

# Global Risk Watch Newsletter

## Authorities' Stance on Conduct Risk became more and more clear

Global Risk Watch Vol.4  
28 July 2015

### Overview of Development in Financial Regulations (Trends & Topics)

#### ◆Authorities' Stance on Conduct Risk became more and more clear (Koichi Iwai, Senior Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Looking at recent regulatory developments, we could see how cautious regulatory authorities are against conduct risk (misconduct) and foresee the coming regulatory/supervisory framework to control the risk. Authorities recognize problems and inherent risks of misconduct from both micro and macro-prudential perspectives. Therefore, regulators acknowledge various measures are needed to address the conduct risk in financial sector. The countermeasures by regulators seem to consist of five pillars. Let us examine each pillar in line with regulatory reforms that occurred this month.

The first is to strengthen governance of financial institutions. Authorities recognize that the root causes of frequent misconducts are malfunctions of internal governance within financial institutions. Specific measures to strengthen internal governance might be, as shown in the final rules recently published by UK Financial Conduct Authority, (1) to clarify responsibilities/accountabilities for wide range of employees and punish individuals who failed to pursue their own responsibility and (2) to reform remuneration systems in order to avoid excessive risk-taking by employees.

The second is to control misconduct through capital requirements. In another words, imposing capital requirements, as a Pillar1 measure, on unexpected losses incurred by misconducts. Among this month's regulatory reforms, European Banking Authority (EBA) has shown its policy to explicitly define misconduct as an operational risk event in the final draft paper on Advanced Measurement Approaches (AMA). In addition, the European Systemic Risk Board (ESRB) has published a report on conduct risk in banking sector and recommended to require banks to set appropriate provision to cover expended losses incurred by misconduct.

The third measure is Pillar 2. The Bank of England and European Banking Authority have already stated to explicitly incorporate conduct risk in supervisory stress testing. This month, ESRB emphasizes the importance to evaluate conduct risk through stress test from the macro-prudential perspective and governance and risk culture as part of a supervisory review and evaluation process. It also underscores the importance for regulators to require banks to hold additional capital reserves in order to cover losses due to potential conduct risk.

The fourth development is empowerment of authorities and reform of regulatory scheme. For example, the report by the International Organization of Securities Commissions proposed to grant the criminal prosecution authority to securities regulators in order to strengthen their enforcement power and abilities to detect misconducts, as well as to establish cooperative framework among regulatory authorities.

The final trend is to continue building market infrastructure and strengthening abilities to detect and pursue misconduct. The report by EBA indicated that there are more rooms to further leverage Legal Entity Identifier (LEI). LEI is the international identification scheme to specify each party performing financial transactions. This could be utilized in a wide range of trades beyond just derivative transactions, which could aid banks and authorities to recognize high risk entities (that is, trading that could lead to misconduct).

By observing the recent regulatory trends, it is clear that authorities will pursue more stringent and multilayered measures towards conduct risk. In light of these developments, financial institutions will be required to manage conduct risk through various mechanisms.

Deloitte Tohmatsu Group (Deloitte Japan) is the name of the Japan member firm group of Deloitte Touche Tohmatsu Limited (DTTL), a UK private company limited by guarantee, which includes Deloitte Touche Tohmatsu LLC, Deloitte Tohmatsu Consulting LLC, Deloitte Tohmatsu Financial Advisory LLC, Deloitte Tohmatsu Tax Co., DT Legal Japan, and all of their respective subsidiaries and affiliates. Deloitte Tohmatsu Group (Deloitte Japan) is among the nation's leading professional services firms and each entity in Deloitte Tohmatsu Group (Deloitte Japan) provides services in accordance with applicable laws and regulations. The services include audit, tax, legal, consulting, and financial advisory services which are delivered to many clients including multinational enterprises and major Japanese business entities through over 7,900 professionals in nearly 40 cities throughout Japan. For more information, please visit the Deloitte Tohmatsu Group (Deloitte Japan)'s website at [www.deloitte.com/jp/en](http://www.deloitte.com/jp/en).

Deloitte provides audit, consulting, financial advisory, risk management, tax and related services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries and territories, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte's more than 210,000 professionals are committed to becoming the standard of excellence.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see [www.deloitte.com/about](http://www.deloitte.com/about) for a more detailed description of DTTL and its member firms.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte Network") is, by means of this communication, rendering professional advice or services. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.