sector (2015)

*The regulator is the referee, the companies are the players. A bad referee can ruin a game, but even a good referee can't make the passes go straight. Change will have to come from the industry itself.*

*John Griffith-Jones, Chairman of the FCA*

With respect to the Conduct Risk control model, a number of banks have leveraged on the internal control framework defined for operational risk.

In that sense, it is common to find:

- ▶ A control inventory, which consists of a set of process controls, the purpose of which is to ensure that procedures are consistent with the established Conduct Risk appetite. Such controls typically work by identifying whether certain criteria throughout the end-to-end process have been met, and not allowing the process to continue if they have not. Thus, they 'control' whether the outcome of each process poses any Conduct Risk.
- ▶ A set of control indicators that assess and monitor the effectiveness of the internal controls inventoried in the previous point. Each control indicator is assigned to an owner responsible for defining the appropriate threshold levels and mitigating actions in the event of threshold breaches.
- ▶ Incident investigations (both internally and externally) to assess whether there are any lessons to be learned. These reviews should be performed periodically.

Controls play an essential role in Conduct Risk assessment. Most financial institutions have developed a risk and control self-assessment methodology that systematically reviews inherent Conduct Risks, assesses the effectiveness of the controls defined and evaluates the residual risks. This methodology is usually developed in a phased approach, incorporating the following actions:

- ▶ Identification of inherent risks
- ▶ Assessment of the controls in place
- ▶ Remediation of residual risks
- ▶ Monitoring of risk levels

This self-assessment is used in most cases to build a heat map that can be used to determine the impact of each applicable inherent risk. For each risk, the likelihood of the event is also considered.

### **Risk identification and measurement**

As part of the risk management framework, a pivotal point in any Conduct Risk strategy is to be able to effectively identify and anticipate the Conduct Risk events (i.e. to be able to detect the early signs of "the next PPI" in order to prevent it from happening). The substantial losses that have crystallised in the past few years with a root cause in Conduct Risk, sometimes equivalent to several years' worth of a financial institution's profits, make this point even more critical, and reaffirm its position at the top of the agenda of Conduct Risk practitioners, with financial institutions investing large amounts of resources.

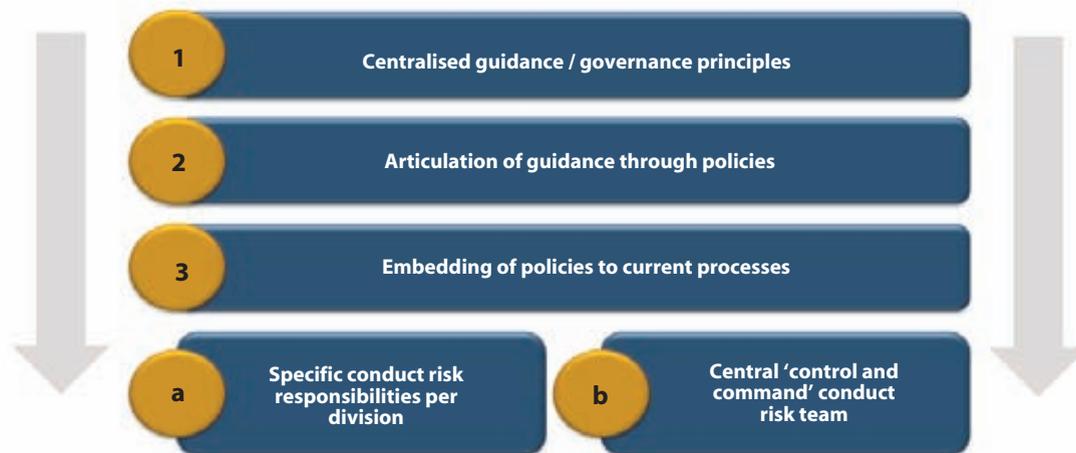
Linked to that point, though a slightly different discipline, financial institutions are also investing heavily in being able to measure their exposure to Conduct Risk or, in other words, to be able to communicate to senior management the magnitude of their risk of misconduct. As the following section will elaborate in more detail, financial institutions can take several actions to achieve that goal.

However, the nature of Conduct Risk makes an effective risk identification and risk measurement framework quite challenging, at least using standard risk measurement and management techniques. There are many reasons for this proving to be a challenge and, to a certain extent, they are not very different from the case of other classical risks.

Some of the challenges for effective Conduct Risk identification and measurement are:

- ▶ The underlying drivers that can trigger a Conduct Risk event are very varied, from asymmetries of information to

Fig. 10. Conduct Risk Governance



Source: Management Solutions, 2016

inadequate incentives, poor customer financial culture, poor product design, failure in a process, macroeconomic conditions etc.

- ▶ Those drivers are not completely independent but, in some cases, are highly correlated, which increases the difficulty in building predictive models from an independent set of explanatory variables.
- ▶ There is a significant delay between the moment a failure in the control model occurs and the moment the consequences surface. In that sense, a proper root cause analysis, as well as the gathering of information and model feedback is ineffective.
- ▶ As in the case of some other classical risks, the nature of the Conduct Risk events that concern financial institutions the most are those of low probability / high impact. In other words, for those particular risk events there is no sufficient historical information to be able to properly “recognise” patterns.
- ▶ The quality and depth of the historical information is poor and allows limited data analytics. In order to properly perform forward looking data analytics<sup>19</sup>, there are very strong data requirements around limited historical information:
  - ▶ Data from different domains needs to be available at the lowest possible level (to allow for meaningful aggregations and disaggregation)
  - ▶ Equally importantly, data from very different domains needs to be “connectable” i.e. linked to each other. This is done via single identifiers or more complex Big Data techniques that allow for different domains to be combined with one another.

is semantically described (at a level agreed by Board members) and the actual set of indicators and metrics that would provide a sense of risk exposure and measurement. Risk appetite statements are usually written using a principles-based approach, meaning that they are quite broad and generic to be able to specifically allocate one or many risk measures to them.

Even when the risk appetite statements are decomposed into sub-statements and more granular guidance, their nature is usually process driven (since that is the way the bank is programmed to operate), which means that they are very useful to impose restrictions and controls on the front-to-back product lifecycle (as discussed above), but not so much to dynamically measure the risk, nor identify patterns that would lead to future issues. The blueprint for Conduct Risk identification and measurement section contains a more detailed analysis of this aspect of the Conduct Risk Framework.

### Conduct Risk Reporting

One of the most essential elements of the Conduct Risk framework is the ability to communicate the current levels of exposure to Conduct Risk to the rest of the organisation, as well as the main issues in relation to Conduct Risk.

Market best practices show a set of commonly agreed key risk indicators that are defined and measured at the most granular level, namely, the product/customer segment/business line level. A subset of those are defined at an enterprise-wide level and aggregated. When possible, these are linked to the risk appetite statements to provide a view of exposure versus appetite. Thresholds are defined for each of those KRI that allow reporting and escalation on an exception basis.

<sup>19</sup> It should be taken into consideration that data analytics does not necessarily need to achieve the best possible level of accuracy. Since it is only intended to identify patterns, it can tolerate a certain level of inaccuracy in the data it uses, provided that such inaccuracy does not significantly impact the conclusions.

Beyond the above reasons, or precisely because of them, there is a gap between how the risk appetite of a financial institution

Beyond those firm-wide key risk indicators, each business division or sub-team uses its own measurements of the level of performance of their control environment. The implementation of a robust Conduct Risk reporting framework faces a number of challenges, including:

- ▶ Agreeing a common set of indicators that are meaningful and measurable across the enterprise can prove challenging in complex, global systemically important institutions. They require a strong effort in relation to semantic description and consistent physical implementation.
- ▶ Often data is split across many different source systems, and identifying the information's end-to-end lineage and golden source is a challenge. Ownership of data is also unclear in many cases.
- ▶ It is important to ensure that the process of aggregation does not "normalise" or remove any outliers in the data, which could potentially be an early indication of abnormal activity or misconduct.

Moreover, as in the case of other risk types, the act itself of defining a set of metrics to monitor performance changes the behaviour of organisations, in the sense that the businesses begin to act in such a way as to ensure the metrics improve<sup>20</sup>. Although in general this is a good practice, it can provide a false sense of assurance, and reduce the level of alert for potential Conduct Risk drivers not reflected in the measurement.

### **Governance, Accountability and Organisational Structure**

The Conduct Risk framework is embedded into a governance model and an organisational structure that sets clear accountabilities across the first and second line of defence.

Most financial institutions start with a centralised guidance, usually led by the second line of defence, which is then crystallised into enterprise-wide policies, procedures and standards.

Once these are in place, there is a process of policy adoption and BAU embedding of the Conduct Risk management into the first line of defence. Such embedding can take different forms and be articulated using different organisational approaches. One of the most widespread consists of creating specialised Conduct Risk teams ingrained in the first line of defense and specialised by either business division, product line or customer segment.

- ▶ Financial institutions that are more matured in the management of Conduct Risk have specialised executive level Committees and Councils embedded in the Business, where the main Conduct Risk indicators are monitored and discussed. Alerts and issues escalated are also discussed at that level, together with the progress of the most relevant Conduct Risk related remediation programmes and any

relevant regulatory interaction (regulatory visits, letters, regulatory risk events in the industry etc.). In addition to those Councils, during the Board Risk Committee or the Board Committee some time is usually dedicated to the discussion and escalation of any relevant Conduct Risk related aspects or issues.

- ▶ From a risk identification and measurement perspective, the most matured organisations have control, execution and risk identification as one of the responsibilities of the first line of defence, and support this process of identification with a central data analytics capability used to identify patterns and outliers across divisions, geographies, products and customers.
- ▶ From a second line of defence perspective, in addition to the issuance of policies and standards, the consolidation of Conduct Risk measurement, etc., there is usually a responsibility around overseeing and challenging the level of compliance with the Conduct Risk policies. This is usually performed by an assurance function (typically managed centrally but with spokes and specialisation by business division / product / segment) that is able to look across business lines, products and markets, and execute thematic reviews and independent control.
- ▶ From an individual accountability perspective, the best practice (triggered in some cases by regulation, such as the Senior Management and Certification Regime in the UK) involves defining and documenting senior management responsibilities, and holding managers personally responsible for misconduct events unless they can prove reasonable steps were taken to avoid the risk. Furthermore, employees in certain positions (such as customer facing) need to be assessed and deemed 'fit and proper' to fulfil their respective role. This practice of holding individuals accountable follows a series of market failures where financial institutions were deemed guilty of misconduct, but regulators could not place the blame on specific individuals within the organisation.
- ▶ Following the regulatory developments outlined above, banks under their scope will not only be required to document the responsibilities of certain individuals, but also to communicate the performance of such employees against their defined responsibilities to the regulator. Furthermore, to enhance individual accountability across the Conduct Risk framework, financial institutions may also implement tools such as a responsibilities map (a single document describing the organisation's management and governance arrangements), as well as enhance their handover arrangements when individuals move between roles, so that reasonable steps are taken to ensure newly appointed managers are aware of all information and risks relevant to their position.

<sup>20</sup> See Hawthorne effect



### **Conduct Risk assurance and assurance plan**

In order to guarantee that the control model executed by the first line of defence is mitigating risks effectively, some banks will create a second line of defence assurance function. The structure can vary, but market best practices allow for an independent and effective escalation of issues to senior management (independent from other functions and business units).

The assurance function will use different tools in the execution of its oversight responsibilities. These include:

- ▶ Simple monitoring of KPI
- ▶ Independent control testing (mystery shopping, post-deal customer calls, transaction recording, etc.)
- ▶ Thematic reviews across divisions, cross product, customer segment, process, ...
- ▶ Deep dive analysis.

The choice of methodology is usually different for each combination of product / client / business division / region and is sensitive to the results of the Risk Control Self-Assessments (RCSA), but also to the level of awareness of the real inherent and residual risk in the area and the transparency of its business processes.

The assurance function organises its activity based upon an assurance plan that is produced yearly, but reviewed several times during the year depending on priorities and the evolution of the heat map of the organisation. Such an assurance plan is complemented with ad hoc reviews that address specific topics of interest influenced both by the market and the business or the regulatory climate. Lastly, to ensure that assurance can meet its objectives effectively, it usually has its own governance and committee structures where risk assessments and findings are directly communicated to relevant stakeholders.

### **Culture, behaviour and incentives**

Strengthening the Conduct Risk operating model and complementing it with enhanced capabilities may improve its effectiveness in the early identification of malpractice. However, corporate culture is seen by most practitioners and regulators as the core of the Conduct Risk framework. Corporate culture here refers to the set of values and behaviours that drive and influence how employees think, act and speak. Clive Adamson, Director of Supervision at the FCA, views culture as the “judgements, ethics and behaviours displayed at those key moments, big or small, that matter to the performance and reputation of firms and the service that it provides to customers and clients.” There is broad recognition in most financial institutions that it is culture rather than regulation that most effectively ensure professionalism and integrity.

Many banks have realised that in order to embed good behaviours into their organisation, they need to strengthen their values and enhance their culture. However, such a deep cultural shift of this nature comes with challenges of its own, including:

- ▶ It must be driven from the top of the organisation, and therefore needs to be included in the top management agenda.
- ▶ A change in culture cannot happen overnight; The Cass Business School released a publication suggesting it will take over 15 years to alter the behaviour of firms<sup>21</sup>.
- ▶ It starts from the recruitment phase, where work ethics needs to be promoted to being considered as the most desired skill, above all technical capabilities.
- ▶ There is no straightforward way to measure the underlying level of work ethics and corporate culture of an organisation.

<sup>21</sup> Cass Business School (2014)

*Culture is not something we can prescribe, nor would we want to – it is for firms to decide the type of culture they want. But whatever a firm's corporate culture looks like, the fair treatment of customers and market integrity should be central – and it should not be undermined by people or business practices.”*

*Linda Woodall, then Director of Mortgages and Consumer Lending at the FCA*

Some of the best practices in the market include the embedding of adequate conduct into the incentive schemes, increasing training and awareness programmes or the implementation of effective anonymous escalation procedures for blowing the whistle on inadequate behaviours.

There is evidence that companies are already implementing some of the above measures; for example, a survey by Reuters saw a 48% change in attitude from the board, with 40% installing new policies and 32% of banks offering training to boost awareness of Conduct Risk<sup>22</sup>. In addition, some banks have given seminars to their employees addressing the company's core values, while other banks have broadcasted videos to its employees illustrating their mistakes. The Bank of England's Financial Stability Report in July 2015 revealed bonuses as a share of pay had fallen from 17% to 11% of total income between 2011 and 2014<sup>23</sup>, suggesting there is less evidence of financial promotion. Although these measures indicate some progress in shifting the culture across the industry, it is still an ongoing process and banks will benefit greatly from continuing to effectively tackle the challenges outlined above in order to improve behaviours in their organisation.

### **IT infrastructure and data architecture**

The overall management of Conduct Risk needs to be supported by a strong IT infrastructure and data architecture that allows for timely and accurate aggregation of the data used to compute each conduct indicator, but also to combine different data sources to perform advanced data analytics and apply big data techniques to risk and pattern identification.

In this sense, data related regulations such as Risk Data Aggregation and Risk Reporting (BCBS 239) have helped some Global Systemically Important Banks (SIBs) to define a Conduct

Risk data landscape, organise conduct related data (via data taxonomies and data dictionaries), identify its origin (through lineage) and prepare it not only for reporting but also for risk analytics (via the use of single identifiers or semantic queries and optimisation, amongst others).

Financial institutions still face challenges in the area of data architecture and IT infrastructure, including:

- ▶ Deciding which information to use is not a straightforward task; given the evolving nature of Conduct Risk, the process of identifying critical data elements needs to be an ongoing one.
- ▶ Often, data is split across many different source systems, and identifying the information's end-to-end lineage is a challenge, thus resulting in inefficiency when users have to locate certain data points. Ownership of data is also unclear in many cases.
- ▶ Data related processes usually contain end user computing tools, manual adjustments or enrichments, with the corresponding impact in the quality and timeliness of data. Although managing large volumes of data is no longer a problem due to advanced technologies, their maintenance is often characterised by several issues. This includes inadequate quality of the data gathered, which can have significant implications in the accuracy of any results derived from that data.
- ▶ Convergence of the core IT infrastructure to support achieve an integrated view of the risks and controls of underlying processes, with functions and frameworks for, among others operational risk, internal control, compliance and internal audit.

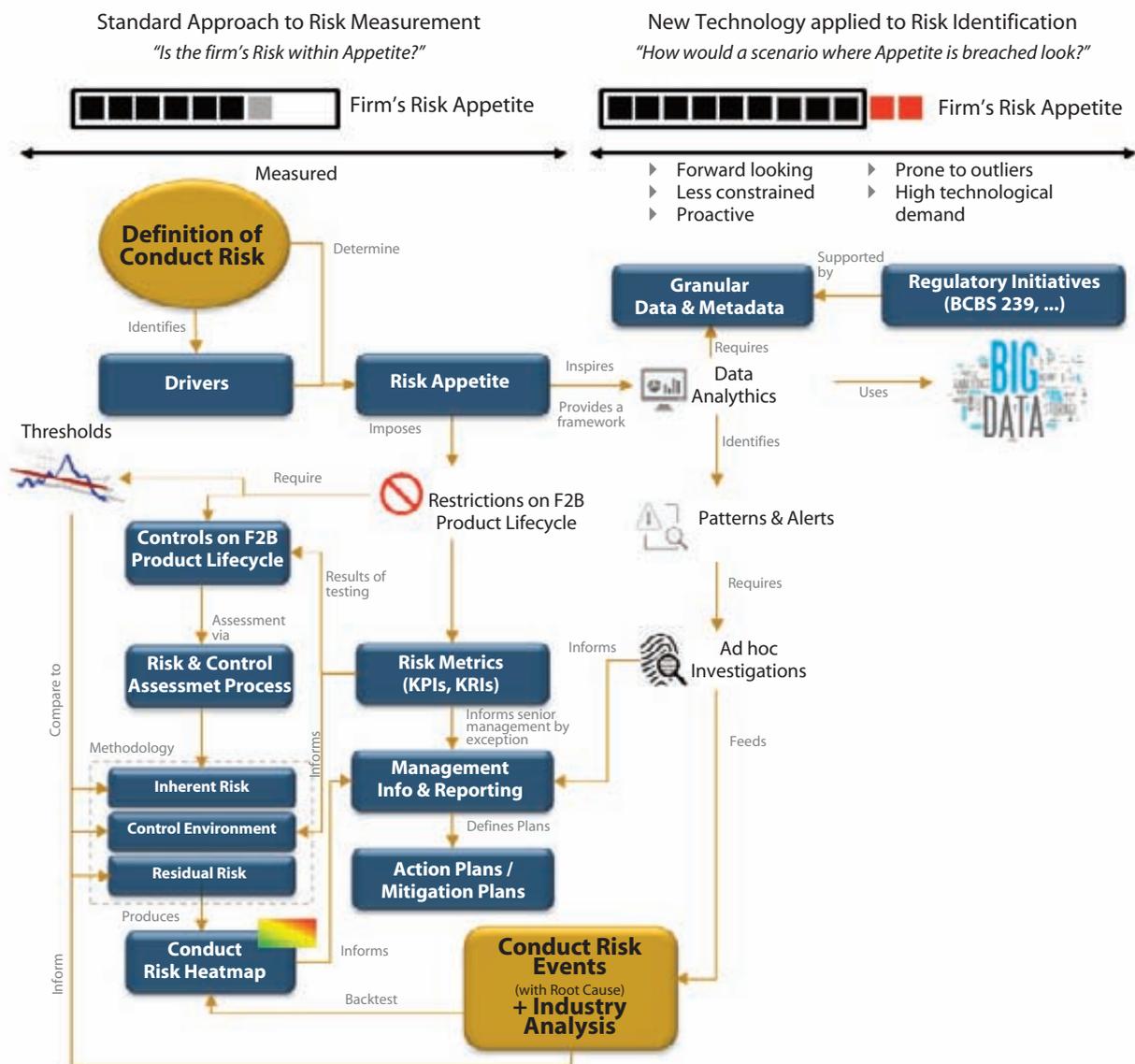
<sup>22</sup> Thomson Reuters (2015)

<sup>23</sup> Bank of England (2015)

# A blueprint for Conduct Risk identification and measurement

*Laws control the lesser man...  
Right conduct controls the greater one.*  
Mark Twain

Fig. 11. Conduct Risk Framework



Source: Management Solutions, 2016

## Overall description of the framework

This section will look into the process of Conduct Risk identification and measurement in greater detail, and describe a 'blueprint' framework for overcoming some of those challenges. Such a framework for risk identification and measurement will have the following components:

- ▶ The definition and measurement of the appetite for Conduct Risk
- ▶ A Risk and Control Assessment Process
- ▶ A complementary approach leveraging on advanced data analytics

The framework is summarised in the figure 11. The explanation of the diagram is as follows:

- ▶ Determining the appetite for Conduct Risk begins with the **definition of Conduct Risk** for the organisation and, especially, the version of the definition where the drivers of Conduct Risk are outlined. A bank would then determine its risk appetite, with a view to ensuring that these drivers do not materialise into misconduct.
- ▶ Furthermore, the risk appetite is expressed in terms of a set of statements and sub-statements, which outline the bank's appetite with respect to the catalogue of potential Conduct Risks that would pose a threat to the organisation (e.g. "All sales must be made to the target market identified unless a waiver has been approved having gone through the formal governance"). Given the nature of Conduct Risk, those statements are usually written in terms of **absolute principles** that impose restrictions on the front-to-back product lifecycle.
- ▶ These restrictions usually require a further translation into Key Risk Indicators and corresponding thresholds that can be used to support a system of measurement and alerts (e.g. waivers / approvals of exceptions to product distribution).
- ▶ Such metrics are aggregated and reported to senior management on a regular basis (through a set of reports, dashboards, etc.) in order to effectively monitor exposure to Conduct Risk and identify any trends in the metrics that suggest potential misconduct. A metric exceeding its defined threshold is an indication that the bank is likely to incur Conduct Risk; such an event would thus create an alert, which would be escalated in order to define a remediation plan and minimise Conduct Risk.
- ▶ At the same time, the restrictions in the product lifecycle coming from the Risk Appetite (and the associated **controls** to ensure that those restrictions are embedded) require a Risk and Control Assessment Process.

- ▶ Such a process typically leverages on the infrastructure of operational risk, but is specific to conduct and uses the catalogue of potential Conduct Risks as its underlying fabric. This control assessment process includes a standard analysis of:

- ▶ **Inherent risks** (risks identified as part of the catalogue of Conduct Risk) – e.g. Risk of customer not receiving all relevant information about the product at the point of sale.

- ▶ **Controls** defined in the control model, and a control evaluation and testing mechanism via which the organisation can gain assurance that the controls are being executed accordingly. E.g. the Front Office platform does not allow a transaction to be executed unless a printed version of the Terms of Reference has been given to the client.

- ▶ **The residual risks assessment** that determines the remaining risks after the controls have been implemented, and which is then translated into a Residual Risk heatmap.

- ▶ The Risk and Control Assessment Process is continuously fed by and tested with another capability of the framework, the analysis of past events. This capability provides root cause analysis and classification (in a way that is treatable by the RCSA analysis) of previous Conduct Risk events that have occurred within the organisation or that have affected peers in the industry, and allows to:

- ▶ Statistically test the heatmap (i.e. analyse whether issues do crystallise with the probability and severity suggested by the heatmap)

- ▶ Improve the identification of inherent risks and control environment.

As explained in the previous section, the Assurance function oversees the effectiveness of the controls (e.g. performing mystery shopping or post-sales call to customers.). Assurance decides on the degree of intervention needed based on the probability of an event occurring (assessed on the basis of the quality of existing procedures and controls), the severity of the event (measured through number of clients impacted, detriment caused, economic impact of the remediation, etc.), and the level of awareness, quality of information and transparency in relation to the business division / area under scope. This is then used as the input for drawing the residual risk heatmap.

In addition to the above approach, which provides a systematic methodology for the identification and measurement of Conduct Risk, the last element of the Conduct Risk identification and measurement framework relates to the use of **data analytics**, usually involving Big Data techniques (right hand side of the diagram at the beginning of this section):

- ▶ This analysis tries to answer a slightly different question, but gives rise to a fundamentally different way of looking at the topic. Rather than trying to ensure and prove that the risks are within appetite, the foundational question in this second capability is: “how would a scenario in which the risk appetite is breached look?” In other words, start with the assumption that there will be cases in the organisation where the risk appetite is being breached and then identify what the symptoms are of such a case. E.g. combine information from product volumes and profitability and compare it against client segmentation, level of debt and / or range and profession in order to spot outliers,
- ▶ In order to answer this question, the approach proposed is to use a slightly less restricted methodology, where **data analytics** is used to combine information from different sources and recognise patterns that might indicate evidence of such breaches. Those patterns can come from different data analysis techniques:
  - ▶ Outlier analysis (extreme value analysis, proximity-based models, linear and spectral models etc.)
  - ▶ Behavioural analysis
  - ▶ Stress Testing and financial forecast
  - ▶ Social media monitoring, sentiment and trend analysis

As part of their analysis, a data scientist would have the aim of determining which patterns of behaviour are unusual or unexpected (for example, a product outperforming in terms of profitability, a branch, relationship manager or region with commercial results higher than average, a given product or service with concentration of early cancelations in a particular branch, etc.).

Once a pattern is spotted as potentially signalling a breach of the risk appetite, the data foundations of that pattern

are discussed with subject matter experts in the assurance and business teams to either discard them as false alarms, or to trigger a deep dive in order to understand them in more detail.

- ▶ This analysis requires strong analytical capabilities (including data scientists with strong risk background, rather than classical risk subject matter experts), a technological infrastructure that is able to support complex computation and a data infrastructure that supports data mining and analytics.
- ▶ Such data infrastructure is currently in place or being developed, leveraging on the efforts that the organisation has made in order to build their Big Data capabilities and their data infrastructure (semantic meaning disambiguation, etc. from programmes such as BCBS 239).

### Working Example

This section will develop an example of the process of Conduct Risk identification and measurement, as described above, for one of the business processes which has recently received significant attention and investment, namely product sales and advice for retail customers.

### Drivers

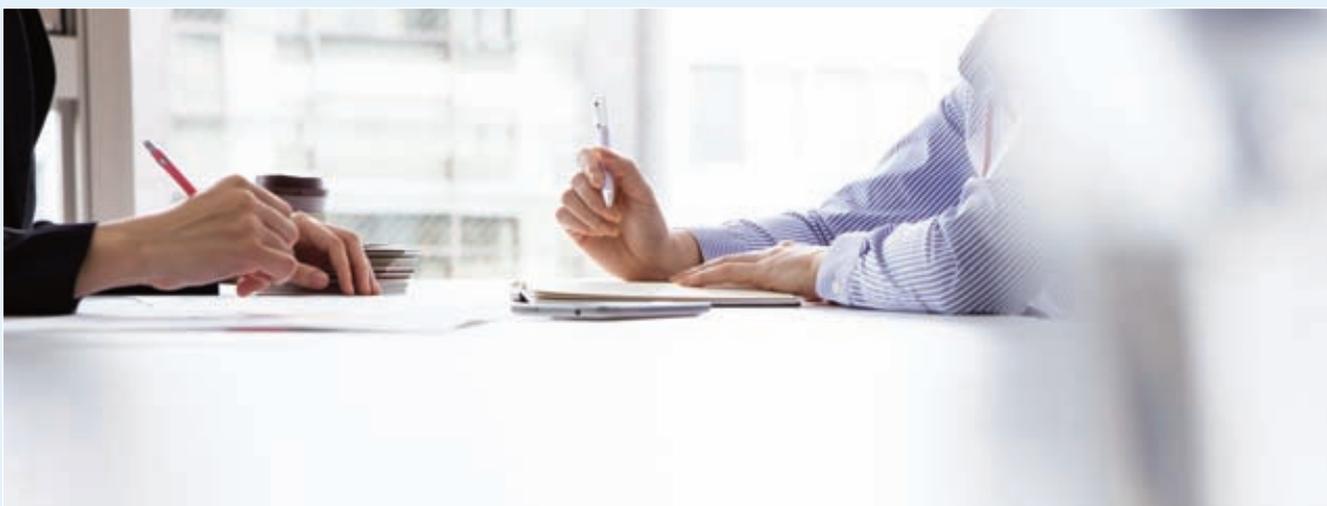
The first step for identifying Conduct Risk in the area of product sales and advice would be to assess which are the applicable drivers (using, as an example, the FCA’s model for Conduct Risk drivers, as outlined before), i.e. how Conduct Risk can emerge in the process of selling products and/or advising customers.

Each of the Conduct Risk drivers needs to be assessed from the perspective of product sales and advice, to understand how relevant they are in this process:

Fig. 12. Examples of dashboards monitoring different KRIs, including information on complaints



<b>Drivers</b>		<b>Applicability in Product Sales and Advice</b>
Inherent	Information Asymmetries	A very important factor in the selling of retail products, as customers having incomplete information may result in them making decisions which do not represent the best possible outcome. Information asymmetries may therefore signal improper or incomplete provision of information to the customer and hence constitute a key source of Conduct Risk in the selling/advising of products.
	Biases & Rules of Thumb	Consumers may not always make decisions based on rational factors, and instead tend to employ various mental shortcuts. This can lead to the purchase of products that do not meet their financial needs. In the past, this has been exacerbated by customer advisers taking advantage of such biases to boost sales, which forms a clear case of misconduct. As such, the provider of the product/service (in this case, the staff advising the customer) needs to clearly demonstrate the value that the customer would get out of it.
	The growing importance of financial capability	Client advisers may sometimes overestimate their clients' understanding of financial information. This can give rise to Conduct Risk, as in some cases (e.g. in vulnerable customers) clients are not able to fully understand what is being presented to them, and hence may not make the most appropriate decisions.
Structures & Business Conduct	Conflicts of interest	This could involve branch employees or advisers acting in a way that benefits themselves (in order to hit selling targets, or any metric used to measure its performance) rather than acting in a way that ensures the protection of the customer.
	Culture and incentives	Improper incentive schemes may result in customer advisors recommending products to clients that are not tailored to their needs, in order to benefit from high commissions. In the past, this has been a common source of Conduct Risk in the process of selling products.
	Market Structures	A lack of competition in a product category may result in retail customers having a limited choice of providers.
Environmental	Economics and the market	Developments in the economic environment may affect the selection of products that a bank offers to its clients and well as specific product variables (e.g. price). As such, this driver of Conduct Risk is not applicable to product sales and advice, but rather to the development of the product portfolio and design of specific products.
	Technological Factors	Developments in technology have altered the way in which consumers select and purchase banking products, streamlining the process and increasing the information available to them. However, technology may also be the source of Conduct Risk during the selling of products: innovation in a bank's offering may result in more complex products offered to customers through a wide range of channels, who might have difficulty assessing their features. Increased data availability as well as enhanced analytics capabilities of banks could lead to certain higher risk consumers being priced out of the market.
	The policy & regulatory environment	The process of product sales and advice has been influenced greatly by the recent regulatory agenda, however this factor refers to the uncertainty that banks face with respect to increased requirements to change (fuelled by the regulatory environment), which may lead to withdrawal of banks from offering certain products without fully evaluating how to operate in the new regulatory landscape.



Most of these factors would be present and applicable to the product sales and advice process. However, based on the market practice, and for the purpose of simplification, we will highlight the following as the key drivers:

- ▶ Information asymmetries between advisers and customers
- ▶ Biases and rules of thumb used by customers when selecting products
- ▶ Financial capability of customers
- ▶ Organisational culture and incentives affecting the way in which sales staff conduct their duties.
- ▶ Technological developments and market structures that do not result in effective competition for a given product.

### Risk Appetite and Key Risk Indicators

Once the applicable drivers have been identified, the next step in the process would be to determine a bank's appetite with respect to Conduct Risk for product sales and advice. This process essentially refers to linking the drivers of Conduct Risk with assurances that they will not materialise. Such assurances take the form of appetite statements.

In contrast to other risk types, appetite statements for conduct tend to be absolute, defining a zero tolerance for misconduct in any process. In general, statements are developed for each business process (e.g. product design, sales and advice, etc.). However, such statements tend to be generic, and are therefore followed by sub-statements outlining the organisation's objectives with respect to each statement. These sub-statements need to be comprehensive enough in order to address all Conduct Risk drivers identified in relation to the business process that they refer to.

Each of the sub-statements is then linked to a set of Key Risk Indicators (KRIs) intended to measure the organisation's performance in achieving the objective set. In some cases,

sub-statements may be expressed via only one KRI; in other cases however, financial institutions may have to calculate a group of KRIs to measure a particular sub-statement.

For illustrative purposes only, the next page provides an example of an appetite statement for product sales and advice, followed by a set of indicative sub-statements and the type of KRIs that would be used to measure them:

### Management Information and Reporting

Following the articulation of all sub-statements relating to product sales and advice and their respective KRIs, the KRIs will be monitored on an ongoing basis, to ensure that the financial institution is operating within the defined Conduct Risk appetite.

For every conduct KRI defined, it is essential to set a limit of acceptable values (e.g. minimum hours of training for sales staff or maximum number of defaults for a given product), along with an alert and escalation mechanism for when these thresholds have been breached.

An example of a KRI used in the case of product sales and advice is that of complaints. Commonly used across the industry, complaints analysis allows financial institutions to understand what went wrong in the process of selling products and advising customers. As such, an increase in the inflow of customer complaints for a certain product beyond the defined thresholds may indicate that sales staff are not explaining the product's features to customers in an adequate way. Therefore, such an event would be followed by an escalation of the issue for further discussion and decision making.

Figure 13 shows an interactive dashboard<sup>24</sup> used for monitoring the performance of conduct KRIs, the breaches of thresholds and corresponding alert triggers. In this particular example:

<sup>24</sup> Dashboard developed by Management Solutions, and implemented technically by Luxoft

Fig. 13. KRI comparison against thresholds



Dashboard developed by Management Solutions, and implemented technically by Luxoft

## Appetite statement

*Product Sales and Advice - Sales of products and advice offered to customers must be conducted in such a way that ensures good customer outcomes*

Example of sub-statement	Example of KRI or families of KRIs
Sales staff and advisers must be fully and appropriately trained, qualified and supervised	The amount of targeted and accredited training for customer-facing staff will be analysed and compared with Quality Assurance issues and Complaints raised. Outliers in the data regarding staff training will be analysed as they can indicate potential shortcomings in training provided to employees.
All sales must be made to the target market identified unless a waiver has been approved having gone through the formal governance	The sales conducted outside target markets and approvals for such will lay the foundation of the analysis. The proportion of approved waivers will also be taken into account.
Sales must only be made to customers to address an established need and are suitable / affordable given their individual circumstances	Metrics will involve looking into the various customer segments and the corresponding revenue level and default rate.
Sales must be subject to an internal quality assurance to monitor sales quality and practices	Metrics will focus on the processes and areas covered by Quality Assurance and the outcome of the Assurance analysis performed.
Independent monitoring of sales must be conducted to monitor sales quality and practices	Metrics will include the number of various Control test activities and the result of such, as well as Quality Assurance Issues
Customers must be given adequate and clear information at the point of sale to allow them to make an informed choice	The result of customer complaints handling in terms of different geographical areas and customer segments as well as products with incomplete information will be the basis of the metrics
Customers must not be pressured into making decisions and are given adequate time to make an informed decision	The metrics will include the quantity and segmentation of customer complaints as well as the timeframe of customer response and defaulting. Furthermore, a post-sale Customer Experience Survey will be used in measuring the amount of customers experiencing pressure
Customers must be made aware at the point of sale of the fees, exclusions, eligibility criteria, claims criteria and charges that apply and the circumstances in which they would be applied	The metrics will include products with incomplete information, the quantity and segmentation of customer complaints and amount of new transactions susceptible to require the delivery of pre-contract information
All fees and charges applied to customer products, accounts or services must be clearly communicated and outlined prior to, and at the point of application	The metrics will analyse customer complaints on product charges
Customers must be provided with clear and accurate information, by the most effective delivery channel, to allow them to be aware of, and take advantage of any product offer which may improve their financial position	The marketing material sent to existing customers will be analysed in relation to total marketing material sent. Furthermore, the frequency of updates sent to customers regarding their individual account will be used for measuring the delivery of information



Fig. 14. Example of heatmap and RCSA analysis for Conduct Risk (as a sub-set of Operational Risk) performed with an internally developed tool, SIRO®



Source: Management Solutions, 2016

- ▶ KRIs have been classified across four categories (Product Design, Distribution, Complaints and Post Sales)
- ▶ Each of the categories has a RAG (Red, Amber, Green) status, depending on how many of the KRIs within that category have exceeded their threshold, and which includes a weighting factor (materiality).
- ▶ The overall dashboard can then be modified to display the performance of individual KRIs under each category. In this way, it provides drill-down and data discovery capabilities.
- ▶ The sales system requires a set of inputs and internally computes affordability analysis before the transaction can be completed.
- ▶ The terms of reference that the customer must sign include an executive version and real examples of what the product might cost / how it might perform in specific circumstances.

Such controls aim to eliminate the Conduct Risk, as identified through the process of defining the Conduct Risk appetite.

### Risk Control Assessment

As described earlier, the process of monitoring exposure to Conduct Risk through the use of metrics is complemented by a Risk Control Assessment mechanism, as a means to ensure that the current controls in place are effective mitigants of the Conduct Risk originated in the product sales and advice process.

Financial institutions will use a wide range of controls to mitigate the different Conduct Risk drivers identified. In the particular case of product sales and advice, the controls might include:

- ▶ Front-office system will not allow the execution of a sale for products that have not obtained a sign-off from the Product Monitoring Committee, or will not allow a customer to be selected, for the sale, that is not part of the target market for that particular product.
- ▶ System checks that require the customer's sign-off to confirm that they have read and understood the product's terms & conditions before the product can be processed in the back office

A first control assessment might be performed through a 'Risk Control Self-Assessment' (RCSA) capability, whereby testing of the controls is executed by the staff whose duties fall within the remit of the process to which each control applies. This approach leverages on the detailed knowledge of the employees in the business to identify where the risks are likely to occur. As such, control effectiveness is assessed and improvement plans are developed jointly with the Assurance teams. The RCSA exercise may be executed via self-audit performed by the users, completion of questionnaires, and control model workshops held between the users, as well as via various other approaches.

Controls are also subjected to an independent assessment by the Assurance function, which tests their effectiveness through an independent Control Assessment Process in order to identify where Conduct Risk has materialised in spite of these controls (i.e. the residual risk).

This can involve various techniques and organisational approaches:

- ▶ Quality Assurance function: in some cases, a specialised QA function embedded in the first line of defence (different from Risk Assurance, which will perform independent oversight from the second line of defence) covering the



different areas involved in the sales and advice process. The function typically reviews the processes in place and identifies any issues associated with them, which have the potential to give rise to instances of Conduct Risk. The process of quality assurance can include reviewing a sample of physical files to ensure adequate documentation of processes, listening to recorded client calls, and also shadowing sales employees.

- ▶ **Mystery shopping:** banks can use a mystery shopper to gain an insight into their sales and advice process. This may include an assessment of the customer experience, the behaviour of its sales employees, the effectiveness of their sales staff, treatment of vulnerable customers, and disclosure of information to clients, amongst other factors. The process is then rated for each of these categories, and scores are monitored over time. For areas scoring low on a consistent basis, Assurance identifies improvement plans to ensure Conduct Risk is mitigated.
- ▶ **Complaints Root Cause Analysis:** although complaints figures are monitored as part of the process of measuring the bank's adherence to its risk appetite, it is essential for banks to also review the root cause of individual customer complaints, as it can help them trace the issue to the stage of the sale/advice process where it originated and understand where controls failed to prevent Conduct Risk from materialising.
- ▶ **Client Contact:** often, it may be necessary to complement complaints data with additional information from customers. As such, financial institutions can call a sample of clients after the sale of a product, to understand not only how they perceived their customer experience, but also

how well they understood the product they have purchased. This is an effective practice, as it may be the case that customers themselves do not realise that they have been mistreated (for example, this was the case with some PPI customers who were not aware that they had purchased payment insurance).

- ▶ **Thematic Reviews:** to test whether a set of controls is effective in preventing Conduct Risk within product sales and advice, thematic reviews can involve conducting reviews of various stages of the end-to-end process, in order to identify where Conduct Risk is incurred. This can include an assessment of the training offered to client facing staff to ensure it gives adequate weight to mitigation of Conduct Risk. It can also include an analysis of the latest regulatory requirements against the bank's current processes, in order to understand whether they are being compliant. In addition, thematic reviews may also consider the governance framework for escalating control breaches, as it may be the case that controls indicated potential misconduct, but this was not taken into consideration by senior management.

Following the control testing process, usually the Assurance function is able to gain an independent view of the residual risks across the organisation, which are then rated according to the different levels of risk posed, based on probability, severity and frequency.

Moreover, those risk levels can be traced back to different dimensions of aggregation and analysis. One of the dimensions would be the drivers of Conduct Risk, thus demonstrating which of the drivers are more likely to materialise.

Fig. 15. Product Sales & Advice Conduct Risk Map



Source: Management Solutions, 2016

This relationship can then be represented by an Assurance heatmap, outlining the Conduct Risk levels per driver and product:

The heatmap in Fig. 15 illustrates the levels of residual Conduct Risk that each driver poses to the bank, split per process (i.e. sales and advice) and product. This heatmap can also be represented in various levels of detail (i.e. in deeper detail, showing the Conduct Risk levels per channel and even process, or more aggregated, demonstrating the risk for each business, e.g. Retail, Corporate, etc.).

Each cell has been rated as a result of the controls outlined earlier; for example, a 'Red' in the Advice of Mortgages with respect to Information Asymmetries may be the result of a mystery shopping exercise that demonstrated that inadequate controls allow staff advising customers to misinform them about the relationship between floating mortgages and movement in market variables. Furthermore, an 'Amber' in the Sales of Credit Cards with respect to Financial Capability may be the result of products sold to customers that did not meet the minimum credit requirements, thus signalling the failure of the respective control for that process.

This work provides, in a number of cases, a statistical sense check and effective challenge to the RCSA process and the rest of mechanisms used across a bank to assess the exposure to Conduct Risk in the organisation.

### Data Analytics and Big Data

The heatmap in Fig. 15 is therefore a useful tool for financial institutions to monitor their exposure to Conduct Risk over time, as well as for prioritising areas of improvement.

However, in almost all cases, the mechanism above:

- ▶ Relies on a well-structured methodology, that requires a certain timeframe to be executed (RCSAs every 3 months or 6 months, assurance plans that have a yearly time horizon, etc.)
- ▶ Are based on the measurement of the existing control infrastructure, and are not always forward looking.

Given the potential negative impact that Conduct Risk events will have for the organisation, an increasing number of financial institutions are complementing their risk measurement framework with a very proactive, forward looking approach to risk identification.

This is usually done by leveraging on big data techniques and infrastructure. Some examples of such capabilities are highlighted on the next page.

## ***Outliers in Sales Data***

- ▶ Examining units that are outperforming the rest of the bank in sales figures may highlight some shortcomings in the sales process.
- ▶ For example, a bank may identify that a branch is recording exceptionally high sales figures in retail investment products, and decide to launch a review in order to understand the root cause of the increased performance. This review may reveal that the branch has recruited several new advisers recently, who lack the experience of advising customers adequately. This may in turn indicate that the increase in sales is a result of customers purchasing products without having the caveats clearly explained to them, which might otherwise have deterred their decision; thus, in this instance, a Conduct Risk has materialised.

## ***Social Media Scanning***

- ▶ The abundance of information now available from social media means that banks know more about their customers and their perceptions than ever before. Apart from the benefits with respect to marketing opportunities and reaching more customers via social networking, banks can also leverage on social media to improve their understanding of the customer experience they offer and identify any shortcomings with respect to Conduct Risk. This can take the form of sentiment tracking through social media, monitoring of customer posts/reviews on social media with respect to their experience in receiving advice, as well as tracking of comments submitted by customers in other media (e.g. news articles). This will ensure that products are aimed at the right customer group and advice is better tailored to the client, thus minimising the likelihood of misconduct in the advice or sale of a product.
- ▶ For example, a retail bank may decide to monitor the number of references it receives on social media, such as Twitter:
  - ▶ To extract more validity from this process, a mechanism is implemented for tracking the number of references coming from specific geographical regions, which leads it to notice an upward trend of customer comments regarding the bank in northern Germany.
  - ▶ This could prompt the bank to review the reason for this upward trend, which reveals that customers have been posting negative reviews on Twitter regarding the advice they received on their savings products; thus the bank is able to launch a review and discover that customers of a certain branch in that region have been sold products without fulfilling all the requirements for being eligible.
- ▶ In this example, social media monitoring assisted the bank in identifying misconduct. It should also be noted that if the bank received only an aggregated view of activity in social media (e.g. comments regarding the bank on Twitter throughout the country), it may not have been able to identify a potential issue, as the increase of comments in a particular region may have been 'normalised' by stable activity across the rest of the country. Therefore, having the capacity to deploy more specific analyses (as opposed to high level scanning) makes it possible to yield meaningful results.

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## ***Leveraging on Big Data Capabilities***

- ▶ By utilising all the data available to them, banks will be in a position to better understand their customers' needs as well as their financial position. Increased information will result in credit scores carrying more validity, and improved customer insight will translate into exquisitely targeted recommendations; thus, products sold to customers will be more aligned to their needs and financial position, hence reducing the risk of customers purchasing products that are not right for them.
- ▶ For example, a bank utilising big data may complement its risk models with data stemming from non-traditional sources, such as customer spending habits, to get a deeper insight into customers' profiles, the type of products they favour, as well as how prudent they are, in addition to other aspects. This insight can then be used when advising the customer on what products are more suitable to them, based on the information that the bank has available on the customer's preferences and financial position.

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# Glossary

ASIC: Australian Securities and Investments Commission

BCBS: Basel Committee on Banking Supervision

BIS: Bank for International Settlements

CR: Certification Regime

EBA: European Banking Authority

EMIR: European Market Infrastructure Regulation

ESRB: European Systemic Risk Board

FCA: Financial Conduct Authority

FEMR: Fair and Effective Markets Review

FICC: Fixed Income Clearing Corporation

FOFA: Future of Financial Advice

FSA: Financial Services Authority

FX Probe: Forex Probe

G-SIB: Global Systemically Important Bank

KID: Key Information Document

LIBOR: London Inter-Bank Offered Rate

MAD: Market Abuse Directive

MAR: Market Abuse Regulation

MAS: Monetary Authority of Singapore

MiFID: Markets in Financial Instruments Directive

PPI: Payment Protection Insurance

RCSA: Risk Control Self Assessment

SMR: Senior Managers Regime

TCF: Treating Consumers Fairly





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