ASIA PACIFIC FINANCE AND RISK SERIES

CONDUCT RISK MANAGEMENT IN THE ASIA PACIFIC REGION

IMPROVING RELATIONSHIPS, RETURNS AND REGULATION
By tackling conduct risk management early, Asia Pacific financial services institutions have the opportunity to strengthen relationships with clients, improve overall returns, and prevent the high levels of regulation and scrutiny that firms have been subjected to in Europe and the US.

The importance of conduct in the financial services industry cannot be overstated. Financial Services is a business built on trust: we serve clients’ interests; we protect clients’ data; and we profit when customers prosper. Yet sometimes firms prosper when their clients do not, and interests of firms and their clients are not always aligned. The spate of conduct risk issues in Europe and the US, from payment protection insurance to LIBOR/foreign exchange (FX) fixing to financial advice have rightly shocked many and have resulted in staggering fines to the industry. Between 2008 and 2012, the cost of conduct for the 10 most affected global banks was estimated to be approximately US$250 BN\(^1\). All of this has led to deep questioning of how firms go about serving their clients’ interests.

This paper suggests ways in which banks, insurers, and wealth managers in the Asia Pacific region can approach conduct risk:

- We define conduct risk and its scope
- We look at the types of misconduct that have surfaced in the Asia Pacific region and provide a view on emerging risks
- We explain why managing and mitigating conduct risk in an optimised way is important
- We discuss potential future trends in the Asia Pacific regulatory landscape regarding conduct and the extent to which regulation could become increasingly restrictive and intrusive – as well as how to engage in a constructive discussion with regulatory authorities

We conclude by outlining five elements that are essential to ensuring a comprehensive and effective conduct risk management strategy:

1. Define a conduct risk strategy and conduct risk appetite
2. Perform a conduct risk diagnostic to identify the changes that may be required
3. Re-align your business model, products, and practices with good customer outcomes
4. Strengthen the tools, processes, and controls to mitigate conduct risk
5. Re-enforce the above activities through leadership behaviour, culture adaptation, training, and incentives

Firms that adopt a comprehensive strategy to managing conduct risk can obtain a significant competitive advantage. Preparation is likely to be rewarded by a growing reputation and consequently a larger share of the market as clients switch to more reputable firms. Those financial services firms that are able to plan ahead are also likely to see their cost of compliance and remediation decline, enabling them to be more efficient and, ultimately, more profitable than their peers.

\(^1\) London School of Economics and Political Science 2014 <http://blogs.lse.ac.uk/conductcosts/bank-conduct-costs-results/>.
WHAT IS CONDUCT RISK?

Conduct refers to the behaviour of financial services institutions towards their clients and counterparties in the financial markets. Conduct risk is the risk of a company’s activities having a detrimental impact on customers or negatively impacting market stability.

Recent examples of misconduct include the mis-selling of products and services, fraudulent actions, unjustified fees, product/service performance, and market manipulation. The table on the next page (see Exhibit 1) illustrates recent incidents involving conduct risk in the Asia Pacific region.

Mis-selling of products that are either not suited to or not understood by the customer is the most common type of misconduct across the Asia Pacific region. This is especially true of the wealth and insurance industry, where customers may find the financial products overly complex and difficult to understand. Internal fraud is another problem that appears to be particularly prevalent in developing Asian countries. However, sophisticated markets are not immune to intentional misconduct either – as the alleged market manipulation in Australia, Hong Kong, Japan, New Zealand, and Singapore would seem to suggest.

Conduct risk is the risk of a company’s activities having a detrimental impact on customers or negatively impacting market stability.
### Exhibit 1: Recent examples of misconduct in the Asia Pacific region

<table>
<thead>
<tr>
<th>Country</th>
<th>Mis-selling of products and services</th>
<th>Major internal fraud incidents</th>
<th>Fees/margins</th>
<th>Product/service performance</th>
<th>Market manipulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Mis-selling of complex products to less sophisticated institutional investors</td>
<td>Financial planning fraud</td>
<td>Excessive credit card late fees</td>
<td></td>
<td>Alleged manipulation of:</td>
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<td>• ASX 200</td>
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<td>• Bank Bill Swap Rate</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• FX market</td>
</tr>
<tr>
<td>China</td>
<td>Alleged mis-selling of investment funds</td>
<td>Use of deposits to fund loan-sharking schemes</td>
<td>Warnings about excessive fees and charges</td>
<td></td>
<td>Alleged “pump-and-dump” schemes</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Mis-selling of minibonds</td>
<td>Excessive fees for dormant accounts</td>
<td>Unexpected poor performance of investment-linked assurance schemes</td>
<td></td>
<td>Alleged currency market and HIBOR manipulation</td>
</tr>
<tr>
<td>India</td>
<td>Mis-selling of:</td>
<td>Fraudulent sale of insurance policies by third parties</td>
<td>High bank fees for selling insurance cover</td>
<td></td>
<td>FX market manipulation in rupee</td>
</tr>
<tr>
<td></td>
<td>• Unit-linked insurance policies</td>
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<td></td>
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<tr>
<td></td>
<td>• Insurance policies to underage customers</td>
<td></td>
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</tr>
<tr>
<td>Japan</td>
<td>Mis-selling of investment products (trusts)</td>
<td>Bribery in return for investment business</td>
<td>Manipulation of Yen LIBOR</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Missing pension funds and falsification of performance</td>
<td>Alleged FX manipulations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>Mis-selling of investment products</td>
<td>Extension of illegal loans</td>
<td>Private customer data hacked</td>
<td></td>
<td>Price manipulation in derivatives market</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Exploitation of loopholes in credit card policies</td>
<td></td>
<td></td>
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<tr>
<td>New Zealand</td>
<td>Mis-selling of complex interest-rate swap loans to farmers</td>
<td>Alleged excessive bank default fees</td>
<td>Alleged FX market manipulation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>Mis-selling of minibonds</td>
<td>Manipulation of LIBOR and other benchmark rates</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Oliver Wyman research
WHAT ARE THE EMERGING RISKS?

Emerging conduct risks arise from a number of factors, including current product design and sales practices, changes in the market environment, changing customer profiles, and the adoption of new technologies. We expect to see additional incidents of misconduct come to light in the medium term as:

- Increased regulatory scrutiny and market attention to benchmark rates raises the likelihood of rate manipulation being discovered (including FX and interest rates)
- Booming property prices across Asia have created a very attractive short term returns history for property-related investment schemes – raising the risks of highly leveraged products being sold to real estate investors and of irrational exuberance in appraisal values being used to justify lax mortgage lending standards
- Historically low interest rates and low volatility of FX rates may have made customers complacent about the tail risks associated with complex interest rate and/or FX derivatives. Interest rate increases and/or FX shocks are likely to reveal incidents of mis-selling of these instruments
- Historically low interest rates (i.e. cheap leverage) across the region may lead to investors assuming greater risks and leverage than they can comfortably support
- Incidents related to the shadow banking system in China are likely to become more publicised
- Low levels of financial literacy in many Asia Pacific countries may allow a higher instance of predatory behaviour by sales staff incentivised by volumes instead of customer outcomes
- With many organisations moving to digital sales there is a risk of poorly designed sales algorithms being detrimental to customers. Additionally, the advice offered on company websites may be inadequate to ensuring positive customer outcomes. This is particularly relevant for more complex products, such as online trading platforms that offer derivatives or structured products that inexperienced investors can buy directly via the Internet

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2 Appraisal valuation appears to have played a role in the US subprime crisis. Practices in Asia Pacific countries show some evidence of this risk being too often ignored.

3 China’s shadow banking system is comprised of institutions and structures that perform banking functions outside regulated depository institutions (including trust and wealth management companies, finance and leasing companies, and private equity funds).
WHY MUST CONDUCT RISK BE MANAGED AND MITIGATED?

Poor conduct leads to the deterioration of relationships, subpar returns, and increased regulatory burden on institutions:

- **Relationships**: Building trust and loyalty among customers and investors often can take decades to develop, but be destroyed in a moment. The cultural importance of long-term relationships, for corporate and retail customers alike, cannot be underestimated in the Asia Pacific region. Misconduct jeopardises reputations that cannot be rebuilt overnight, not even with sophisticated marketing campaigns or rebranding efforts, particularly not in Asia.

- **Returns**: While fines and legal costs may be significant, they are merely the most obvious and direct consequences of misconduct. An even greater cost comes from the damage done to an institution’s reputation and brand and from diverting management’s attention away from creating value and instead toward dealing with regulatory investigations, litigation, and remediation. (See Exhibit 2 for estimated measures of conduct-related value destruction)

- **Regulation**: In response to incidents of misconduct, global regulators have increased their powers and expertise to impose stricter standards on retail and wholesale institutions alike. Their approaches are increasingly restrictive and intrusive; in some cases, regulators have dictated exactly how conduct risk is to be managed, without allowing management to formulate a strategy that takes into account both customer and shareholder outcomes.

Exhibit 2: Conduct risk has emerged as a material source of value destruction

<table>
<thead>
<tr>
<th>RISK</th>
<th>SIZE OF LOSS/FINE (US$ BN)</th>
<th>MARKET CAP IMPACT*1 (US$ BN)</th>
<th>MULTIPLIER*2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mis-selling</td>
<td>0.5-1</td>
<td>1-8</td>
<td>8x</td>
</tr>
<tr>
<td>Trading control issues</td>
<td>2-7</td>
<td>5-13</td>
<td>2x</td>
</tr>
<tr>
<td>Market manipulations</td>
<td>0.2-1</td>
<td>1-5</td>
<td>4x</td>
</tr>
<tr>
<td>Other conduct fines</td>
<td>0.1-2</td>
<td>~1</td>
<td>6x</td>
</tr>
</tbody>
</table>

*1 Measures underperformance relative to a sector index around the time of the loss

*2 Measures the ratio of market cap impact to size of the loss/fine

Source: Oliver Wyman analysis based on data from 2008 to early 2013
HOW WILL CONDUCT REGULATION EVOLVE?

The growing number of incidents of misconduct indicates a need for increased oversight to ensure positive customer and market outcomes. Conduct risk is also emerging as a major priority for most regulators due to increased government attention, and pressure from consumer lobby groups.

Regulators in such markets as the US (Consumer Financial Protection Bureau, CFPB) or the UK (Financial Conduct Authority, FCA) have concentrated their resources for overseeing conduct into dedicated teams or separate agencies, enforcing sweeping regulations that cover a broad array of conduct related issues. For example, the FCA has set up a framework that includes a business model and strategy analysis and interview-based assessments of how firms embed fair treatment and ensure market integrity. In many cases, regulatory action has been intrusive with agency watchdogs dictating how conduct risk is to be managed and which areas of the bank are to be reviewed (including thematic deep dives into incentives, sales practices, pricing, etc.).

Regulators have moved away from a reactive to a pre-emptive and judgment-based approach, and now seek to address the underlying causes of misconduct rather than simply dealing with symptoms. And most importantly, they are moving from an approach focused only on compliance with rules to one that encourages firms to do the right thing with respect to the customers they serve and the markets they operate in.

Asia Pacific countries where misconduct scandals have occurred in the market have started to move in a similar direction (see Exhibit 3). We predict a continuing tightening of regulation and a shift towards greater accountability by financial institutions. This would likely include but would not be limited to strengthening fiduciary duties around customer outcomes and creating avenues for recourse in case of negative customer outcomes.

It is more important than ever that the industry join the debate around conduct regulation. The financial services industry must acknowledge issues, be ready to diagnose drivers, explain the approach to conduct management, and provide a credible commitment to change. Institutions should engage in a dialogue with regulators and politicians to ensure that their strategies, with respect to conduct, are well communicated, understood, and accepted.
### Exhibit 3: Regulatory responses in the Asia Pacific region

<table>
<thead>
<tr>
<th>REGULATOR</th>
<th>RESPONSE TO MISCONDUCT</th>
</tr>
</thead>
</table>
| **AUSTRALIA** | • Responded strongly to financial advice misconduct, including imposing license conditions on financial planning arms of banks accused of fraud  
• Enhanced surveillance of market activity through increased investigative powers including the authority to tap phones  
• Increased maximum jail term and fines for market misconduct, including insider trading  
• Enhanced monitoring of high-frequency trading and pre-emptive actions against particular strategies and/or systems |
| Australian Securities and Investments Commission (ASIC) |  |
| Australian Government | • Introduced the Future of Financial Advice (FOFA) reforms:  
  − Banned commission payments to advisers of investment and superannuation products  
  − Introduced clearer standards for financial advisers to act in the best interest of clients  
  − Mandated financial advisers to provide annual fee disclosure statements to clients  
• Australian Financial System Inquiry considering:  
  − Enhancing ASIC penalty and product intervention powers  
  − Increasing issuer responsibility for product suitability |
| **CHINA** | • Imposed a 15-month freeze in the IPO market and implemented tougher rules, including restrictions on funds raised and the price-to-earnings ratio of new offerings |
| China Securities Regulatory Commission (CSRC) |  |
| China Banking Regulatory Commission (CBRC) | • Cracked down on insider trading in mutual funds and by institutional investors |
| **HONG KONG** | • Triggered by the mis-selling of Lehman Brothers Minibonds, HKMA has:  
  − Devoted greater resources and established new teams to enhance conduct supervision of authorised institutions  
  − Introduced several investor protection measures, including the audio-recording of sales and a client risk profiling process  
  − Stepped up on-site and off-site examination on the sale of investment products |
| Hong Kong Monetary Authority (HKMA) |  |
| Hong Kong Securities and Futures Commission (SFC) | • Established a corporate regulation taskforce to detect red flags in the stock market and tackle fraud by listed companies |
| **INDIA** | • Imposed heavy restrictions on the design and pricing of specific insurance products to confront unethical sales practices |
| Insurance Regulatory and Development Authority (IRDA) |  |
| Securities and Exchange Board of India (SEBI) | • Revised its consent order mechanism so that serious charges such as insider trading and fraud can no longer be settled through consent  
• Enhanced surveillance system across multiple exchanges to identify potentially fraudulent transactions |
| Reserve Bank of India (RBI) | • Considering introducing a set of “treat customers fairly” (TCF) norms governing the sale of third-party products and requiring banks to prove they have acted in the best interest of the customer  
• Issued various circulars addressing the internal vigilance functions of banks to prevent fraud and malpractice |

*Source: Oliver Wyman research*
### Exhibit 3: Regulatory responses in the Asia Pacific region (cont’d)

<table>
<thead>
<tr>
<th>REGULATOR</th>
<th>RESPONSE TO MISCONDUCT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>JAPAN</strong></td>
<td></td>
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</tbody>
</table>
| Financial Services Agency (FSA) | - Raised the penalties for insider trading, including those who leak non-public information or induce another to trade on such information  
- Enhanced relations with money laundering and anti-social forces, including:  
  - The establishment of a specialised task force  
  - Extensions to on-site inspection periods and allocation of additional resources |
| **KOREA** |                        |
| Financial Services Commission (FSC) | - Enhanced powers to obtain telecommunication records and impose travel restrictions on individuals suspected of manipulating stock prices  
- Established of an exclusive department to investigate unfair financial activities  
- Introduced a “fast-track” system to streamline the investigative process |
| Financial Supervisory Service (FSS) | - Mandated credit companies to notify customers about changes in credit card benefits six months before the changes become effective |
| **NEW ZEALAND** |                      |
| Financial Markets Authority (FMA) | - Introduced numerous changes to the governance and accountability framework of financial products under the Financial Markets Conduct Act 2013, covering:  
  - Managed investment schemes managers and their licensed supervisors  
  - Debt issuers and their licensed supervisors  
  - Restricted schemes and their trustees |
| **SINGAPORE** |                      |
| Monetary Authority of Singapore (MAS) | - Introduced regulatory requirements for financial intermediaries to include a user-friendly Product Highlights Sheet for their investment products  
- Proposed a new regulatory framework that introduces criminal and civil sanctions for financial benchmark manipulation |

*Source: Oliver Wyman research*
HOW CAN CONDUCT RISK BE MANAGED AND MITIGATED?

FIVE ELEMENTS OF A COMPREHENSIVE CONDUCT RISK MANAGEMENT STRATEGY

We have seen a persistent lack of a clear conduct management strategy, failures to diagnose root causes, and misaligned culture and incentives to be problems. In working with our financial services clients, we have found that a strong tone from the top, effective diagnostic techniques and proper alignment of business models are key to managing conduct risk. This has led us to develop a comprehensive framework (see Exhibit 4), which we have since used throughout our global work on the regulatory and client agenda.

Exhibit 4: Conduct risk management strategy

1. Define conduct risk strategy and appetite
2. Perform a conduct risk diagnostic (periodic)
3. Re-align business model, products, and practices with good customer outcomes
4. Strengthen tools, processes, and controls
5. Instill leadership behaviour, culture, training, and incentives
DEFINE CONDUCT RISK STRATEGY AND CONDUCT RISK APPETITE

Each company must define what good conduct means for its people and business. Best practice institutions have established a clear relationship between good conduct and business strategy through their values and company mission. A conduct risk appetite that is aligned with those values and mission must first be defined and then cascaded across the institution. The conduct risk appetite can include statements around customer understanding, suitability, service delivery, and avoiding financial detriment to clients. Appropriate limits should be set and monitored using conduct risk indicators (e.g. customer outcomes testing, complaints, suitability metrics, etc.). When deciding on their risk appetite, companies must aim to reach a balance between managing risk, spending on controls, and remaining agile in the market.

Without clear ownership and accountability firms run the risk of their conduct strategy not being properly implemented. It is important to decide who is responsible for which aspects of conduct risk management, for example, a dedicated committee for strategy and risk appetite setting, risk and compliance departments for framework design, business departments for daily execution, etc. Irrespective of the exact ownership structure, it will be important to holistically leverage existing frameworks which support conduct risk management and integrate conduct risk considerations as those frameworks evolve (e.g. operational risk, compliance, sales process optimisation, etc.).

PERFORM A CONDUCT RISK DIAGNOSTIC TO IDENTIFY CHANGES REQUIRED

Many institutions find it difficult to know where to start managing conduct risk. They often benefit from a well-structured diagnostic to identify major conduct risk vulnerabilities across the organisation. Risk identification can be performed using a “follow-the-money” approach, exposing potential areas of customer detriment by looking at products/segments where unusually high returns are generated. The diagnostic can focus on fee structures, pricing, ability to exit, suitability, etc.

Such exercises have been shown to uncover risky products and practices, and allow for the creation of mitigation plans whereby customers can be profitably retained and migrated onto more suitable pricing structures. Other potential hot-spots that have come up in the course of running the diagnostic include unrealistic sales targets, activities of remote teams that may be operating within a different culture, and siloed – or, conversely, overly friendly – relationships between different parts of the institution.
ELEMENT 3
RE-ALIGN YOUR BUSINESS MODEL, PRODUCTS, AND PRACTICES WITH GOOD CUSTOMER OUTCOMES

Good conduct is a difficult goal to achieve if the fundamentals of a business model are in conflict with good customer outcomes. To address this issue, best practice institutions have started to realign their business models to truly address customer needs and are reducing the focus on maximising product sales. Front office staff will need to shift from selling “products that many people need, to anyone” to “selling the right product to the right person,” thus transforming themselves from product specialists into customer specialists.

Focusing on good customer outcomes also means not hiding behind the “rule book” – which is how most financial institutions treat their product terms and conditions. The old defence “we did nothing wrong because we followed the rules” is no longer acceptable to the regulator or the public. Similarly, wholesale banks cannot revert to the “everyone knows the rules of the game” mentality because their actions often affect retail consumers and investors as well. Institutions will need to raise the bar around what is expected of them and their degree of accountability for customer outcomes.

ELEMENT 4
STRENGTHEN TOOLS, PROCESSES, AND CONTROLS IN ORDER TO MITIGATE CONDUCT RISK

Experience has shown that misconduct stems from failures along different parts of the value chain. Therefore, in addition to the product diagnostic, five major processes should also be reviewed, preferably by frontline management:

- **Product development:** Is conduct risk considered during new product approval process? Can conduct justifications be found for key product features (e.g. fees, insurance renewal pricing, etc.)?
- **Customer segmentation:** Do segmentation and profiling tools cover the needs, risk appetite, financial experience, eligibility, and loss tolerance of the customer?
- **Customer prioritisation:** Are commercial terms aligned to positive outcomes for a given product/customer combination?
- **Sales:** Is the sales force adequately trained? Is there a link between qualification levels and product sales authority? Are there outcomes testing (e.g. mystery shopping)? Does the frontline have adequate resources and support to conduct the necessary suitability tests?
- **Post-sales:** Is product performance actively monitored for customer detriment? This is particularly important in the wealth management business since uneven performance or changing client circumstances may make an entirely appropriate portfolio unsuitable over time.
ELEMENT 5
RE-ENFORCE THE ABOVE ACTIVITIES THROUGH LEADERSHIP BEHAVIOUR, CULTURE ADAPTATION, TRAINING, AND INCENTIVES

Good conduct is a question of culture. Culture is how we persistently act – “what we do when no-one is looking”. Hence, it is essential that the first four activities be reinforced through a very strong tone from the top and well-articulated messages. It should be apparent to employees that their conduct is being monitored. Exemplary conduct is to be encouraged and celebrated, while conduct failures ought to result in disciplinary actions, including reductions to bonuses and, ultimately, dismissal.

Many institutions have started to shift their culture through training, incentives, and in some cases risk-aware hiring practices. In the retail space, we have seen reduced sales weightings within incentive schemes with weight redirected to service, customer retention, and positive behaviours. The way executives are incentivised is also very important – “how” results are being achieved should be considered along the results themselves.

Exemplary conduct is to be encouraged and celebrated, while conduct failures ought to result in disciplinary actions.
CONCLUSION

The Asia Pacific region is not immune to incidents of misconduct, and these instances typically damage reputations, client relationships, and returns. We expect more risks to emerge in the region, especially given the current benign interest rate environment, changing customer demographics, and the introduction of new technologies designed to serve customers. Regulators across the region are likely to continue strengthening their conduct oversight capabilities and raising expectations around good customer and market outcomes.

The financial services industry has a clear interest and responsibility to join the dialogue around conduct, acknowledge issues, diagnose the drivers of misconduct, and effectively manage the risk. Firms that self-regulate and raise industry standards will be able to create a business environment more aligned with customer interests, and their approach and culture may become a source of competitive advantage. Managing conduct risk is likely to be rewarded by a growing reputation and consequently a larger share of the market as clients switch to the more reputable firms. Those firms that plan ahead are likely to see their costs of compliance and remediation decline, enabling them to become more efficient and, ultimately, more profitable than their peers.