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# INCREMENTAL IMPLEMENTATION... towards a Market Conduct Framework

Six years after the decision was taken to move to a Twin Peaks model of regulation, the Financial Sector Regulation Bill was passed by the National Assembly on 22 June 2017, and sent to President Zuma for assent. The Bill, once signed into law, will put a Twin Peaks model of financial sector regulation in place in South Africa.

The shift to a Twin Peaks model of regulation requires the establishment of two primary regulators, being a Prudential Authority (located within the SARB) and a new Market Conduct regulator – the Financial Sector Conduct Authority (FSCA) will replace the current FSB. The Prudential Authority's primary objective will be to maintain and enhance the safety and soundness of financial institutions that provide financial products, whereas the FSCA will be responsible for the regulation and supervision of the conduct of business for all financial institutions, and the integrity of the financial markets.

The establishment of a dedicated market conduct regulator is a first for South African financial services institutions. It is clear that the Regulator's approach and supervision will be very different to that which institutions have previously experienced. Principles based and forward looking are two key values that underpin the supervisory approach that will

be adopted by the FSCA. The FSCA will place significant emphasis on the concept of "show us, don't tell us." The FSCA will seek to develop a clear understanding of those institutions' structures, operations, and product and service lines, within its supervisory ambit.

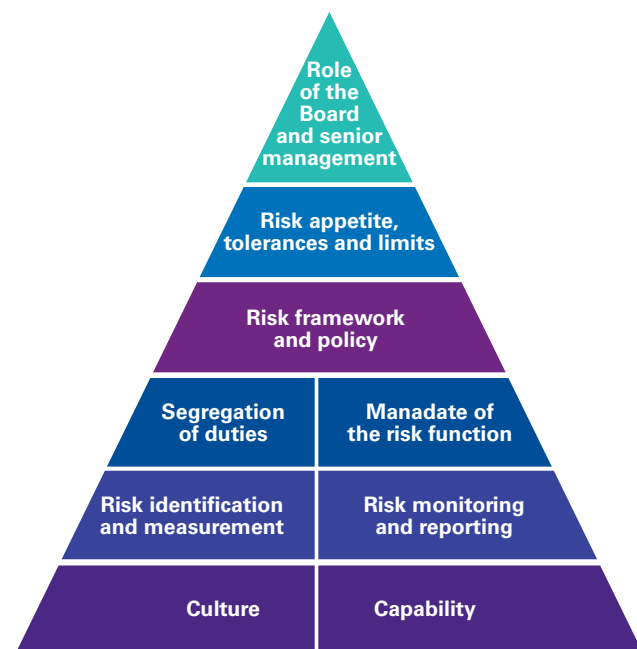
Effective management of conduct risk will be central to the FSCA supervisory mandate. To this end, institutions should manage their conduct risk within an established risk control framework that is imbedded in the operations. A market conduct framework ("framework") should be developed to provide the institution with an efficient and effective risk management process to identify, manage and respond to its conduct risks. The framework sets the approach to managing conduct risk and should be robust and proportionate to the conduct risks faced by that entity.

The FSCA expects that institutions implement market conduct in a manner that is most appropriate for that institution, having regard to its strategy and business model.

There is no single correct approach to the implementation of market conduct. Establishing a framework serves as a guide to the institution on conduct risk.

Whilst we consider some of the components of a framework in more detail, the conduct risk framework should include at least the following components:

- business definition of conduct risk;
- conduct risk governance structure;
- roles and responsibilities/accountability;
- risk identification and assessment;
- risk appetite and risk tolerances/thresholds;
- conduct risk metrics and key risk identifiers; and
- risk reporting and escalation



### Role of the board and senior management

Within the framework, conduct risk should be formally defined. Senior management should have a clearly articulated and understood definition of what Conduct Risk means to the institution and an understanding of the appetite which the institution has for Conduct Risk. As is the case with market conduct in the United Kingdom (UK), we expect that no authoritative definition of conduct risk will be provided. The Financial Conduct Authority

(FCA) in the UK resisted providing a clear definition of conduct risk as they believed it would be interpreted as setting boundaries and limits to the scope of market conduct, counterproductive to industry proactively identifying conduct risks for themselves. We believe that the same approach will be applied by the FSCA in South Africa. Institutions will be given the opportunity to define conduct risk for themselves, taking into account their strategies, business models and product and service offerings. However, broadly speaking, conduct risk is the risk of a firm treating its customers unfairly and delivering inappropriate outcomes.

### Conduct risk governance structure

An effective and clearly articulated conduct risk governance structure must be developed for the institution that enables the identification, assessment, management and monitoring of conduct risk. Senior management should focus on the outcomes they are delivering for their customers rather than focus purely on their own commercial interests

### Roles and responsibilities

Clear roles and responsibilities for conduct risk must be established. The roles and responsibilities are typically divided into first, second and third lines of defence. The first line of defence resides with business itself. The second line of defence must reside with the risk and compliance function and the third line of defence will typically be the internal audit function. This is the preferred approach in our experience and is certainly what we understand what the FSCA's expectation will be.

In terms thereof, business is responsible for identification and management of conduct risk. This responsibility resides within each business unit and function.

Accountability should be assigned to those executives and managers involved in making commercial decisions that directly or indirectly impact on customers and with

every employee, as they perform their role - all employees have a personal responsibility to ensure conduct risk is effectively managed in their role. Each business must establish and maintain detailed operational procedures and processes in respect of its management of conduct risk and individual key performance indicators must be assigned to executives, managers and other employees whose roles have been mapped to the market conduct framework. It is crucial for the key performance indicators to be aligned to achieving the conduct outcomes and there should be meaningful consequence for executives, managers and other employees who fail to deliver on these key performance indicators.

As the second line of defence, risk and compliance will develop and administer the conduct risk framework (while business will remain responsible for implementation thereof) and be responsible for oversight, monitoring and providing assurance that conduct risk is being properly implemented and managed.

### Risk identification and assessment

To be able to manage, monitor and control conduct risks, the conduct risks must first be identified and assessed. This will involve a top down assessment of the business model and strategy aimed to identify and understand the inherent gross state conduct risks in the business model and strategy and the materiality of those identified risks. This is referred to as the business model and strategy analysis (BMSA).

A risk register must be developed, intended to provide a breakdown and taxonomy of the risk universe identified through the BMSA.

The purpose and objective of the BMSA must be clearly specified and there should be a clear designation of responsibility and accountability for the BMSA.

At its core, the BMSA is designed as a way of:

- Considering historic decisions and putting them in the context of current and future planned activities, to understand the impact these may have on business sustainability and consistently fair customer treatment;
- Identifying specific elements of a product and/or business operation that may pose a level of conduct risk requiring intervention or further assessment;
- Assessing how the business model and strategy could impact on customer outcomes or the sustainability of the business model;
- Assessing the impact that external factors have on the sustainability of the current and future business model and customer proposition.

The objective of the BMSA is to identify the root causes or drivers of conduct risk in the business model and strategy to facilitate preventative action and as a result provide greater likelihood of identifying potential customer detriment before it crystallises and to identify risk that may already be causing customer detriment and require immediate remediation. Measures must be put in place to manage and monitor these conduct risks, with the intention of enabling early intervention by the business and avoid negative or inappropriate outcomes for customers or the markets in which they operate.

### **Risk appetite and risk thresholds**

The BMSA should align to the business' conduct risk appetite. When determining the actions to be taken in respect of conduct risks identified and assessed pursuant to the BMSA, it is important to consider the materiality of each identified conduct risk against the business unit conduct risk appetite.

The risk appetite is the level of risk that the business is willing to accept in order to achieve its strategy and business objectives. The framework should clearly specify what the risk appetite is, which will largely be informed by the strategy, business model and by the conduct risk

outcomes. The risk appetite should be articulated in a risk appetite statement and should be a factor of what can be material to customers and not the business. In order to support the reporting and escalation of conduct risk issues, conduct risk thresholds or tolerances should be developed.

Any risks or issues that take or are anticipated to take risk exposure outside of an acceptable risk threshold will be escalated for monitoring. The format for escalating conduct risks must be agreed. Appropriate processes and reporting lines must be established for timely and accurate escalation of conduct risk issues. These risk thresholds will be in the form of agreed metrics – key risk indicators/ key performance indicators – supported by detailed management information. This will need to be enhanced by qualitative judgement to enhance the rationale. Each business unit is required to manage conduct risk within these agreed risk thresholds.

### **Management Information (MI)**

The Regulator expects that institutions are able to articulate and demonstrate how they are managing conduct risk with the same ability and competency as they are able to articulate how they manage any other risk, e.g. market risk. MI is a key source of identifying and rectifying market conduct issues and demonstrating to the Regulator that both backward looking and forward looking processes are in place to identify market conduct risks. There are many sources of MI that the Regulator expects institutions to analyse.

MI must be collected from the institutions systems. In order for the information to be useful, management must identify the information required to be extracted to monitor each particular conduct risk. In some cases, the information may not exist and processes must be designed to collect the information. In addition to the institutions management of conduct risk through MI analysis, are the Conduct of Business Returns (CBRs).

The CBRs are a new set of market conduct returns for all life and non-life insurers in South Africa, excluding reinsurers and captive insurers. CBRs require extensive and detailed business information.

The CBRs significantly enhance the reporting burden and complexity, raising the importance of quality data and MI. The FSCA will analyse and interpret the data they receive from institutions and apply it in their conduct supervision. It is imperative that the data is understood by institutions before they submit it, and that they are applying the MI to manage, monitor and control conduct risks within their institutions.

The market conduct framework is not static and is expected to evolve as business implements and develops its approach to conduct risk. The current FSB talks of incremental implementation. They do not expect that institutions have this perfected, but rather expect that institutions have moved beyond talking of the six TCF outcomes, and are actively identifying, tracking and responding to conduct risk within their organisations.

