

Global Risk Watch Newsletter

A Holiday for Global Risk-Off, etc.

Global Risk Watch Vol.12
25 March 2016

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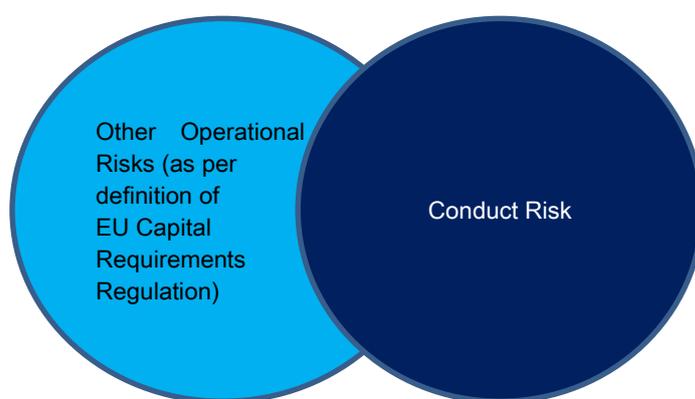
2. Overview of Development in Financial Regulations (Trends & Topics)

The Direction of Conduct Risk Management Framework (Koichi Iwai, Senior Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

As it has been introduced several times in this column, Conduct Risk is not only the important theme of the recent financial regulation and supervision, but it has also become a very critical risk from the viewpoint of financial institutions management. Typical examples of Conduct Risk was the misselling (inappropriate sales) of mortgage products in the US, and manipulation of financial indicators such as the LIBOR (London Interbank Offered Rate) cases. The scope of misconduct has recently expanded to unfair competition and 'sophisticated' financial practices such as the use of algorithm trading. Therefore, financial institutions are faced with increasing potential losses in relation to Conduct Risk.

While managing Conduct Risk has become a challenge in the business management among banks, EBA (European Banking Authority) released implementation procedures for stress testing on February 24th, and presented specific methodologies to measure Conduct Risk. Since this EBA document specifies the approach in stress test, financial institutions are not required to follow the EBA methodology to manage Conduct Risk on a day-to-day basis. However, this EBA approach should be indicative of where the Conduct Risk management practice is heading going forward.

In the released EBA's stress test standards, Conduct Risk is defined as "the current or prospective risk of losses to an institution arising from an inappropriate supply of financial services, including cases of willful or negligent misconduct". Although this definition is noted to be 'vague', it is also worth noting that "Other operational risk" is defined as the portion of the overall operational risk but Conduct Risk. In other words, EBA's definition clearly indicates the overlap between Conduct Risk and Operational Risk, and the overlap areas are recognized as Conduct Risk.



In terms of Conduct Risk measurement methodology, both qualitative and quantitative approaches were presented. Qualitative approach is used to estimate a large scale Conduct Risk, basically projecting future losses by applying the range of settlement in each misconduct event and probability of occurrence. On the other hand, quantitative approach uses internal models, but can only be used for estimating relatively small scale Conduct Risk. In addition, the quantitative approach also requires a minimum standard that is based on five years of track record to be applied, affirming EBA's concerns for underestimation of risks through internal models.

At the same timing, the Basel Committee on Banking Supervision (BCBS) also issued the second consultation paper on operational risk capital framework. Although this document does not explicitly discuss Conduct Risk, the proposed new approach (Standardised Measurement Approach, SMA) is based on rigorous internal loss data management. Specifically, internally generated loss data for SMA must be based on at least a 10-year observation period while existing Advanced Measurement Approach requires 5-year loss data. In addition, the bank must collect information on recoveries of gross loss amounts as well as descriptive information about the drivers or causes of the loss event.

While Conduct Risk has begun to attract attention in Japan, management frameworks for this new risk category are still at a development stage among Japanese financial institutions. Considering the global trends and EBA / BCBS's discussion mentioned in the above, Japanese financial institutions perhaps reached a phase to get ready to figure out the appropriate definition and identification methodology for Conduct Risk, as well as the information collection & management framework for Conduct Risk.

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