Conduct Risk – Doing what is "Right"

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With regulators around the globe growing teeth and using their supervisory powers, banks globally have been confronted with a huge wave of new regulatory requirements. In addition they have also been dealing with game-changing and previously unseen fines to repent their sins of the past.

Given the ongoing public perception that the financial services industry has lost touch with society and that ethics and principles have not appeared to play a prominent role as to how firms conduct themselves, this area is rapidly becoming the main focal point for financial regulators globally.

After the fall-out of the financial crisis, regulatory attention has been heavily drawn towards firms' conduct, meaning the behaviour of banks and financial institutions. Recent changes in the UK supervisory model, culminating in the establishment of the Financial Conduct Authority (FCA) are indeed evidence of the shifting focus towards 'conduct risk'.

Conduct risk is here to stay and needs to be at the heart of banks' strategies, business models, risk appetite frameworks and **everything** these firms do. Consequently, the conduct theme and in particular sound behaviours, need to be embedded into each and every firm's cultural fabric, not simply to in order to satisfying regulators' desires but more importantly, to survive the new financial world order.

Defining Conduct Risk

Although there has been a lot of noise recently related to 'Conduct risk', accompanied by a range of academic research and practitioners' white papers, a clear definition of the term itself is quite hard to come by. The FSA previously gave some guidance in the Retail Conduct Risk Outlook 2011 but with a focus on retail conduct risk:

> **"Conduct risk – that is, the risk that firm behaviour will result in poor outcomes for customers."**

Although a good starting point, when taking the FCA's new strategic objectives into account, namely consumer protection, safeguarding the financial system and ensuring effective competition – which naturally also include wholesale markets, it is tempting to define it somewhat more holistically:

> **"Conduct risk is caused by action(s) – or inaction – of an individual financial institution or the financial services industry that result in customer detriment, negatively impacts market stability or restrict effective competition."**

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'People' or 'Conduct' Risk within the Operational Risk Landscape

Where people design or manufacture products, including the provision of financial services, things can (and frequently do) go wrong. Naturally, this includes areas such as poorly designed processes and procedures as well as shoddy pieces of software or incomplete code of algorithmic models, to name a few. This is what is largely known and often referred to as 'people risk'.

In contrast, other operational risks that are not attributable to 'people' are thought of as and are considered to be caused by an 'external factor'; essentially this would fall into the more traditional 'external events' Operational Risk category under Basel II. This includes the likes of natural disasters, terrorism, cyber attacks, phishing and the like.

Assuming most natural disasters and other external events are uncontrollable, we may conclude that people risks are – at least in theory – controllable, albeit some with limitations. Most, if not all people risks, are somewhat due to inappropriate conduct; with the caveat that appropriateness is somewhat depending on the individual circumstance and/or context that is being observed.

Consequently, inappropriate behaviour or misconduct may be considered as one of the main root causes of people risk.

The Nuances of "Right"

Whilst the management of conduct risk in general and the FCA in particular is focused on 'doing the right thing', this does beg the question how to define what is 'right'?

There certainly appear to be several nuances of doing the 'right' thing, such as

- **You're instructed;** i.e. being obedient and compliant with rules
- **For the right reason;** i.e. something that is appropriate but may not agree with formalised rules
- **For others;** i.e. ignoring one's own needs and wants by doing something selflessly for others

Looking at these different nuances, you may argue that the regulatory model, i.e. the rules-based approach, would have been perfectly satisfied by ticking all the regulatory boxes, meaning as firms have been told what to do by the regulators.

However, in the new supervisory world and from a conduct risk perspective, this is not sufficient: Firms need to be aware that the regulators, and in particular the FCA in the UK, are keen on firms doing things right. This means selling the right product to the right customer at the right time under the right circumstances, and also constantly evaluating whether something that was previously right is now not appropriate anymore.

In theory, this sounds fairly simple and straightforward, but in practice this is likely going to pose a major challenge for most, if not all firms. And naturally, it will take some time to instil this approach into firms' corporate cultures by bringing it to life.

Regulatory pushes into areas of 'Conduct'

Since the Financial Crisis in mid-2007, regulatory approaches evolved away from rules-based and towards risk-based regulation. In fact, with the creation of the FCA, there are now one (out of two) supervisory bodies in the UK specifically focussing on conduct and with the following beneficiaries and stated outcomes in mind.

- **Consumers** get financial services and products that meet their needs from firms they can trust
- **Firms** compete effectively and have the interest of their customers and integrity of the market at the heart of how they run their business
- **Markets and Financial Systems** are sound, stable and resilient with transparent price formation

On the continent and across Europe, with a future possibility for the centralisation of prudential banking supervision, there is the expectation that the national supervisory authorities (NSAs) are more likely going to focus on conduct risk, similar to the development we have seen in the UK. As such, the UK is somewhat seen as a first mover in the regulatory space and developments here are certainly closely being monitored by both, the regulatory community as well as regulated firms themselves.

Having said that, whilst common themes in the conduct space will continue emerging and will be addressed by the regulators affected, there is likely going to be much less convergence for conduct risk when compared to prudential regulation.

Conduct Risk Performance Measurement

Given the areas under particular scrutiny by the FCA from a conduct risk perspective, namely

- Consumer protection,
- Effective competition and
- Robustness of the financial markets and systems,

it is important to understand within this context how the FCA will supervise firms in the UK. The supervisory model in order to monitor these areas will be based on the following three key pillars:

- **Firm Systematic Framework (FSF),** which mainly comprises structured assessments of firms in order to prevent mishaps

- **Event-driven supervisory work,** allowing to address problems more pro-actively as they emerge, by deploying better use of market surveillance and analytical intelligence

- **Issues and Product-driven supervisory work,** mainly driven by sector risk assessments addressing issues which may cause potentially poor outcomes for consumers and market participants.

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The **Firm Systematic Framework's (FSF)** particular focus is an assessment of the firm's conduct risk and closely examines firms for the following:

- Business model
- Strategy
- Conduct embedment of Treating Customers Fairly and Market Integrity by assessing:
  - Governance and Culture
  - Product Design
  - Sales and Transaction processes
  - Post-sales /services and Transaction handling.

The purpose here is to measure the sustainability of the firm's business in respect of conduct and with a view of identifying future risks to the firm, its customers and the stability of the market. This somewhat represents a refreshed Business model threshold condition check that firms will have to undergo when receiving their initial regulatory authorisation.

Following the FSF, the FCA decides remedial actions firms will need to take and communicates these to them. The frequency and scope of these assessments is determined by the conduct supervision category for the firm:

FCA Conduct Supervision Category	Firm's characteristics	Supervisory classification	Firm systematic framework activities & frequency
C1	Banking and Insurance groups with a very large number of retail customers. Universal/investment banks with very large client assets and trading operations.	Fixed portfolio	Continuous assessment Following the analysis by working through the assessment on a two-year cycle.
C2	A substantial number of Retail customers Large Wholesale firms	Fixed portfolio	Continuous assessment Following the analysis by working through the assessment on a two-year cycle.
C3	Retail Customers and/or A significant wholesale presence	Flexible portfolio	Focus on firms that are outliers compared to their peers. Focused review of their business, how it's run and how it's controlled.
C4	Smaller firms Including almost all intermediaries	Flexible portfolio	Lighter assessment than for C3 firms. 'Touch point' with all C4 firms once every four years.

(Source: "Journey to the FCA", October 2012, see Reference & Further reading section below)

your firm, essentially meaning you need to actively develop and articulate how your firm is tackling conduct risk.

Of course, this needs to come **straight from the top,** i.e. the Board, requiring strong cultural leadership, and then cascade through all organisational cracks and crevices in order to embed conduct risk awareness throughout your organisation. This includes policies and governance and building the capability to measure it with suitable key performance indicators and management information and regulatory reporting systems.

As part of this approach, you need to **embed conduct risk management** into the product design process of your firm, as this is one of the key areas of regulatory scrutiny with a focus on transparency and simplification.

And yes, your board and senior management needs to be aware that supervisors globally have started looking increasingly not only at much tougher penalties but also considerably more criminal prosecutions by **holding individual persons liable for wrong-doing of their firms.**

Doing what's right by not just ticking the regulatory compliance box but also right within reason should help

What's next: And how can your firm address these new requirements?

The broad definition of conduct risk outlined above implies that this is **prevalent throughout your firm's activities and largely driven by the principles and spirit of good conduct** and not just a simple ticking of regulatory compliance boxes.

Hence, it needs **a clear definition of this risk type and an assignment of conduct-related responsibilities** throughout

reducing the risk of an individual's prosecution - but it requires an almost continuous self-reflection and self-assessment by asking:

- **"Should I/we be doing this?"**
- **"Is it right now and will it be considered to be right later?"**
- **"How would this decision look to others, including the regulators from the conduct risk perspective?"**

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And by the way, just in case you wondered, **'doing nothing' is also a decision to doing something** (i.e. being consciously inactive and accepting the status quo), so if you are discovering wrong conduct in your firm, turning a blind eye because it generates profitable business and always has been, will not protect you/your firm when good conduct is concerned.

What does it mean for me and my firm?

As evidenced recently by the USD 13billion fine imposed on JP Morgan as well as other banks and financial institutions, regulators globally are sharpening their teeth and expertise to improve behaviour and market conduct throughout the industry. **Conduct risk is at the centre and key driver of many supervisory initiatives.**

If your firm is not managing these risks pro-actively by addressing conduct-related issues head-on, then you may be in for a rude awakening meaning more heavy fines, potentially imprisonment, reputational damage and probably most important, an exodus of your customers.

In addition, you may be subjected to increased regulatory scrutiny, including temporary closure and/or restrictions on your trading & other business activities limiting your competitiveness.

By selling the right product in the right circumstance and the right time to the right customer, you are doing what's right for both, your firm and for society.

You and your firm are playing a crucial part in this but you need to constantly question yourself and your employees whether or not if it what they are doing (or not) is 'right'. That is the real challenge and one that will not go away – if anything, will intensify further.

Conclusion:

Pro-active conduct risk management is not a luxury; it is a necessity ensuring regulatory and commercial sustainability by benefiting your customers as well as your firm.

The author invites your comments via email to MK@riskrewardlimited.com

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NOTES
1) See also Roger Steare, The Corporate Philosopher, http://www.thecorporatephilosopher.org/
2) See also "Journey to the FCA, October 2012", http://www.fca.org.uk/static/documents/fsa-journey-to-the-fca.pdf

REFERENCES & FURTHER READING

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