Conduct Risk: what is it and can you measure it?

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Partner
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Agenda

1. What is Conduct risk and how does it impact

2. First - some context
   • Back to basics – I know what it is when I see it

3. How big is the issue (UK experience vs Australia)
   • TCF on steroids or something new?
   • FCA Core Conduct Risk Assessment

4. If you want to manage it, can you measure it?
   • Setting and managing conduct risk appetite in the new world
   • What should the conduct risk framework focus on?
   • Firms have the data, but it gets lost in translation
   • Real Conduct MI drives better outcomes vs classic “TCF dashboards”

5. Questions
What is conduct risk
### Compliance: the 16:1 equation

<table>
<thead>
<tr>
<th>Problem Statement</th>
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</thead>
<tbody>
<tr>
<td>Expectations of future conduct risk governance/frameworks</td>
</tr>
<tr>
<td>Peer group response</td>
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</tbody>
</table>

#### Key themes

- Compliance cost is rising inextricably
- Effectiveness of current frameworks are inadequate at best
- Conduct risk is arguably the UK’s most material and least understood risk issue
- Current model is not fit for purpose in the new world
- Art needs to be turned into science:
  - Predictive
  - Objective
  - Automated
- And be self-funding?
- Cost/efficiency of existing model (‘where is my money spent and on what?’)
- Re-orientating existing MI to conduct risk outcomes
- Re-wiring conduct risk framework and measures into the end to end business model
Back to basics – I know what it is when I see it

### Conduct Risk characteristics
- Aggregation of many events, most small ticket items, some not
- High probability
- Distinction between misconduct and detriment with time lag between them
- Scale of detriment may be contingent on market movements: should that affect how severely behaviour is viewed?
- Waterbed effect: clearing up one issue may just move the problem if incentives not fixed.
- Impact of the same monetary loss different for different consumers
- Potential for multiple risks to accumulate in the bank

### Cultural fault lines (appetite versus behaviour)
Recent enforcement action by the FSA appears to highlight possible fault lines between firms’ desired culture’ and actual behaviours

<table>
<thead>
<tr>
<th>Firm</th>
<th>Issue</th>
<th>Fine</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Line/Churchill Insurance</td>
<td>Complaints handling</td>
<td>£2.8m</td>
</tr>
<tr>
<td>Santander</td>
<td>Misleading literate on Structured Products and coverage by FSCS</td>
<td>£1.5m</td>
</tr>
<tr>
<td>HSBC</td>
<td>Investment advice and sale of investment products by NHFA</td>
<td>£10.5m</td>
</tr>
<tr>
<td>Combined Insurance</td>
<td>Unsuitable advice and complaints handling</td>
<td>£2.8m</td>
</tr>
</tbody>
</table>
How big is the issue – UK v Australia
How big is the issue – UK v Australia

Recent costs of remediation

<table>
<thead>
<tr>
<th>Country</th>
<th>Costs</th>
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<tbody>
<tr>
<td>US</td>
<td>$25B on residential mortgage lending</td>
</tr>
<tr>
<td>US</td>
<td>$445M on unfair, deceptive, abusive acts and practices</td>
</tr>
<tr>
<td>UK</td>
<td>£10B on payment protection insurance</td>
</tr>
<tr>
<td>HK</td>
<td>Up to $2B to compensate investors in Lehman Brothers structured products</td>
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</tbody>
</table>
TCF* on steroids or something new?


- Financial
  - Financial performance targets

- Strategy
  - Propositions and brands

- Infrastructure
  - Core business processes
  - Operational infrastructure and technology
  - Organisational structure and governance

- Behavioural
  - MI and KPI dashboard
  - People and culture

* - Treating Customers Fairly

Existing Controls are not holistic or joined up

Compliance advice/support
Product Development Process
Product Review Process
Marketing Compliance – Literature Review
Unfair Contract Terms Review
Root Cause Analysis - Escalations & Complaints
Findings from GIA & Compliance Monitoring Reviews

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FCA* Core Conduct Risk Assessment will have a fundamental impact throughout organisations

- Whole of market/sector-wide review
- Firm/peer group review
- Product/thematic interventions
- Governance & behavioural effectiveness
Regulatory developments timeline – UK/EU and Australia

- European Market Infrastructure Regulation (EMIR) / Centralised Clearing for Derivatives
- Retail Distribution Review
- Recovery and Resolution Planning
- Consumer Credit Regime
- Banking Conduct Regime

Timeline:
- 2009: Compliance
- 2010: Implementation
- 2011: Further developments
- 2012: Ongoing
- 2013: Completion
- 2014: Final stages

UK and Australia

- EU/UK
- Australia

(Implementation of recommendations – by 2019)

(Implementation of recommendations – by 2019)
How do you manage it?
Setting and managing conduct risk appetite in the new world

Reduced/No profits
‘Too expensive’
Reduced likelihood of regulatory intervention and remedial work
Zero LTV
Cost of control means product is unviable

Short term high profits
Historic data suggests increased likelihood of regulatory intervention, remediation and reputational risk

Zero Risk Tolerance
‘Too Risky’

Long term value and trust

Potential Conduct Risks Areas

- Market/environment
- Proposition/brands
- Clients
- Core Business Processes
- Operations and Infrastructure
- People and culture
What should the conduct risk framework focus on?

From a fundamental perspective putting a value on Conduct Risk should be straightforward considering the drivers of risk to the bank and its customers:

- **Design**
  - Should be set very low
  - Design risks
    - Intrinsically complex
    - Target market difficult to identify with precision
    - Potential misalignment with regulatory standards or expectations
    - Represents poor value for money for customers
    - Product profitability

- **Execution**
  - Should be set low
  - Execution risks
    - Poor staff understanding and/or weak T&C
    - Process deficiencies or manual workarounds
    - Suitability of advice not demonstrable
    - Adverse impact of sales targets and reward and incentive
    - Control weakness/failure
    - Sales volume volatility

- **Environmental**
  - Low probability, high impact
  - Environmental risks
    - Product performance
    - Macroeconomic factors
    - Regulatory intervention and focus (at product/industry level)
    - Media or consumer group focus
    - CMC activity
    - Emerging themes from Conduct Risk Outlook

Cost

Investment in conduct risk mitigation

*versus*

the cost of repeated public and regulatory scrutiny
Firms have the data, but it gets lost in translation
Real Conduct MI drives better outcomes vs classic “TCF dashboards”

Assessment methodology can be used to:

- Anticipate emerging risk within the business and operating models
- As a test of ‘operation or experience’ against ‘design or expected outcome’

Financial

- Financial performance targets
- Markets

Strategy

- Propositions and brands
- Clients
- Core business processes

Infrastructure

- Operational infrastructure and technology
- Organisational structure and governance
- People and culture

Behavioural

- MI and KPI dashboard
- Measures and incentives
Exam questions

What is the organisation's expected loss tolerance on individual products, books, or service lines: with respect to conduct?

In terms of scenario planning, what is the unexpected loss tolerance on the same book?

What would the Board’s initial response be if an executive suggested to withdraw from this market?
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