

## MITIGATING RETAIL CONDUCT RISK – COMPLEX PRODUCTS

The importance of meeting the Financial Conduct Authority's (FCA) Conduct of Business regulatory requirements cannot be overstated. The FCA's Chief Executive, Martin Wheatley, states that "the FCA has high expectations of firms that want to sell products to retail customers". The new regulator has product intervention powers and is moving to enforce outcomes-focused regulation by ensuring firms put their customers at the heart of their plans and that they test their plans rigorously. FCA supervisors will be empowered to make judgements on the risks firms pose to customers and act upon them. As a result of such regulatory intervention, Payment Protection Insurance (PPI) has suddenly disappeared. At the same time, other forms of alternative complex protection products have soared.

In its most recent retail distribution review, the FCA lists, amongst others, "charge unbundling", "fair treatment of customers" and "complexity of retail investment products" as key retail conduct risk themes. Firms should provide suitable advice for a customer's individual needs, circumstances and objectives and should design products that are not unnecessarily complex. The fees and charges should be fair from the customer's perspective. For the FCA, such unbundling is intended to aid comparability across products by increasing transparency. Additionally, the FCA is also concerned about innovative, complex and potentially risky funding strategies that lack adequate governance and oversight and that might pose risks to market integrity and consumer protection. Firms must act *now*. The FCA signalled its intention to deal rapidly and harshly with firms that neglect these risks. The problem lies in the following - how can a firm engaging in complex products for retail customers demonstrate that it is treating customers fairly and unbundle its charges and funding structures given the complex nature of its products? Furthermore, how can this be achieved efficiently, robustly and fast if there is no historical data?

### SOLUTION

Our solution is based on an approach that computes the risk premium by measuring the risk profiles implied in products. A complex product, such as a structured deposit or guaranteed product, does not necessarily imply a riskier payoff from the customer's point of view, BUT it certainly is a riskier product from the company's point of view, simply because the operating profile for a complex product is different from that of a standard product. For example, the systems and controls to manage the product will be more difficult to implement and to maintain. Since the fees charged implicitly entail the risk premium of the product's individual risk components, it makes sense to measure these individual risk components. By doing so, a company achieves the following objectives:

1. The individual risk factors and drivers in a complex product along with sensitivities are understood so that management can deal with them appropriately;
2. The cost of total operating risk is unbundled; and
3. The risk costs entailed in such products will implicitly support the required fee charging structure.

### MONTE CARLO PLUS (MC+)

The MC+ system utilises a statistical modelling method where key risk scenarios resulting from the complexity of the products are placed at the centre of analysis. The model uses subjectively-defined, forward-looking expert estimates to build hypothetical but plausible risk scenarios. The methodology is robust because the powerful Monte Carlo (MC) methodology runs a large number of iterations. It is also efficient as it only requires a few inputs i.e. no large data sets. For each risk scenario, the user only needs to input a limited number of expert opinions.

Furthermore, the MC+ tool utilises processes which the regulators require for modelling losses in the advanced measurement approach (AMA) for operational risk capital requirements.

### BENEFITS of MC+

- ▶ Analyse and easily mitigate the retail conduct risk for complex products with a robust method that fulfils the regulatory requirements
- ▶ Compute the individual and aggregate components of risk as well as the risk-adjusted return of a complex product
- ▶ Identify the key drivers of the risk premia and measure the sensitivities
- ▶ Run what-if analyses to investigate which controls will improve capital efficiency and mitigate risks
- ▶ Deploy and implement the methodology within *days* rather than weeks or months resulting in time- and cost-saving efficiencies.

The scenario-based approach allows firms to fully consider and factor in all applicable elements of conduct risk in their operational risk assessments and capital requirements.

## PRODUCT COMPLEXITY, UNBUNDLING AND TCF – AN EXAMPLE

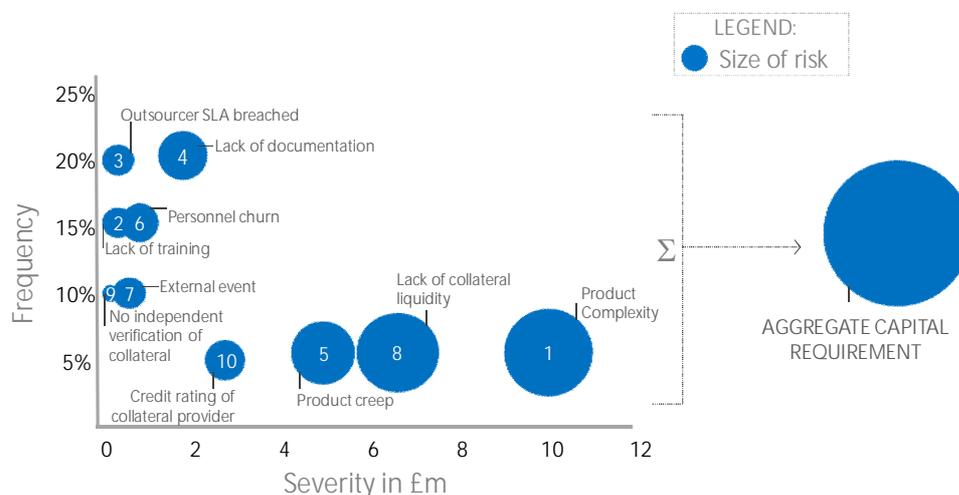
Product complexity, unbundling and TCF are three retail risk categories which should be considered together. Thus, our approach deals with these retail conduct risks simultaneously. The table below represents a selection of key risk scenarios (in no particular order) that the FCA associates with complex products (see Retail Distribution Review 2012). The first hypothetical but plausible risk scenario centres on consumer misunderstanding. Due to the nature and complexity of the product, the potential for consumer misunderstanding exists even though the firm has significantly invested in research and literature. This misunderstanding could lead to litigation by consumer groups leaving the company with a hefty loss. Another scenario considered is associated with external counterparties. For example, the Service Level Agreements (SLAs) may be breached, leading to additional costs.

### Hypothetical but Plausible Key Risks Scenarios of a Complex Product (from the 2012 Retail Distribution Review):

|         | Risk Scenario                                   | Result   | Potential impact on company  |
|---------|---|--|--|
| Risk 1  | Product complexity                              | Consumer misunderstanding                                    | Costs due to consumer group litigation   |
| Risk 2  | Lack of training, support                       | Insufficient internal knowledge of product and target market | Additional training cost investment  |
| Risk 3  | Outsourcer SLAs breached                        | Company needs to amend SLAs                                  | Additional costs associated with SLA agreement                                   |
| Risk 4  | Lack of process documentation                   | Inability to respond quickly to market volatility            | Error in investment appraisal  |
| Risk 5  | Product creep                                   | New product arising from incremental product changes         | FCA approval process invalidated   |
| Risk 6  | Personnel churn                                 | Need to replace key personnel                                | Higher recruitment costs and salaries  |
| Risk 7  | Key process break down due to an external event | Significant investment to fix the problem                    | Additional resource and capital outlay   |
| Risk 8  | Lack of collateral liquidity                    | Loss to the fund or product value                            | Compensation payouts to clients  |
| Risk 9  | No independent valuation of collateral          | Breach of client agreement                                   | Ex gratia payments to clients  |
| Risk 10 | Credit rating of collateral issuer              | Downgrades coupled with increase in mitigating trade volumes | Operational errors and losses resulting from failure to track credit performance |

In order to calculate the risk profile of a new complex product from the above key risk scenarios, for a mid-sized bank, we assume that each scenario has a probability of occurring over a one-year horizon (see the frequency axis below) and a severity of loss is estimated if the scenario occurs in any given year (see the severity axis in £m). Given the frequency and severity assumptions, each scenario's 1 in 200 year capital requirement (i.e. 99.5% confidence level risk) has been estimated using the MC+ model. As can be seen in the figure below, the frequency and severity coordinates, together with the implied 99.5% size of risk, represent a more complete view of the risk profile for the complex product. The conventional severity/frequency assessments neglect this dimension. Finally, using the MC+ model, an aggregate capital requirement has also been computed (which, in this case, assumes a zero percent correlation between the key scenarios).

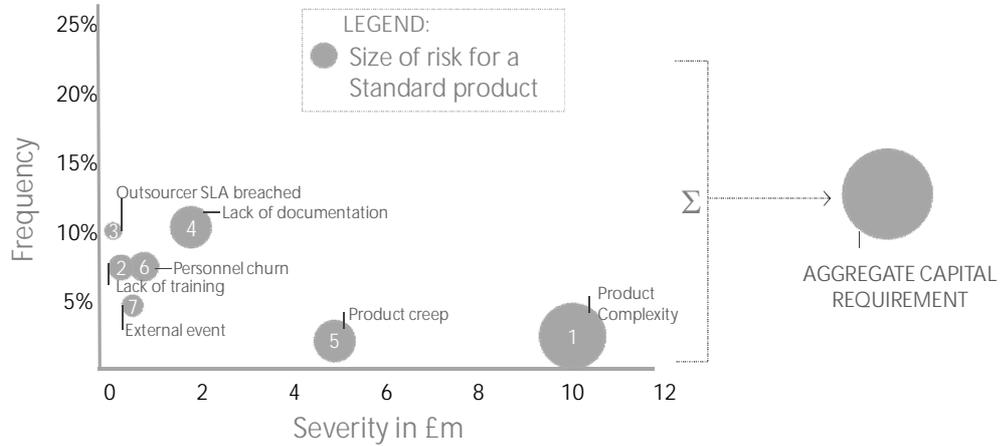
Thus, the impacts of the various key risks can be assessed and unbundled clearly and transparently. Rational decisions can then be made about product pricing and funding. This transparency will ultimately benefit both customers and markets.



Further analysis can be conducted comparing the risk profile of a complex product to the risk profile a standard product as depicted below. The individual and aggregate risk capital requirements at the 99.5% confidence level have been estimated by making the following assumptions:

1. There are less risk scenarios (only the first seven scenarios from the above table are valid scenarios), and
2. Those risk scenarios are assumed to occur 50% less frequently than for a complex product.

As expected, both at individual scenario level and at aggregate level, a standard product is less risky than a complex product.



The firm is thus in a better position to make a decision about the level of complexity and related risk-based costs of the products it chooses to promote.