NOTE ON EBA 2016 STRESS TEST AND CONDUCT RISK

Through the Conduct Costs Project, an Associated Research Project of CCP Research Foundation (CCP RF), we have created a proprietary dataset evidencing (on the basis of publicly available information) the financial consequences of bank misconduct, and additionally have set out a framework for heightened transparency of conduct costs data.¹ And, it is in this connection that CCP RF has received a number of requests for comment on the latest results of the European Banking Authority's (EBA's) 2016 EU-wide stress test of 51 banks (from 15 EU and EEA countries, covering around 70% of banking assets in each jurisdiction and across the EU).² In particular, we have been asked to provide commentary on the explicit addition of conduct risk, as a subset of operational risk, to the 2016 exercise.

Firstly, we welcome the EBA's emerging focus on conduct risk, which last year the European Systemic Risk Board notably highlighted has the potential to create systemic risks.³ And, indeed, we concur with the sentiments of Andrea Enria (chairman of the EBA) that its 2016 exercise, which has a three-year horizon, has been enhanced by adding estimated conduct costs for each bank in the 'adverse scenario'.⁴ Equally, there are certain concerns that we must also bring to light; given that this is a newly developed addition, which is still ostensibly subject to further appraisal and refinement in future exercises.

Secondly, the results corroborate the elevated status of conduct risk in the prudential assessment of a firm's safety and soundness, but in themselves raise many other questions, which we highlight below.

¹ The proposed framework can be accessed via the following link: http://conductcosts.ccppresearchfoundation.com/cc-reporting-proposal
² The results can be accessed via the following link: http://www.eba.europa.eu/documents/10180/1532819/2016-EU-wide-stress-test-Results.pdf
⁴ Link: https://next.ft.com/content/5496cc86-5417-11e6-befd-2fc0c26b3c60
The EBA’s stress test results and methodology: the conduct risk factor

The results of the 2016 exercise, were:5

“Operational risk has a -110bps impact (-€105bn) mostly driven by conduct risk (-80bps, -€71bn)...

The methodology of the 2016 EU-wide stress test required banks to project operational risk losses applying their internal models, but subject to strict floors based on their loss experience. In particular, additional guidance and reporting requirements were set for material conduct risk events determined primarily by interaction between supervisors and banks and featuring for example mis-selling, market manipulation and money laundering.

Aggregate cumulative operational risk losses in the adverse scenario are €105bn. Conduct risk losses account for €71bn, the rest is composed of projected losses classified as other operational risk or losses that could not be classified due to the projection approach applied by the corresponding banks (see Figure 22).

In total, 15 banks estimated an impact of conduct risk above €1bn. Relative to the starting point, operational risk losses are projected to increase by 45% from €33bn in 2015 to €48bn in 2016 in the adverse scenario. Conduct risk losses increase from €27bn in 2015 to €37bn in 2016.”

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### Profit and Loss (P&L) Account

<table>
<thead>
<tr>
<th>Gains or (-) losses arising from operational risk</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2016-2018 cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gains or (-) losses arising from conduct risk</td>
<td>-48</td>
<td>-30</td>
<td>-26</td>
<td>-105</td>
</tr>
<tr>
<td>Gains or (-) losses arising from other operational risk</td>
<td>-37</td>
<td>-19</td>
<td>-15</td>
<td>-71</td>
</tr>
</tbody>
</table>

In its Methodological Note for the stress test, the EBA provide the following definition and discussion of conduct risk:  

“Conduct risk is defined as the current or prospective risk of losses to an institution arising from an inappropriate supply of financial services, including cases of wilful or negligent misconduct…

Banks shall refer to paragraphs 253–257 of the EBA Guidelines on common procedures and methodologies for the SREP…

For the purpose of reporting historical data and projections in the stress test templates, conduct risk losses will be approximated by banks to event type 4 (‘clients, products and business practices’) and event type 1 (‘internal fraud’) of the COREP template for operational risk (C 17.00). Institutions shall justify the exclusion from the consideration as conduct risk of any event classified as event type 1 or 4…

In addition, banks shall report as conduct risk any events that match the definition provided, even if they are reported as an event type other than 1 or 4 of the above-mentioned COREP template, providing evidence to the competent authority that justifies this classification.”

Here is a further overview of the methodology used for conduct risk:  

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6 Ibid, P.21  
8 Ibid, P17
In summary, the methodology requires banks to project P&L impact losses emanating from conduct risk (and other operational risks), using, when relevant, their internal models and, in particular for conduct risk, available qualitative information. In this way, banks stress their conduct risk losses by applying either a qualitative or quantitative approach; and either way, a minimum floor for new non-material conduct risk losses will apply. In order to quality assure bank's projections, competent authorities will factor in both their supervisory knowledge of the particular bank, as well as a comparison to the sector and the impact of similar issues in the bank's peer group.

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9 Ibid, P88.
10 Ibid, P92. According to the EBA, a "historical material conduct risk event is defined as any misconduct issue that has triggered aggregate gross losses greater than 10 bps of the end-2015 CET1 capital of the institution at a consolidated level during the period 2011-2015... A new conduct risk event is defined as a misconduct issue that, as of the start of the exercise (31 December 2015), is unknown to the bank or is already known but has had no material P&L impact (below 10 bps of the end-2015 CET1 capital of the institution at a consolidated level) during the 2011-2015 period. In this context, new known conduct risk events are material if the firm expects the event to trigger gross losses greater than 10 bps of the end-2015 CET1 capital of the institution at a consolidated level during 3 years of the exercise."
11 Ibid, P92.
CCP Observations: Conduct risk is a welcome addition to bank stress tests. However, the underlying data reporting and methodology needs refinement.

Following a review of these results and methodological process, there are a number of questions, discussion points and issues that arise:

1. What exactly does the EBA mean by "conduct risk" and are there any general 'grey areas' when classifying this risk? While the EBA provides a definition of conduct risk as a somewhat general articulation and delineate related losses by banks to event type 4 ('clients, products and business practices') and event type 1 ('internal fraud'), there still remains scope for more granular policy guidance and delineation. *A priori*, a greater understanding of conduct risk, will create the bedrock for the objective of **standardised conduct risk metric reporting**; on the basis of which regulatory capital adequacy measurements and stress scenarios can be assessed. One example of more granular delineation of conduct risk is the six "Culpability Codes" developed by CCP RF, ranging from 'clustered criminality' and 'corporate-integrity related breach' to 'imputed breach'. Subjecting conduct risk metrics (like conduct costs) to a weighting based on culpability (and indeed, 'cause') acknowledges the limitations inherent in an [unadjusted] quantitative methodology and improves qualitative judgement over conduct risk projections. It further recognises (and offers an insight into) a firm's reputational risk and its effect on its conduct risk profile – where one accepts the risk that significant levels of adjusted conduct costs undermines the firm's standing in the market; the sustainability of its business model and, if evidenced over time, risks adversely affecting the firm's performance and capital.

2. We are told that in the adverse scenario conduct risk losses amount to €71bn; however, how is this aggregated figure distributed across the 51 banks? As a follow on, are there any banks where this risk is more concentrated? It is acknowledged that that the EBA has disclosed that projected impact of conduct risk for 15 banks is above €1bn. That said, in determining not only the level but distribution of conduct risk, and to raise market (along with public) confidence in these results, we take the position that **disclosure of conduct risk losses at the individual bank level (as opposed to an aggregate figure)** is a more

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satisfactory approach to pursue. Further, attuned to the observation that, for the 2016 to 2018 cumulative period, the latest exercise estimates conduct risk losses at approximately 68% of operational risk in the adverse scenario, there appears to be a cogent argument for greater operational consideration on how — or how much — conduct risk affects the safety and soundness of an individual bank (in terms of profit, credit availability etc.). Some banks such as Deutsche Bank have provided additional disclosure, stating that "the EBA now includes simulation of operational risk, including conduct and litigation risk. This reduces our CET1 [Common Equity Tier 1] ratio under the ‘adverse’ scenario by 2.2 percentage points." However, unless banks disclose such information, no further breakdown on conduct risk losses at the individual bank level, as it pertains to the stress test, can be ascertained.

3. What methodology and assumptions were used by banks for the 'internal models' that were applied to project operational risk losses and, more specifically, conduct risk losses? To what extent are the models between banks consistent? What types of material conduct risk events (for example, mis-selling, market manipulation and money laundering) are considered to be the most prevalent? As to the modelling, the quality assurance by the competent authorities should alleviate some concerns but this is by no means a panacea. It goes without saying that the validity of the models are of central importance, as reiterated by a recent media publication: "On the face of it the latest EU stress tests look like good news but they are only as good as the scenarios modelled." All the same, the degree of circumspection surrounding these models still weighs heavily on some; to cite the secretary general of Basel Committee: "Operational risk models have failed to mitigate operational risk losses and, at the same time, have resulted in risk-weighted asset differences across banks that are difficult to justify."

4. Did the stress test exercise call into question the need for additional provisioning relating to conduct risk — even on an aggregated basis? (This was a specific question that we received in our request for comment.) Did the stress tests reveal the need for greater transparency in conduct risk provisions? As to the

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former question, the EBA offer an illustration of a qualitative approach for projections in the adverse scenario: 16

<table>
<thead>
<tr>
<th>Table 9: Projection of conduct risk losses under the qualitative approach and in the adverse scenario – Illustration</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Existing treatment of the misconduct issue</strong></td>
</tr>
<tr>
<td>An accounting provision has been raised. There is a high degree of certainty over the eventual cost.</td>
</tr>
<tr>
<td>An accounting provision has been raised. There is a high degree of uncertainty over the eventual settlement cost. While the IAS 37 provision strikes a balance between potential upside and downside, the likelihood of adverse outcomes exceeding existing provisions is greater than remote.</td>
</tr>
<tr>
<td>An accounting provision has not been raised. While a settlement cost is not probable, there is sufficient evidence to determine a range of settlement outcomes, and the possibility of a significant settlement cost is greater than remote.</td>
</tr>
<tr>
<td>An accounting provision has not been raised. While a possible obligation has been identified, current evidence is insufficient to be able to reliably quantify any potential liability, or range of liabilities, that may exist. The possibility of a significant settlement cost is greater than remote.</td>
</tr>
</tbody>
</table>

The approach above relies on the existing accounting treatment of misconduct issues that provides the basis for the projections. In other words, the accounting provisioning informs projections (and arguably not vice versa). To this end, when there is a "high degree of uncertainty" over the eventual settlement costs, the estimate should exceed the existing provision. Therefore projections can exceed provisions, and even if they do it does not follow that additional provisioning will be required. The issue, however, is with provisioning for misconduct (as asked in the latter question) — in terms of disclosure and quantitative measure.

By way of background, research carried out by our Conduct Costs Project has demonstrated that, subject to IAS 37, banks in practice typically do not (and are

not required to) include a separate line provisioning item for conduct risk in their financial reporting. Instead conduct risk (to varying extents) may be accounted for in broader provisions, including 'Operational risk events', 'Other', 'Disputes', 'Customer Remediation', 'Legal Proceedings', 'Regulatory Matters', 'Litigation' etc. In addition, we have seen events where conduct risk has been significantly under-provisioned by banks: for example, BNP Paribas' provisioning accounted for only 12.4% of its US$8.9 billion fine in 2014. 17 The EBA is privy to this concern, and in 2013 noted that "rising and increasingly materialising conduct risks raises the questions as to whether risks are sufficiently provisioned for, and whether provisioning is adequately disclosed." 18 As Professor Kevin Dowd rightly observes in his recent report on bank stress tests, "provisions are little more than guesses and any errors in these guesses could have very large impacts on banks' capital and hence on their post-stress leverage ratios." 19

There ought therefore to be significant concern over the potential to manipulate conduct risk models in capital provisioning scenarios where the reporting framework lacks granularity and the disclosure lacks publication – as the latter begets accountability and mitigates the opportunity to arbitrage the models behind closed doors. Of course, we cannot escape the uncertainties inherent in projecting conduct risk – such is the peculiar nature of that risk-type. But it stands to reason that a detailed, itemised account of all amounts included in any provision that relates to anticipated conduct costs in financial reporting (as we have prescribed in our 'Conduct Costs Reporting' framework20), will create the necessary transparency for relevant stakeholders to discern if banks have been found liable to under-provision for conduct risk — an issue that, as represented above, can have prudential consequences too. The same reporting framework for conduct risk provisioning should also apply ex ante within firm's annual reports, adding a further opportunity to quality assure conduct cost data (whether that be firm-specific data (and internal models), sectoral comparisons, conduct cost contagion risk or when mandating a floor for new non-material conduct risk losses.

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17 PP.3 and 4 of link: http://foreigners.textovirtual.com/ccp-research-foundation/271/171995/why-it-is-important-to-add-up-the-total-conduct-costs.pdf
20 Link: http://conductcosts.ccpresearchfoundation.com/cc-reporting-proposal
Finally we stress that conduct risk management is a multi-dimensional challenge that not only has prudential implications but extends beyond regulatory compliance to general confidence and trust. This challenge, in turn, calls for a multi-faceted approach, examining a broad area of scope from the development of 'grey area standards' (including cross-pollination of best practice) to conduct performance and trust metrics. CCP RF is at the forefront of this challenge and continues to research and develop new and existing metrics that inform and empower stakeholders in their assessment of an organisation's conduct, culture and trustworthiness.

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