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Global Risk Watch Newsletter

Central Banks are Faced with Deepening Agony as Monetary Policy Reaches its Limits, etc.

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

 # Conduct Risk Measures at a Crossroads (Koichi Iwai, Senior Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

As we have addressed this topic several times over the last year, conduct risk remains one of the key themes in financial regulatory reforms. It deals with conduct and incentive of employees in the financial institutions as well as various problems rooted in culture and tries to suppress undesirable actions of financial institutions such as mis-selling of financial products, manipulation of financial indicators, and money laundering. Conduct risk related regulatory and supervisory changes continue to take place, however, some recent developments seem to suggest that conduct risk related policy measures may have reach a crossroads. We will review the developments over the last month with regard to this point.

The European Banking Authority (EBA) published the results of EU-wide banking sector (51 banks) stress test in July, and these results revealed the magnitude of conduct risk impact on bank's capital position. Specifically, under the 3-year period adverse scenarios, conduct risk related losses alone deteriorated the overall capital adequacy ratio by 1.1% points. Moreover, conduct risk related negative impacts were larger than those by market risk and almost

1/3 of credit risk impact. Upon reviewing this result, European authorities will most likely to demand further enhancement of conduct risk management and also pose more stringent stance in this regards.

On the flip side, the side effects produced by authorities' rigorous stance on conduct risk have begun to surface. The Committee on Payments and Market Infrastructures (CPMI) has published a report on correspondent banking and revealed their concerns over the side effects. The report confirms that over past few years of rigorous greater regulatory controls and stringent enforcements, a number of banks were apprehended with 'Authorities Risk', thereby withdrawing from the correspondent banking businesses in order to avoid the occurrence of misconduct such as money laundering as much as possible. CPMI also pointed out that shrinking correspondent banking business will lead to a new (systemic) risk in the financial system, and may hinder 'financial inclusion'. Consequently, shrinking correspondent banking business signaled the 'unintended effect' created by ongoing authorities' policy measures to suppress conduct risk.

Consequently, authorities are facing with dilemma when dealing with conduct risk. If the authority strengthens regulations and enforcements, financial institutions will withdraw from business areas with higher likelihood of underlying misconduct and administrative sanctions, thus creating an unintended effect like the correspondent banking case, which ultimately weaken the functions in the financial system itself. On the other hand, a more lenient stance taken by authorities may avoid these unintended effects, but also potentially allow financial institutions to conduct unfair / improper behaviors to pursue maximum profit as previously seen and cause a decline in confidence in the financial system.

As for the policy makers, the time is coming close to rethink how to ensure an appropriate balance regarding conduct risk. Moreover, what would be the right approach? One way is to respect the autonomy of financial institution and let the financial institutions to set the conduct risk measures by themselves. Another (extreme) approach would be for the authorities to quash the concurrence of misconduct itself through laws and regulations and enforcements. Whether to choose one approach or follow the path in the middle, this might not be in the far future.

Financial Stability Board (FSB) is expecting to compile a misconduct related working report in September at the G20 Summit. Whether this FSB report will suggest more rigorous stance, or to ease off the pressures from the authority side and allow more independence for financial institutions to tackle conduct risk, FSB's decision may define the positioning of conduct risk in global financial regulation.