

Conduct risk – a risk too far?

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Agenda

- Risk and risk management
- Operational risk and conduct risk
- Regulating conduct risk
- Managing conduct risk

Risk and risk management

- What is a risk?

Risks are:

- ‘lack of . . .’, ‘insufficient . . .’
- ‘failure of . . .’
- ‘inadequate . . .’
- ‘unauthorised . . .’

Risks are:

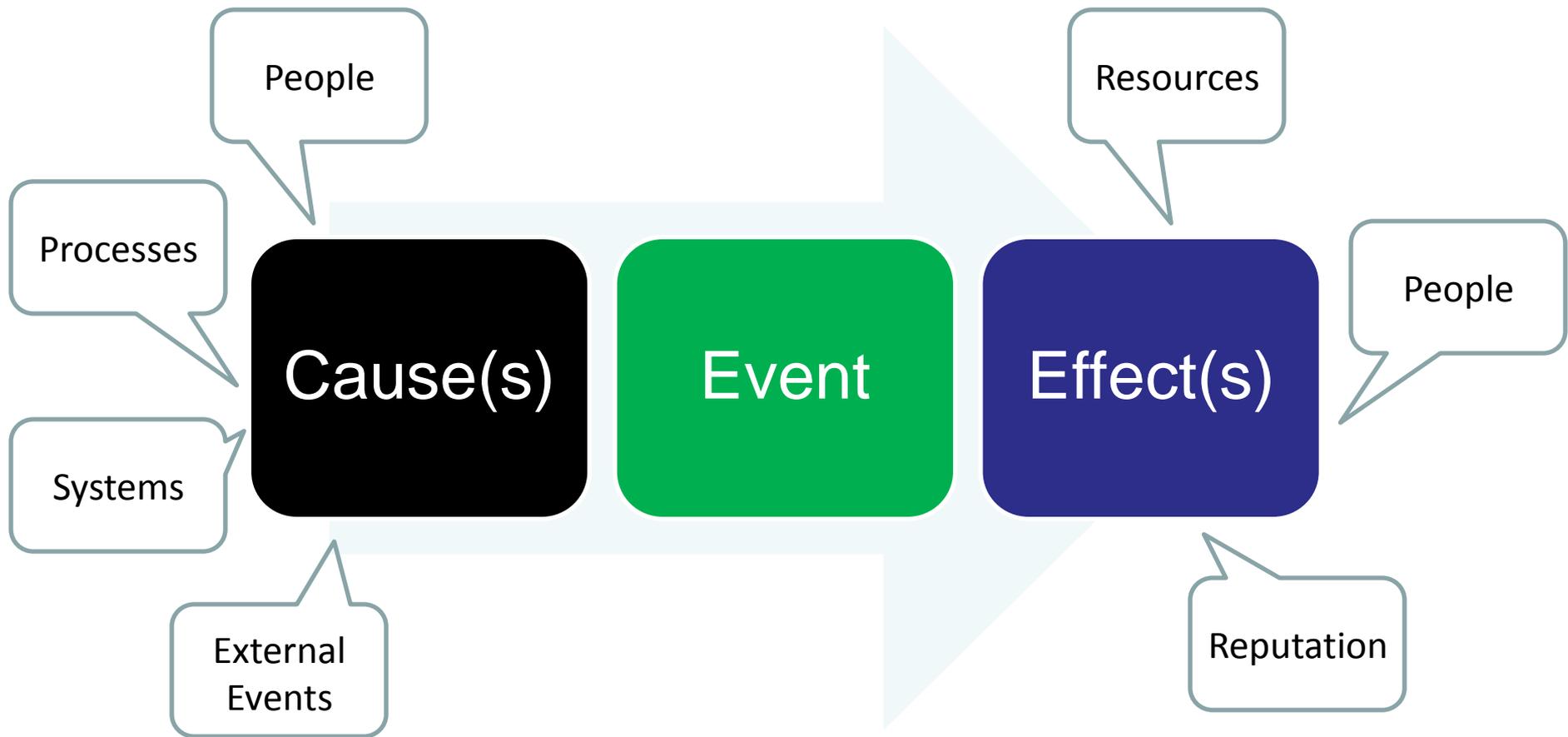
- ‘lack of . . .’, ‘insufficient . . .’
- ‘failure of . . .’
- ‘inadequate . . .’
- ‘unauthorised . . .’

Which is why the definition of operational risk reads:

‘The risk of loss **resulting from inadequate or failed** internal processes, people or systems or from external events’

Risk and risk management

- What is a risk?
- What is risk management?



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Operational risk and conduct risk

- What is operational risk?

Operational risk – definition and scope

- The definition:
‘The risk of loss resulting from inadequate or failed internal processes, people or systems or from external events’

An attempt to frame the unframeable, to assuage fears about the uncontrollable 'rogue others' and to tame the man-made monsters [of the financial system].

Prof Michael Power, *Organized uncertainty : designing a world of risk management* (OUP, 2007)



Operational risk – definition and scope

- The definition:
‘The risk of loss resulting from inadequate or failed internal processes, people or systems or from external events’
- Does your definition cover:
 - Strategic risk?
 - Legal risk?
 - Conduct risk?
 - Regulatory risk?
 - Reputation risk?

Operational risk and conduct risk

- What is operational risk?
- What does the operational risk function do?

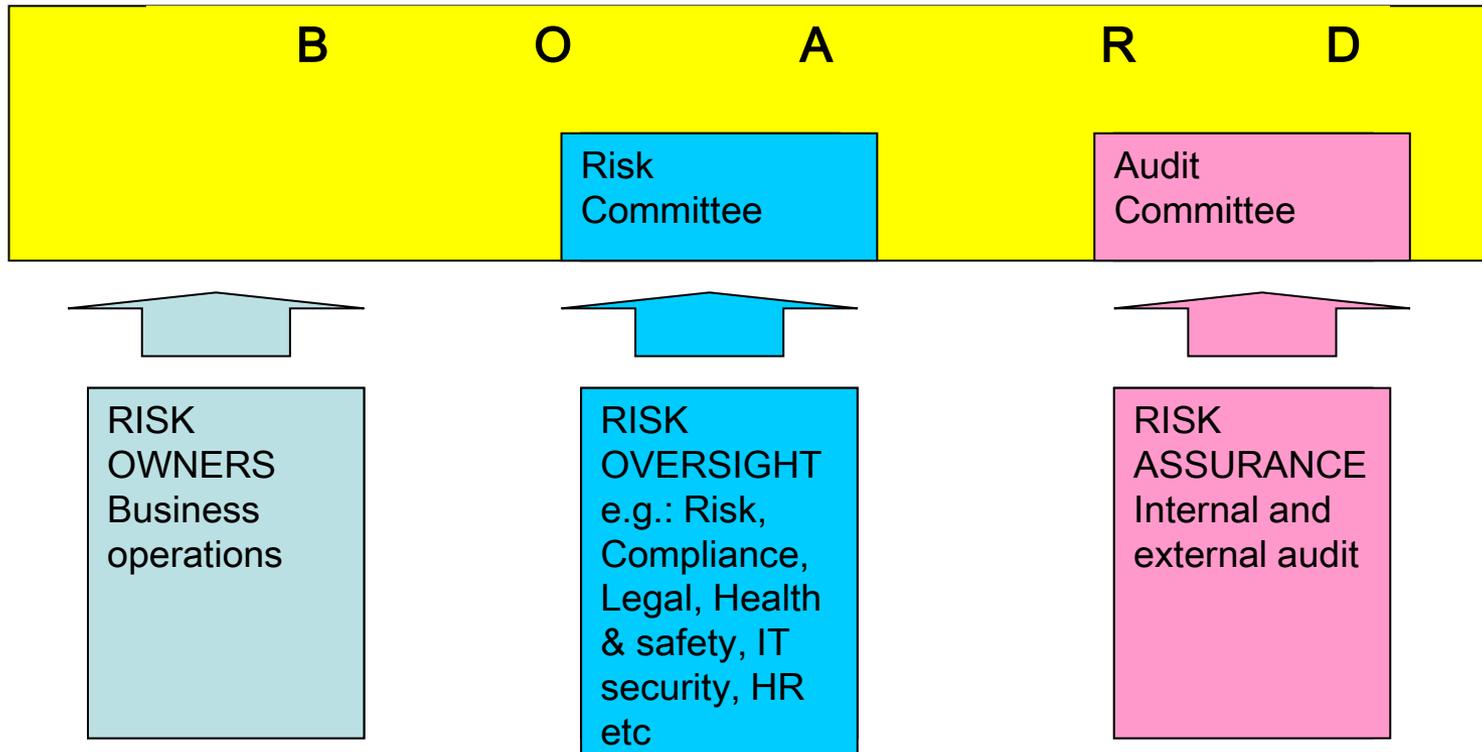
The (operational) risk management function?

- New products
- Business Continuity Planning
- 3rd party dependencies (outsourcing, supply chain etc)
- Insurance-buying
- IT security
- Compliance
- Legal
- Employment/HR: health & safety; discrimination
 - People risk

Does your operational risk function in fact manage:

‘The risk of loss resulting from inadequate or failed internal processes, people or systems or from external events’

And where does it sit?



Operational risk and conduct risk

- What is operational risk?
- What does the operational risk function do?
- What is conduct risk?

Conduct risk

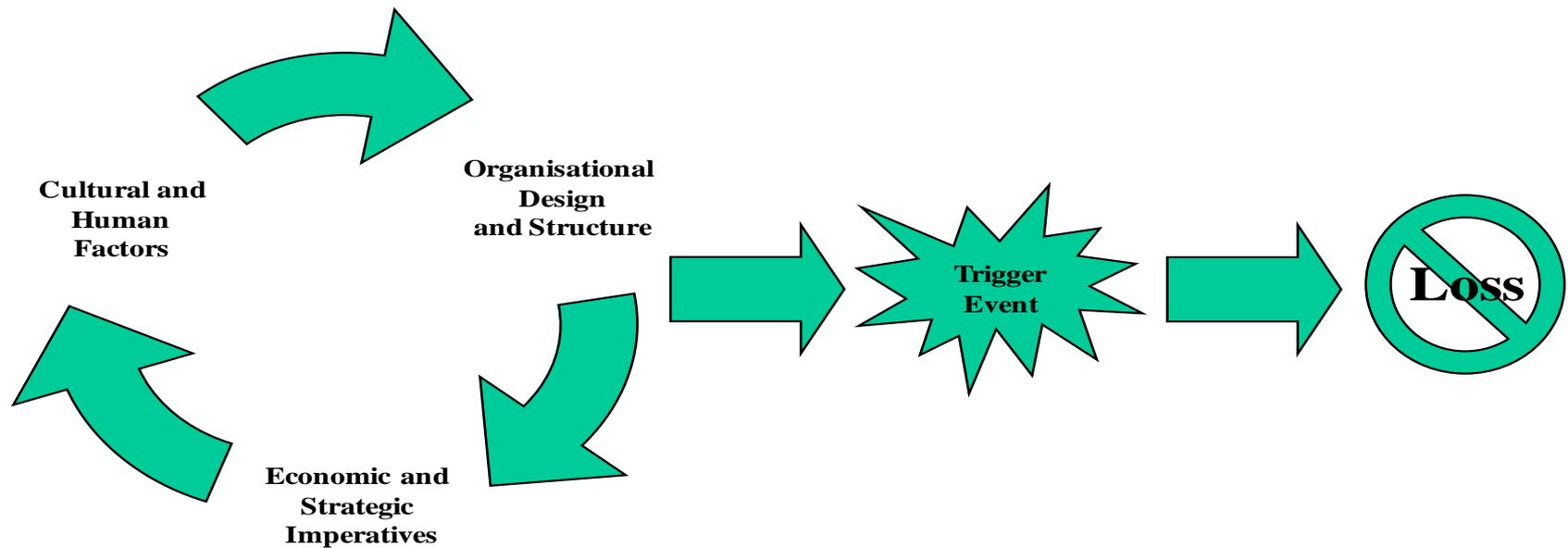
- ‘the risk that firm behaviours will result in poor outcomes for customers’
 - ‘consumers get financial services and products that meet their needs from firms they can trust’
 - ‘markets and financial systems are sound, stable and resilient, with transparent pricing information’
 - ‘firms compete effectively, with the interests of their customers and the integrity of the market at the heart of how they run their business’
- FCA objective: ‘To make relevant markets work well so consumers get a fair deal.’

Key drivers of conduct risk

(FCA Risk Outlook 2013)

- Inherent [customers factors]
 - Information asymmetries
 - Biases & heuristics
 - Inadequate financial capability
- Environmental
 - Economic and market trends
 - Technological developments
 - Regulatory and policy changes
- Structures and behaviours
 - Conflicts of interest
 - Culture and incentives
 - Ineffective competition

A Typical Crisis Model



Dr Simon Ashby, *The 6 C's of the financial crisis*, (Financial Services Research Forum, Nottingham University Business School: April 2010)

The banking crisis

- The trigger: Asset bubble
 - Sub-prime lending
 - Complex instruments (failure to challenge or understand)
- Organisational design and structure
 - Failure to apply good risk management and governance
 - Rating agencies – over-reliance; incompetent
 - Regulators and the regulatory regime (Basel II)
- Economic and strategic imperatives
 - Profit
 - The banking ecosystem: failure to understand systemic risk
 - Electoral imperatives (politicians)
- Cultural and human factors
 - Human behaviour (greed, herd instinct, bullying, complacency, hubris etc) of banks, customers, politicians, regulators

US Congressional Financial Crisis Inquiry Commission (2011)

‘The crisis was **avoidable**.’

The key conclusions were that there were:

‘**dramatic failures of corporate governance and risk management** at many systemically important financial institutions’

‘a **systemic breakdown of accountability and ethics**’

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Salz review (Barclays) 2012

‘It is understandable, and in many respects necessary, that since the start of the financial crisis, there has been an explosion of new regulation and in the intrusiveness of regulators. However, regulation alone cannot address the fundamental underlying causes that led to the business practices which are in the spotlight – the cultural shortcomings we found.’

Conduct risk, culture and the regulators (UK)

- Conduct risk and the FCA

‘It is our job to fundamentally change the culture and conduct of financial services firms and the markets they operate in . . . to inject trust back into financial services’

- Culture and the PRA

‘expect firms to have a culture that supports prudent management. The PRA will not have any ‘right culture’ in mind . . . Focus on whether boards and management clearly understand the circumstances in which the firm’s viability would be under question.’

Is regulation the answer?

- Drivers for regulators
 - Tone from the top – for regulators
 - Control and command
- Results
 - Increasingly complex compliance processes
 - Stifles sense of ownership
 - Constrains initiative of individual teams
 - Suppresses innovation

- ‘. . .board conformity with laid down procedures such as those for enhanced risk oversight will not alone provide better corporate governance . . . Principal deficiencies in boards related more to patterns of behaviour than to organisation.’
(David Walker, Review of corporate governance, 2009)
- ‘A move from a compliance to a learning culture will require those working in child protection to be given more scope to exercise professional judgement . . . forces have come together to create a defensive system that puts so much emphasis on procedures and recording . . . (Prof Eileen Munro, Review of child protection, 2011)

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Conduct risk, culture and the regulators (FSB)

- Foundation elements
 - Risk governance
 - Risk appetite
 - Compensation
- Indicators
 - Tone from the top
 - Accountability
 - Effective communication
 - Incentives

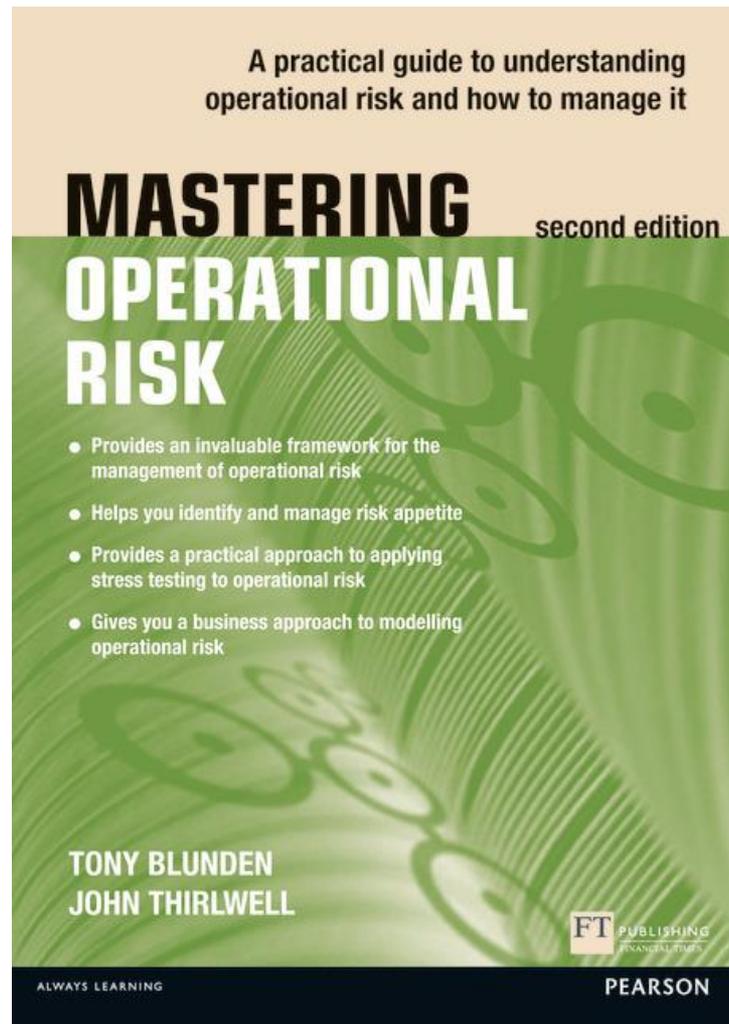
How to embed the right culture

- Committed Leadership
- Strategy and objectives
- Values and behaviours
- Clear roles and responsibilities
- Open channels of communication
- Selection, induction and training
- Reward

Embedding conduct risk

- Conduct risk policy
- Corporate governance
- Conduct risk framework
- Conduct risk appetite
- Monitoring and review of customer outcomes
- Reporting

So who's going to embed
good behaviour and good conduct
in your firm?



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