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## IN-DEPTH ANALYSIS

# Fines for misconduct in the banking sector – what is the situation in the EU?

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Scrutiny paper on the Single Supervisory Mechanism  
provided at the request of the Economic and Monetary Affairs Committee

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### **Fines for misconduct in the banking sector – what is the situation in the EU?**

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Provided in advance of the public hearing  
with the Chair of the Supervisory Board of the ECB  
in ECON  
on 23 March 2017

#### **Abstract**

Misconduct (conduct) risk may be defined as the risk of losses to an institution arising from an inappropriate supply of financial services, including cases of willful or negligent misconduct. Based on EBA data, it generates the vast majority of operational risks expected by Europe's top banks (€71bn according to the 2016 stress test). According to public-domain figures, misconduct costs have been rising strongly for large European banks in 2011-2015, although no European lender matches the costs experienced by large US banks. The distribution of losses looks highly skewed, with a few exceptionally high costs. More than 55% originates from traditional areas like commercial and retail banking. There are signs that conduct costs (per unit of total assets) have been stronger for small and mid-sized institutions, and for banks that ended up in resolution or requiring some other form of extraordinary support.

Conduct risk is addressed by a number of EU-wide regulations and supervisory standards. Still, only half of the EU's competent authorities include conduct risk in their supervisory examination programmes. To discipline conduct risk *ex post* sanctions play a useful role, but should be complemented by *ex ante* tools like improving the quality of bank governance, preventing remuneration schemes that encourage inappropriate practices, encouraging whistle-blowing and improving the clarity of regulations to remove grey areas.

This paper was requested by the European Parliament's Economic and Monetary Affairs Committee.

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## LIST OF ABBREVIATIONS

<b>AIFMD</b>	Alternative Investment Fund Managers Directive (Directive 2011/61/EU)
<b>AML</b>	Anti Money Laundering (Directive 2015/849/EU)
<b>CCP</b>	Conduct Culture People
<b>CET1</b>	Common Equity Tier 1
<b>COREP</b>	Common Reporting Framework
<b>CRD4</b>	Capital Requirements IV Directive (Directive 2013/36 EU)
<b>EBA</b>	European Banking Authority
<b>ESMA</b>	European Securities and Markets Authority
<b>ESRB</b>	European Systemic Risk Board
<b>FCA</b>	Financial Conduct Authority
<b>GL</b>	Guidelines
<b>JC</b>	Joint Committee of the European Supervisory Agencies
<b>KID</b>	Key Information Document
<b>MAD</b>	Market Abuse Directives (2003/6/EC and 2014/57/EU)
<b>MAR</b>	Market Abuse Regulation (2014/596/EU)
<b>MCD</b>	Mortgage Credit Directive (2014/17/EU)
<b>MIFID II</b>	Markets in Financial Instruments Directive II (2014/65/UE)
<b>MIFIR</b>	Markets in Financial Instruments Regulation (2014/600/EU)
<b>ORX</b>	Operational Riskdata eXchange
<b>PAD</b>	Payment Accounts Directive (2014/92/EU)
<b>PRIIPS</b>	Packaged Retail and Insurance-based Investment Products (Regulation 2014/1286/EU)
<b>QLA</b>	Qualitative Approach
<b>QTA</b>	Quantitative Approach
<b>SFT</b>	Securities Financing Transactions (Regulation 2015/2365/EU)
<b>SREP</b>	Supervisory Review and Evaluation Process
<b>SSM</b>	Single Supervisory Mechanism
<b>UCITS</b>	Undertakings for Collective Investment in Transferable Securities

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## EXECUTIVE SUMMARY

Misconduct risk in banking (also known as “conduct risk”) has been growing consistently after the 2007-2009 global financial crisis, because of stricter rules on financial intermediation and increased expectations and awareness by customers and regulators. It may be defined as “the current or prospective risk of losses to an institution arising from an inappropriate supply of financial services, including cases of willful or negligent misconduct”. As such, it includes the mis-selling of financial products to retail and professional customers, the manipulation of financial markets, the violation of rules on e.g. taxes, money laundering, terrorism, international trade bans.

According to the EBA, conduct risk generates the vast majority of operational risks expected by European banks in 2016-2018. Under the adverse scenario used in the 2016 stress test, misconduct losses for Europe’s top 51 banking groups would reduce CET1 capital by €71bn, with 15 banks reporting losses in excess of €1bn. Furthermore, based on an EBA questionnaire filled by 38 large banking institutions, 44% of the respondents had paid out more than €500m in compensation, litigation and similar payments since the financial year 2007/8.

Based on public-domain figures collected by the CCP Research Foundation, misconduct costs have been rising strongly for large European banks in 2011-2015, and end-2015 provisions show that the trend is expected to continue. Although no European lender matches the costs experienced by large US banks, several ones have crossed the €10 bn threshold, including most large UK institutions, BNP Paribas and Deutsche Bank.

On the other hand, news on operational losses associated with conduct risk events occurred in Europe (as collected by the ORX Association) suggest that the trend may have slowed down somewhat in 2015-2016. This, however, does not include costs suffered by European banks in non-European jurisdictions, like some large fines and settlements taking place in the US. The distribution of losses looks highly skewed, with a few extreme cases associated with very high costs. More than 55% of the total costs originate from the provision of traditional banking services aimed at individuals, families and SMEs, like commercial banking and retail banking.

A drill-down exercise based on Italian data shows that – while large banks clearly generate stronger systemic risk due to their size – small and mid-sized institutions have experienced higher misconduct costs per unit of total assets. Additionally, banks that ended up requiring resolution or some other form of extraordinary support show a substantially higher incidence of conduct risk losses, even in the initial years, when most extraordinary interventions still had to materialize.

Due to the wide-ranging nature of conduct risk, it is hard to summarise the main related pieces of regulation. Indeed, large portions of the rules used to address banking misconduct are country-specific, given that relevant events embrace areas (e.g., tax or anti-terrorism legislation) covered by domestic law. When it comes to mis-selling and bank governance, however, a number of EU-wide regulations are in place, which can be used to discipline conduct risk. These are summarised in this paper, as well as the standards and guidelines issued by two European Supervisory Agencies (EBA and ESMA). Notwithstanding this common framework, however, less than a quarter of the EU’s competent authorities have established dedicated teams or units on conduct risk, while slightly more than half include conduct risk in their supervisory examination programmes.

Conduct breaches are sometimes associated with market practices that span across multiple institutions, like rigged benchmark setting or the aggressive marketing of inappropriate products. Hence, fines and settlements may simultaneously hit a large number of banks, originating systemic risks that may undermine the stability of the financial system. Furthermore, misconduct costs may be passed on to customers, or translate into job cuts and lower dividends paid out to shareholders (including retail investors).

Hence, while ex post penalties clearly play a beneficial role, by discouraging inappropriate managerial choices and ensuring that past extra-profits are recuperated, they should not be the main regulatory answer to banking misconduct. Indeed, a whole array of mutually-reinforcing preventive tools should be deployed, to ensure that conduct breaches are made harder to commit and easier to detect at an early stage. These include:

- improving the quality of bank governance: by strengthening the requirements imposed on board members (in terms of both technical qualifications and personal independence);
- preventing remuneration schemes that encourage, or condone, inappropriate marketing practices (e.g. by awarding bonuses that depend on the amount of upfront fees collected on multi-year products);
- encouraging whistle-blowing, as requested by Directive 2013/36/EU (CRD4) through provisions aimed at protecting employees reporting breaches committed within their institutions (and still have to be implemented uniformly across member states);
- improving the clarity of regulations to remove grey areas and discourage borderline practices that, after being perceived as acceptable for many years, may expose the banking system and its stakeholders to the risk of huge, unexpected legal costs.

## 1. INTRODUCTION\*

*This paper was requested by the European Parliament under the supervision of its Economic Governance Support Unit.*

Misconduct risk in banking (also known as “conduct risk”) has been growing consistently after the 2007-2009 global financial crisis, because of stricter rules on financial intermediation and increased expectations and awareness by customers and regulators concerning the fair provision of financial and banking services. Still, no unanimously agreed definition exists for such risk, and it has been argued that a single, narrow characterisation may even prove undesirable<sup>1</sup>.

Furthermore, data on misconduct losses prove hard to collect and decypher, so that one still lacks a clear understanding on their drivers and past evolution. As for regulation, rules on banking conduct are embedded in a wide array of laws and level-2 provisions, with national segmentations still strong, although considerable harmonisation has already been achieved by EU legislators.

This short note starts by reviewing possible definitions and examples of conduct risk (§2); it then looks at empirical data on misconduct losses for banks in the European Union (§3), based on both restricted and public-domain data. §4 reviews the main pieces of EU regulation on misconduct-related matters, including documents and guidelines issued by European Supervisory Agencies. §5 concludes, by outlining actions that should be pursued to prevent misconduct events, rather than to sanction them on a mere *ex post* basis.

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<sup>1</sup> (European Systemic Risk Board, 2015, p. 5).



## 2. WHAT IS (MIS)CONDUCT RISK?

According to (European Banking Authority, 2016a, p. 89), 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 willful or negligent misconduct”. Similarly, (European Systemic Risk Board, 2015) states that “conduct risk is the risk of inappropriate, unethical or unlawful behaviour on the part of an organisation’s management or employees”, and “refers to the risks attached to the way in which a firm and its staff conduct themselves. As such, it includes how customers and investors are treated, mis-selling of financial products, violation of rules and manipulation of markets” and “can be caused by deliberate actions or may be inadvertent and caused by inadequacies in an organisation’s practices, frameworks or education programs”. These (and other<sup>2</sup>) definitions are so broad in scope that misconduct risk – like obscenity<sup>3</sup> – seems to call for an “I-know-it-when-I-see-it” approach, and can be better understood through the following examples<sup>4</sup> (European Systemic Risk Board, 2015):

- mis-selling of financial products to retail customers (e.g., consumer loans or insurance policies);
- mis-selling of financial products to professional investors (e.g., mortgage-backed securities);
- violation of rules, including tax, anti-money laundering and anti-terrorism regulations, as well as trade bans and economic sanctions agreed internationally;
- manipulation of financial markets, including markets for financial instruments, exchange rates, benchmark rates used in derivatives pricing<sup>5</sup>.

Misconduct may be due to an individual employee<sup>6</sup>, to a bank’s institution-wide policies (e.g., in terms of aggressive product design or biased commercial incentives) or even to industry-wide trends where several lenders engage in detrimental practices (e.g., by colluding in setting benchmark rates). The last case may trigger a systemic threat, as a large number of lenders can face a substantial amount of fines and redress costs; furthermore, as noted by (Carney, 2015), misconduct can undermine trust in banking institutions and markets, thereby limiting some hard-won benefits in terms of market infrastructures and financial inclusion.

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<sup>2</sup> Further definitions, as surveyed by (Management Solutions, 2016), are the following: “market conduct risk is the risk of loss or harm to consumers and counterparties arising from undesirable market conduct practices by an institution, and/or its representatives, and/or their inability or unwillingness to comply with the requisite market and business conduct requirements” (Australian Securities and Investments Commission, 2015); “conduct risk is understood as the risk of consumer detriment arising from the wrong products ending up in the wrong hands, and the detriment to society of people not being able to get access to the right products” (Monetary Authority of Singapore, 2007); “conduct risk means the current or prospective risk of losses to an institution arising from inappropriate supply of financial services including willful or negligent misconduct” (Financial Conduct Authority, 2013).

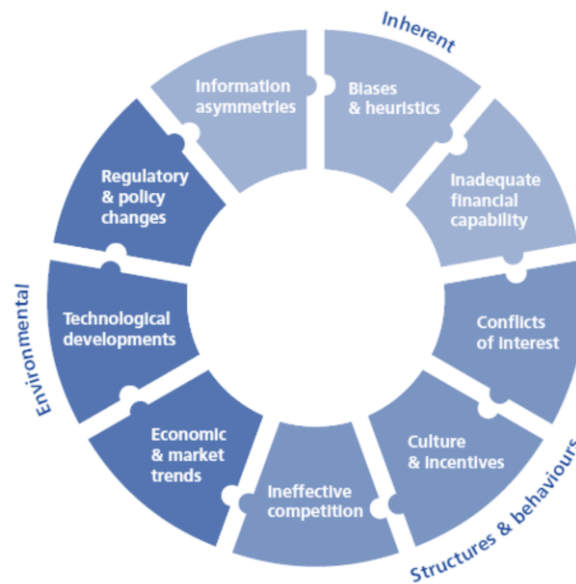
<sup>3</sup> (United States Supreme Court, 1964)

<sup>4</sup> Further examples are provided by (European Banking Authority, 2014) and include: mis-selling of products, in both retail and wholesale markets; pushed cross-selling of products to retail customers, such as packaged bank accounts or add-on products customers do not need; conflicts of interest in conducting business; manipulation of benchmark interest rates, foreign exchange rates or any other financial instruments or indices to enhance the institution’s profits; barriers to switching financial products during their lifetime and/or to switching financial service providers; poorly designed distribution channels that may enable conflicts of interest with false incentives; automatic renewals of products or exit penalties; unfair processing of customer complaints.

<sup>5</sup> According to (Management Solutions, 2016), misconduct risk can be partitioned into three large areas: “retail conduct” (originated by business processes such as product design, sales, complaints handling, collections and recovery), “wholesale conduct” (originated by transactions with wholesale counterparties, and including insider dealing, market abuse and the handling of conflicts of interest) and “corporate conduct” (originated by businesses like cross-border activities, the management of confidential data and other regulatory constraints, including anti-money laundering, anti-bribery, anti-terrorism rules).

<sup>6</sup> In our view, improper behavior by individual employees must involve at least one customer/outsider in order to qualify as misconduct. E.g., fraud by an employee to the detriment of the bank would give rise to a damage, but to no external liability for the latter: as such, it would not count as a form of misconduct.

**Figure 1:** The nine key drivers of (mis)conduct risk



Source: (Financial Conduct Authority, 2013, p. 10)

According to (Financial Conduct Authority, 2013), misconduct risk and its rise over the last decade can be ascribed to nine key drivers, which in turn can be grouped into three large areas (see Figure 1):

- “inherent factors”, due to a combination of *information asymmetries* (where banks use their superior access to information to develop structures and processes that benefit them over the consumer), demand-side *behavioral biases* (leading customers to ask for unsuitable, deceptive or overpriced products) and inadequate *financial capability* (with retail investors lacking the financial literacy, skills and motivation required to select bank services);
- “structures and behaviors”, including *conflicts of interests* (sometimes poorly disclosed and hardly managed), corporate *culture and incentives* (which exacerbate conflicts by rewarding high-risk, short-term business development strategies, and lead the salesforce to promote some products regardless of consumer needs and demands) and *ineffective competition* (e.g., high switching costs that lock customers in, and allow producers to earn large profit margins);
- “environmental factors”, ranging from *economic and market trends* (e.g, increasing income inequalities that lead to stronger demand for credit) to *technological developments* (that may endanger business continuity and trigger unfair exclusion based on improper use of confidential consumer data) and *regulatory changes* (with increased prudential requirements causing lenders to withdraw from certain businesses, leading to customer detriment and to a higher presence of unregulated shadow banks).

Misconduct risk generates three broad classes of costs: sanctions (including fines and other financial penalties), redress costs (to compensate plaintiffs and other customers for the damages caused by inappropriate behaviours) and legal expenses (including internal legal departments and fees paid to outside counsels and technical experts). Sanctions and redress costs can follow from a ruling (by a judicial court or law enforcement agency) or from a private settlement (arranged with customers and/or prosecutors). While sanctions are mostly paid as a lump sum, they depend on investigations and trials that may take a long time. Redress costs often spread over many years, as a growing number of customers become aware of the damages suffered, and ask for compensation. This generates uncertainty and reputational damages, and exerts a negative impact on the value of the banks involved.

### 3. HOW MATERIAL IS CONDUCT RISK FOR EUROPEAN LENDERS?

In this paragraph, misconduct costs will be further discussed, and estimates for their size and composition will be provided, based on a number of different data sources. Our analysis will rely on both confidential data (§3.1.1, based on the results of the 2016 stress test exercise) and public domain sources (§3.2).

#### 3.1 Aggregate information based on confidential data

##### 3.1.1 Stress test results and other EBA data

In 2016, the EBA requested 51 large European banks participating in its stress test exercises to separately report misconduct risk losses, as well as the capital requirements due to such risk under an adverse macroeconomic scenario based on supervisory assumptions for 2016-2018. In doing so, banks had to follow an *ad hoc* methodology<sup>7</sup> that – while based mostly on qualitative judgment – involved a structured process, to help them provide more information than they did in the past.

As indicated by (European Banking Authority, 2016a), misconduct risk had to be identified in line with the EBA Guidelines on the Supervisory Review and Evaluation Process<sup>8</sup> (European Banking Authority, 2014) and could be approximated by banks with two “event types” (“internal fraud” and “clients, products and business practices”) used in the reporting of operational risk<sup>9</sup>.

To prevent stigma and self-fulfilling prophecies, the 2016 stress test results were disclosed to the public in a format that does not include data on conduct risk for individual institutions. However, the EBA stated that most of the aggregate impact of operational risk on CET1 capital under the adverse scenario (-€105bn, that is, -1,1% of risk-weighted assets) was driven by conduct risk (-€71bn or -0,8% of risk-weighted assets), with 15 banks out of 51 reporting conduct risk losses in excess of €1bn. Under the adverse scenario, more than half of the €71bn in conduct risk losses (€37bn) were expected to occur in 2016, compared to a historical figure of €27bn for 2015.

Other than through stress test exercises, conduct risk is also monitored by the EBA in its periodic risk assessments of the EU-wide banking sector, based on a questionnaire filled by about 40 large banking institutions. The December 2016 update states that over 44 % of respondents have paid out more than €500m in compensation, litigation and similar payments since the financial year 2007/8, while 32% have paid out more than €1bn.

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<sup>7</sup> The EBA methodology requires that all banks report conduct risk losses experienced in 2011-2015 (subject to a materiality threshold of €10,000). Lenders having suffered at least one “material conduct risk event” triggering losses for more than 10 basis points of the bank’s consolidated CET1 capital, or expecting to experience one over the stress test horizon, are then requested to use a more sophisticated approach to conduct risk reporting, known as the *qualitative approach* (QLA). Other institutions, instead, are allowed to use a simpler procedure, known as the *quantitative approach* (QTA). Under the QLA, banks must identify past material conduct risk events and estimate losses that they may cause in excess of provisions already booked. Additionally, they must quantify losses that may arise, by end 2018, from new material conduct risk events and non-material events. When assessing bank projections, supervisors take into account comparisons to a peer group of institutions facing similar vulnerabilities to conduct risk. Both the QLA and the QTA include floors for non-material losses, based on the institutions’ track record in the last five years. See (Resti, 2016) for further details.

<sup>8</sup> See Footnote 4.

<sup>9</sup> Event types 1 and 4 of the COREP template for operational risk (“C 17.0”0). Additionally, banks were expected to report as conduct risk any events that would match the definition provided (see Footnote 4).

### 3.1.2 Italian bank data from the ABI's Operational Losses ("DIPO") database

As noted above, conduct risk losses can be proxied by reference to some operational risk categories, namely "Clients, Products & Business Practices" (defined<sup>10</sup> as, "losses arising from an unintentional or negligent failure to meet a professional obligation to specific clients, or from the nature or design of a product") and "Internal Fraud" ("losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/ discrimination events, which involves at least one internal party"). Accordingly, operational risk data provides a valuable source of information on conduct risk.

In 2003 the Italian Bankers' Association ("ABI") launched a data pooling project known as DIPO (*Database Italiano Perdite Operative*, Italian Database of Operational Losses). DIPO currently gathers information from 33 banking groups, including more than 200 legal entities, for any event causing an operational loss above €5,000. Data identification, categorization and enrichment are based on strict, harmonized procedures followed by all member banks. Events due to legal risk are reported based on an ad hoc methodology maintained by DIPO's technical committee<sup>11</sup>.

Although DIPO only covers Italian banks, it provides a rich and reliable source of information that can be used to learn more on how misconduct risk affects different types of banks. In the remainder of this section we provide evidence on four different clusters of institutions<sup>12</sup>:

1. significant institutions supervised by the SSM (6 banks);
2. banks affected by resolution and other extraordinary measures (7 banks, including significant institutions as appropriate);
3. other banks with total assets in excess of €20 billion (5 banks, including 2 subsidiaries of foreign groups);
4. all other banks (10 banks);

For these clusters, Figure 2 shows the evolution of misconduct losses over time, in terms of both absolute amounts and index numbers. While no overall increase emerges from the data<sup>13</sup>, conduct risk losses have been rising (and more volatile over time) for small-medium institutions and for banks affected by extraordinary measures.

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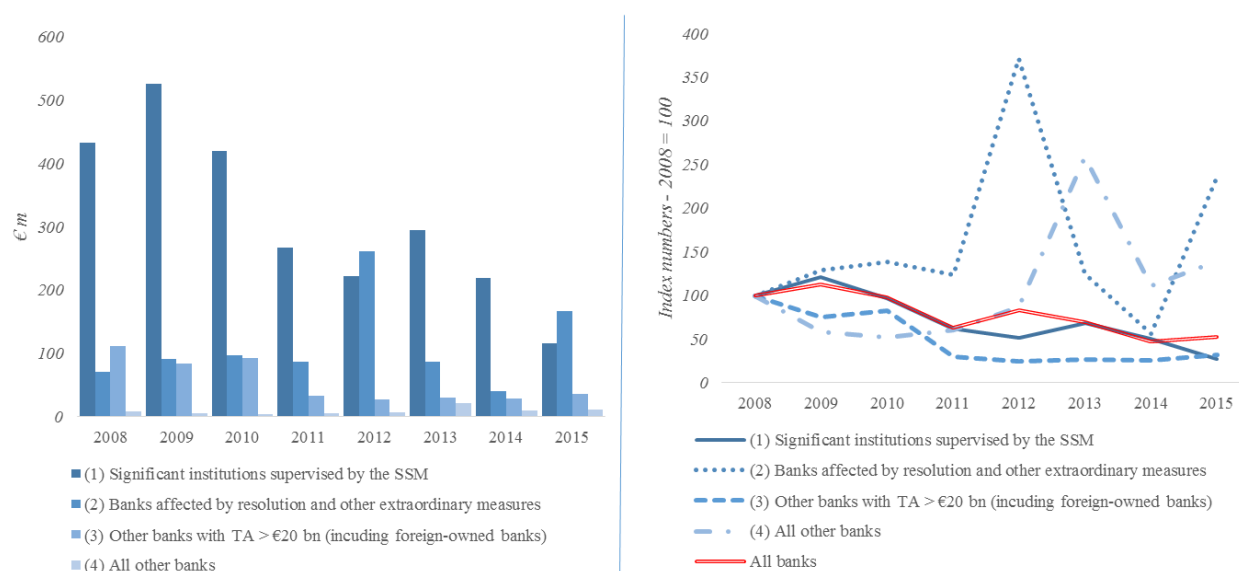
<sup>10</sup> (Basel Committee, 2001 Annex 2).

<sup>11</sup> Further details can be found on <http://www.dipo-operationalrisk.it/index.html>.

<sup>12</sup> These are closed clusters, whose composition stays unchanged throughout the period covered by our analysis. While the DIPO database includes information for 35 groups, our database is limited to 28 items, due to the existence of some reporting entities that are not a bank in a narrow sense (e.g. Poste Italiane Group) or that did not participate in the database during the whole time window covered by our analysis.

<sup>13</sup> Data for the most recent periods may be affected by fact that misconduct losses are frequently discovered and reported with some delay.

**Figure 2: Misconduct risk losses for different clusters of Italian banks**



Source: DIPO operational risk data

Table 1 provides further insight by looking at losses as a share of total assets and Tier 1 capital (note that all data are in basis points, i.e., hundredths of percent points). Again, banks affected by extraordinary measures stand out as the most vulnerable category (including in 2011, when most extraordinary interventions still had to materialize<sup>14</sup>). Interestingly, banks with less than € 20 bn in total assets seem more strongly affected by misconduct costs than larger institutions (although, of course, the latter are more significant in terms of the systemic impact of their losses).

**Table 1: Misconduct losses as a share of total assets and Tier 1 capital (all data are in basis points)**

<i>Losses as a share of total assets - basis points</i>	2011	2012	2013	2014	2015	Mean
(1) Significant institutions supervised by the SSM	1,38	1,13	1,61	1,19	0,62	1,18
(2) Banks affected by resolution and other extraord. measures	2,35	7,28	2,63	1,31	6,08	3,93
(3) Other banks with TA > €20 bn (including foreign-owned)	1,43	1,19	1,33	1,24	1,55	1,35
(4) All other banks	1,01	1,40	4,11	1,65	2,00	2,04
All banks	1,51	1,98	1,78	1,22	1,35	1,57
<i>Losses as a share of T1 capital - basis points</i>	2011	2012	2013	2014	2015	Mean
(1) Significant institutions supervised by the SSM	25,78	20,82	30,47	20,73	10,94	21,75
(2) Banks affected by resolution and other extraord. measures	45,79	164,62	54,78	28,06	114,08	81,47
(3) Other banks with TA > €20 bn (including foreign-owned)	25,46	20,20	22,81	20,25	25,46	22,83
(4) All other banks	12,72	22,03	62,90	26,76	28,58	30,60
All banks	28,09	37,10	33,54	21,58	23,74	28,81

Source: DIPO operational risk data

### 3.2 Public domain data sources

We now turn to public domain data sources, looking at two databases fed by news clippings and media releases. Before we proceed, it is worth noting that such sources may suffer from two biases: first, large banks are more likely to be in the spotlight, compared to smaller institutions; second, some

<sup>14</sup> The ratio of misconduct losses to Tier 1 capital suggests that the former - although significant - did not pose a direct threat to capital levels. Rather, a high level of misconduct losses is likely to have been associated with other weaknesses (e.g. in loan origination or derivatives trading) that may have caused additional (and sizeable) damages to the banks' viability, calling for resolution or other forms of extraordinary intervention.

jurisdictions may look more affected by conduct risk, just because it is more closely monitored by the local media (similarly, media coverage may have improved over time).

### 3.2.1 CCP Research Foundation

The CCP Research Foundation is an academic/consultancy initiative originated by the London School of Economics' "Conduct Costs Project". It promotes research in ethics, risk culture, public trust and related matters and manages a database covering 20 large banking groups worldwide. Conduct costs<sup>15</sup> are referred to the date on which a liability "crystallises" (e.g. due to a ruling or settlement); additionally, the database records each bank's provisions for the final year.

Table 2 shows data taken from the Foundation's latest report (CCP Research Foundation, 2016): all figures have been converted into euros using end-year exchange rates. Although no European lender matches the costs experienced by large US banks, several ones have crossed the €10 bn threshold, including most large UK institutions, BNP Paribas and Deutsche Bank.

**Table 2:** Conduct costs for 20 large banking groups (€ bn)

	2011	2012	2013	2014	2015	Total 2011-2015	Provisions (end 2015)	Grand total
Bank of America (US)	4.35	10.51	14.09	28.28	1.13	58.36	11.05	69.40
JPMorgan Chase (US)	3.81	9.73	12.56	3.27	2.71	32.09	9.01	41.10
Morgan Stanley (US)	2.35	2.65	1.75	2.02	3.07	11.83	17.13	28.96
Lloyds Banking Group (EU)	2.16	4.16	3.67	4.69	5.21	19.89	6.05	25.94
Barclays (EU)	0.65	2.50	2.24	4.21	5.74	15.34	4.74	20.07
Citigroup, Inc (US)	1.70	2.13	1.58	9.82	1.37	16.60	3.20	19.81
RBS (EU)	0.40	1.67	2.20	4.17	2.80	11.24	8.03	19.27
Deutsche Bank (EU)	0.37	0.81	2.70	3.00	3.32	10.21	5.74	15.95
HSBC (EU)	0.59	2.68	1.59	2.38	1.36	8.60	4.14	12.74
BNP Paribas (EU)	0.18	0.17	0.10	7.69	0.16	8.30	4.34	12.64
Wells Fargo (US)	0.98	4.66	2.02	1.03	1.71	10.41	1.19	11.61
Goldman Sachs (US)	0.13	0.34	0.70	3.40	3.68	8.25	1.83	10.08
Credit Suisse (Other)	0.58	0.32	0.63	3.57	0.50	5.59	3.51	9.11
Santander (EU)	0.46	0.74	0.49	2.30	1.68	5.68	2.46	8.13
UBS (Other)	0.37	1.39	1.16	1.07	0.95	4.94	2.89	7.83
National Australia Bank (Other)	0.58	0.57	0.48	0.53	0.88	3.03	1.60	4.64
Commerzbank (EU)	0.10	0.15	0.29	0.09	1.53	2.16	0.39	2.55
Société Générale (EU)	0.00	0.01	0.04	0.03	0.03	0.10	2.13	2.23
Standard Chartered (EU)	0.16	0.52	0.08	0.32	0.07	1.15	0.11	1.26
ING Group (EU)	0.07	0.57	0.06	0.05	0.11	0.86	0.19	1.05
<i>EU (11 banks)</i>	<i>5.13</i>	<i>13.98</i>	<i>13.47</i>	<i>28.93</i>	<i>22.01</i>	<i>83.51</i>	<i>38.32</i>	<i>121.83</i>
<i>US (6 banks)</i>	<i>13.33</i>	<i>30.02</i>	<i>32.71</i>	<i>47.82</i>	<i>13.67</i>	<i>137.54</i>	<i>43.41</i>	<i>180.95</i>
<i>Other (3 banks)</i>	<i>1.52</i>	<i>2.28</i>	<i>2.26</i>	<i>5.16</i>	<i>2.33</i>	<i>13.56</i>	<i>8.01</i>	<i>21.57</i>
Grand total	19.95	46.27	48.45	81.93	38.04	234.64	89.74	324.38

Source: (CCP Research Foundation, 2016). End-year FX rates used when necessary

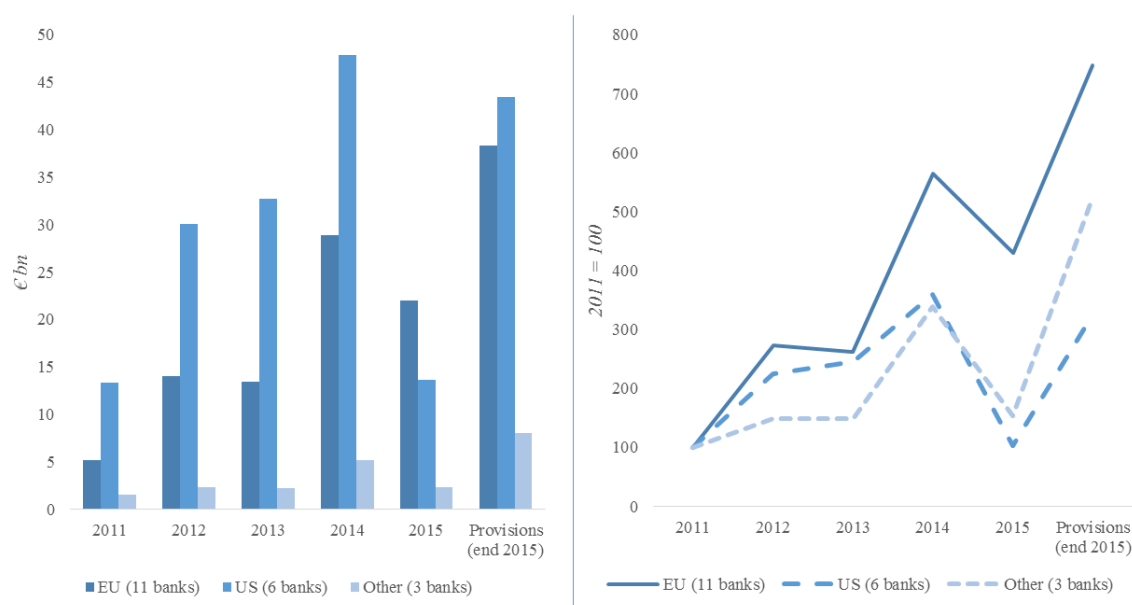
Figure 3 provides a snapshot of long-term trends in the EU, US and elsewhere. One can see that conduct costs have been increasing almost monotonically<sup>16</sup> (although 2014 looks as an extraordinarily expensive year), while the large pool of provisions set aside at the end of 2015 suggests that no trend reversal can be expected in the near future<sup>17</sup>.

<sup>15</sup> A detailed definition of conduct costs according to the CCP Foundation's methodology is provided here: <http://conductcosts.ccpresearchfoundation.com/conduct-costs-definition>.

<sup>16</sup> Part of the losses for 2015 may still have to become publicly known.

<sup>17</sup> While provisions provide a reasonable guidance on expected conduct losses that have not yet "crystallized", there have been events (see Benedict et al., 2016, p. 8) where risk has been significantly under-provisioned by banks: for example, BNP Paribas' provisioning accounted for only 12.4% of its USD 8.9bn fine in 2014.

**Figure 3:** Breakdown of conduct costs by large geographic areas (absolute amounts and index numbers)



Source: (CCP Research Foundation, 2016)

### 3.2.2 ORX Association

The Operational Riskdata eXchange Association (in short: ORX) ORX is a not-for-profit body incorporated in Geneva, owned and run by its members (more than 90 financial institution from 20 countries). Besides promoting working groups, research projects and surveys, ORX runs one of the most valued data exchange platforms on operational risk. ORX data have already been used in the past for academic research<sup>18</sup>.

Next to the confidential information gathered from its associates as part of its data pooling initiatives, ORX also manages a database of loss events based on public information (“ORX News”). The service is provided by a team of multi-lingual experts, who search financial media sources worldwide to identify operational risk loss events in the banking, insurance and asset management sectors. The database includes more than 5,500 events for over 130 countries<sup>19</sup>.

Table 3 shows losses reported in 2012-2016<sup>20</sup> in the European Union<sup>21</sup>, for the event types (“internal fraud” and “clients, products & business practices”) usually associated with conduct risk. Losses related to insurance were filtered away to keep the focus on banking. One can see that misconduct costs have somewhat slowed down in the last two years (in terms of both amounts and number of events); this contrasts with the findings in Table 2, based on CCP Foundation data. This can be explained, however, by a few differences between the two databases: in fact, our ORX News data covers a wider sample but only includes events that occurred in the European Union (leaving out fines and settlements experienced outside the EU by EU-based institutions).

<sup>18</sup> See e.g. (Sands et al., 2016).

<sup>19</sup> Further details can be found on <https://managingrisktogether.orx.org/orx-news>.

<sup>20</sup> Based on a snapshot of the database taken on February 20, 2017.

<sup>21</sup> Note that, unlike the CCP Foundation, ORX allocates each events to the country where it took place, not to the country where the affected bank is headquartered.

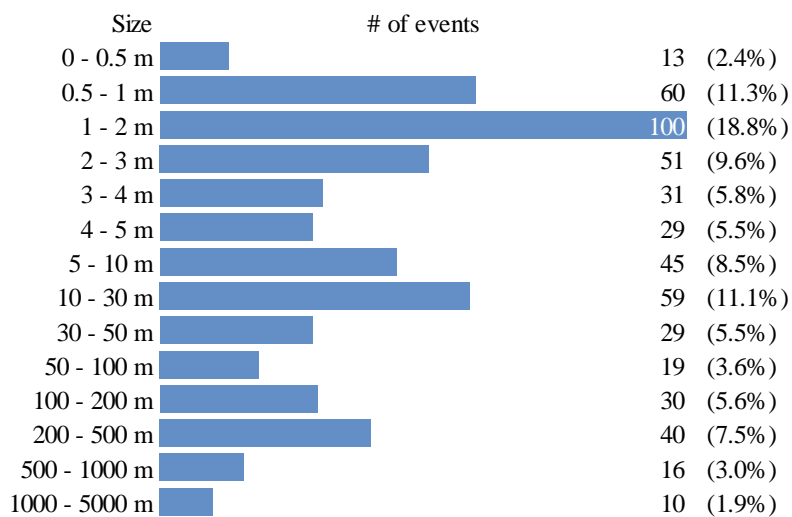


**Table 3:** Conduct costs in the European Union (€ bn)

	2012	2013	2014	2015	2016	Total
Losses (€ bn)	14.5	9.6	15.7	9.2	5.8	54.8
# of losses	136	148	169	87	90	630
Average loss (€ m)	107.0	64.6	92.9	105.5	64.2	86.9

Source: ORX News Database – Data on loss events occurred in the European Union

Based on Table 3, the size of the average misconduct loss is close to €87 million. Figure 4 provides more insight on individual loss sizes: the distribution looks highly skewed, with a significant number of “moderate” losses (more than 50% of the total lies below €5 million) and a few extreme cases associated with very high costs (less than 20% exceed €100 million).

**Figure 4:** Frequency distribution of loss events by size

Source: ORX News Database – Data on loss events occurred in the European Union – 2012-2016

Table 4 ranks losses by business lines: one can see that traditional banking services aimed at individuals, families and SMEs (commercial banking and retail banking) make up for more than 55% of the total. Misconduct costs also tend to originate from “trading & sales” and “private banking” (whereas “corporate items” is a residual category including losses originated from corporate governance flaws and items that cut across several business lines),.



**Table 4:** Conduct costs in the European Union by business line (€ bn)

	<i>Losses (€ bn)</i>	<i>Share</i>
Commercial Banking	19.5	35.6%
Retail Banking	11.8	21.6%
Corporate Items	10.6	19.3%
Trading & Sales	8.6	15.7%
Private Banking	2.8	5.0%
Asset Management	0.8	1.4%
Corporate Finance	0.3	0.5%
Agency Services	0.2	0.4%
Retail Brokerage	0.2	0.3%
Clearing	0.0	0.0%
Total losses	54.8	100.0%

Source: ORX News Database –

Data on loss events occurred in the European Union – 2012-2016

Table 5 reports conduct losses by country. It should be borne in mind that, since data are allocated based on the jurisdiction where misconduct costs emerged, large fines and settlements involving European banks in the US are not included in the table. Next to the absolute amounts, we also provide a measure of “loss intensity” (in basis points), where losses are scaled by total assets (ECB data for 2015). The latter suggests that the enforcement of misconduct-related rules has been comparatively stronger in Greece and Bulgaria; Hungary and Spain also reach levels well above the overall mean.

**Table 5:** Conduct costs in the European Union by country

	<i>Losses (€ bn)</i>	<i>Losses / Total assets*</i>		<i>Losses (€ bn)</i>	<i>Losses / Total assets*</i>
United Kingdom	16.20	14.1	Austria	0.17	1.6
Spain	13.19	36.0	Luxembourg	0.17	2.0
Greece	5.55	158.5	Portugal	0.06	1.3
Italy	5.33	19.6	Sweden	0.03	0.2
Germany	3.59	5.2	Norway	0.02	0.4
Netherlands	3.47	13.7	Latvia	0.01	4.4
Belgium	2.10	21.6	Lithuania	0.01	5.9
Bulgaria	1.89	416.3	Czech Republic	0.01	0.5
France	1.58	2.3	Slovenia	0.01	2.2
Ireland	0.61	12.6	Denmark	0.00	0.0
Hungary	0.31	30.6	Finland	0.00	0.0
Poland	0.24	6.5	Malta	0.00	0.1
Romania	0.21	25.0	<i>Total</i>	<i>54.77</i>	<i>12.8</i>

Source: ORX News Database (2012-2016) and ECB (2015)

Data on loss events occurred in the European Union

\* In basis points, based on 2015 total assets

## 4. REGULATION AND SUPERVISION ON BANKING MISCONDUCT IN THE EU

### 4.1 EU-wide rules on banking misconduct

Due to the wide-ranging nature of conduct risk, it is hard to summarise the main related pieces of regulation. Indeed, large portions of the rules used to address banking misconduct are country-specific, given that relevant events embrace areas (e.g., tax or anti-terrorism legislation) covered by domestic law.

When it comes to financial products mis-selling and bank governance, however, a number of EU-wide regulations are in place, which can be used to discipline conduct risk. These are summarised in Table 6, which completes and updates the list reported by (Management Solutions, 2016).

**Table 6:** Main regulations and directives affecting bank misconduct

<i>Regulation</i>	<i>Main links to misconduct risk</i>
Capital Requirements IV Directive (CRD4, Directive 2013/36 EU)	Rules on bank governance to ensure that the board of directors effectively monitors top managers. Remuneration limits to prevent incentives to excessive risk taking and inappropriate marketing practices
Alternative Investment Fund Managers Directive (AIFMD, Directive 2011/61/EU)	Requirements for minimum standards of conduct in business, safekeeping of investments and authorisation of fund managers
Mortgage Credit Directive (2014/17/EU)	Conduct rules for banks offering first and second charge mortgages. Requirement for banks to implement new pre-contract disclosures and withdrawal/reflection periods. Requirement for regulators to implement an admissions regime for intermediaries
Undertakings for Collective Investment in Transferable Securities (UCITS) Directives	Harmonise rules across the EU regarding mutual funds, including depository duties, asset eligibility, risk diversification, liabilities structure, counterparty risk.
Payment Accounts Directive (2014/92/EU)	Requires that all customers have access to basic accounts. Increases transparency of payment accounts fees. Sets minimum standards for switching to a different bank
Market Abuse Directives and Regulation (Directives 2003/6/EC and 2014/57/EU, Regulation 2014/596/EU)	Prohibits insider dealing and market manipulation. Imposes minimum criminal sanctions for market abuse and requirements for cross border cooperation between all EU member states
Key Information Documents for packaged retail and insurance-based investment products (KIDs for PRIIPs, Regulation 2014/1286/EU)	Requires to provide a key information document for packaged retail investment and insurance products
Markets in Financial Instruments Directive/ Regulation (MiFID II / MiFIR, Directive 2014/65/UE and Regulation 2014/600/EU)	Dictates new investment protection/distribution measures, increased transparency and stricter controls on market processes (e.g. inducements and conflicts of interest)
Fourth Anti Money Laundering Directive (2015/849/EU)	Prevents misuses of the financial system to fund terrorism and illegal activities. Requires member States to put in place national registers of beneficial owners, to ensure transparency around potentially opaque ownership structures
Financial Benchmarks (Regulation 2016/1011/EU)	Sets standards for authorisation and supervision of benchmark contributors. Improves transparency and governance of the production of benchmarks. Ensures appropriate supervision of benchmarks
Securities Financing Transactions Regulation (2015/2365/EU)	Sets disclosure requirements such as providing clients with information on the effects of re-hypothecation and the use of securities financing transactions
Insurance Distribution Directive (2016/97/EU)	Sets rules on knowledge and competence of employees and intermediaries and introduces two conduct principles (that firms must act honestly, fairly and professionally and that all information must be fair, clear and not misleading)

Source: (Management Solutions, 2016)

Two European Supervisory Agencies (EBA and ESMA) have also been issuing technical standards and guidelines to complement these regulations and ensure uniform implementation across member States. The most significant documents, as identified by (European Systemic Risk Board, 2015), are listed in Table 7.

**Table 7: Main supervisory guidelines and standards affecting bank misconduct**

<i>Document</i>	<i>Main links to misconduct risk</i>
EBA GL 44, 2011.	Guidelines on internal governance containing specific principles that banks should apply to address misconduct risk
EBA GL/2012/06	Guidelines for the assessment of the suitability of management body members, highlighting the crucial role of the internal control function, which should prevent misconduct by senior management
ESMA-EBA Principles, 6 June 2013.	Principles for benchmark setting in the European Union, which should prevent benchmark manipulation
“Placement of financial instruments with depositors, retail investors and policy holders” (“Self placement”), JC 2014(62), 31 July 2014.	A review of various rules and practices on self-placement (the sale of own liabilities to customers) and the drivers behind mis-selling (i.e. the design and marketing of financial products, and remuneration arrangements for sales staff).
ESMA, Guidelines on remuneration policies and practices, 11 June 2013.	Guidelines on remuneration policies and practices aimed at preventing distorted incentives leading individuals to misconduct
“Joint Position of the European Supervisory Authorities on Manufacturers’ Product Oversight & Governance Processes”, JC-2013-77.	Guidelines on product oversight and governance requirements for manufacturers and distributors
“Joint Committee Final Report on guidelines for complaints-handling for the securities (ESMA) and banking (EBA) sectors”, JC-2014-43	Guidelines on complaints-handling for the securities (ESMA) and banking (EBA) sectors

Source: (European Systemic Risk Board, 2015)

## 4.2 Supervisory practices on banking misconduct

Misconduct rules and principles are implemented by individual EU countries in a heterogeneous manner. While some member States have created ad-hoc agencies (as was the case of the British Financial Conduct Authority in 2013), other jurisdictions deal with conduct risk through several different bodies (e.g., banking supervisors, stock-market watchdogs, anti-trust authorities, etc.). Furthermore, anti-misconduct regulations are often enforced by the judiciary system, including both criminal prosecutors and civil courts.

As concerns banking supervisors, the EBA guidelines for common SREP procedures and methodologies<sup>22</sup> provide guidance for the assessment of conduct risk. They require that conduct risk be reviewed (as part of the legal risks faced by operational risk management) based on the bank’s business model and incentive policies, looking for “red flags” connected with past complaints and sanctions (including those imposed on institutions that engage in similar activities), as well as for forward-looking threats. Notwithstanding this commonly-agreed framework, less than a quarter of the EU’s competent authorities have established dedicated teams or units on conduct risk, while slightly more than half include conduct risk in their supervisory examination programmes (European Banking Authority, 2016b). Corrective actions used to address poor conduct risk management range from requesting process improvements to imposing administrative penalties and additional own funds requirements (see Table 8 for details).

<sup>22</sup> (European Banking Authority, 2014)  
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**Table 8:** Main supervisory actions to address conduct risk (by number of competent authorities that use a specific measure)

	2013	2014	2015
Request improvements in processes, arrangements and strategies	12	13	13
Require institutions to present a plan to restore compliance	9	9	8
Imposing administrative penalties/measures	7	7	6
Imposing additional own funds requirements	4	6	6
Request/impose additional disclosures	2	2	1
Impose (temporary) business restrictions	1	1	2
Apply a specific provisioning policy	1	1	1
Other qualitative measures	2	2	2
Other quantitative measures	0	0	1

Source: (European Banking Authority, 2016c) – 2015 refers to first half only

## 5. FINAL REMARKS

As noted by (Financial Stability Board, 2015), the complexity of the decision-making processes within banks is so high that it may prove difficult to track individual responsibilities associated with misconduct episodes (and with failures to prevent or detect them). Consequently, the burden of *ex post* sanctions may fall on the bank, its shareholders and stakeholders, rather than on the natural persons directly involved in the wrongdoings.

Additionally, conduct breaches are sometimes associated with market practices that span across multiple institutions, like rigged benchmark setting or the aggressive marketing of inappropriate products that generate high short-term profits. In such cases, fines and settlements may simultaneously hit a large number of banks, originating an industry-wide wave of unexpected costs. Indeed, according to (Financial Stability Board, 2015), in 2009-2014 “less than 5% of fines and settlements were of a firm-specific nature; the rest involved several large banks in a number of jurisdictions”.

Hence, large supervisory sanctions and legal liabilities arising from mass litigation may end up undermining the financial stability of the banking system. Furthermore, misconduct costs may be passed on to customers, or translate into job cuts and lower dividends paid out to shareholders (including retail investors), something that can hardly be seen as a positive outcome for consumers, savers, families and small businesses.

This is not to say that banks should be allowed to benefit from inappropriate business practices. Penalties serve a socially desirable purpose, by discouraging future breaches and ensuring that past extra-profits are recovered (with shareholders having to pay for their inability to set up a transparent and sustainable corporate governance scheme). However, while the public opinion may find some comfort in seeing banks held responsible for inappropriate market practices, *ex post* fines and redress costs should not be the main regulatory answer to banking misconduct. Indeed, they need to be complemented by a whole array of preventive tools, to ensure that conduct breaches are made harder to commit and easier to detect at an early stage.

To this aim, several mutually-reinforcing levers can be used, to ensure that misconduct risk is actively managed and its consequences kept in check. The main ones are the following:

- *Improve the quality of bank governance*: by strengthening the requirements imposed on board members (in terms of both technical qualifications and personal independence), regulation can ensure that improper conduct by CEOs and other executive directors is challenged and contrasted from the inside, and unfair policies are detected and reversed before they cause widespread damage. While banking supervisors in the EU have committed to common guidelines on the assessment of the suitability of members of the management body<sup>23</sup>, peer reviews indicate that further progress may be achieved, as numerous divergences still exist in a number of key areas (e.g. in the implementation of rules on independence and conflict of interest).
- *Ensure that remunerations do not encourage, or condone, inappropriate marketing practices*. Bank products like asset management, investment advice, structured securities or consumer

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<sup>23</sup> (European Banking Authority, 2012). A new set of joint guidelines by EBA and ESMA (European Banking Authority and European Securities and Markets Authority, 2016) is currently in the consultation phase. The draft text contains criteria to assess the individual and collective knowledge, skills and experience, integrity and independence of members of the management body, as well as requirements in terms of minimum time commitment and diversity (to prevent unanimous “group thinking”). Institutions are required to establish policies for providing board members with appropriate training. However, the definition of independence provided in the draft looks weak, with all board members being qualified as “independent” regardless of their conflicts of interest (e.g. personal, professional or economic relationships, loans received from the bank), as long as the latter “can be managed”.

lending are sometimes marketed in a way that overemphasises short-term commercial targets. This may translate into variable remuneration schemes that reward aggressive placement strategies, e.g. by awarding bonuses that depend on the amount of upfront fees collected on multi-year products. While considerable work has been done by the ESAs regarding remuneration guidelines for staff selling investment funds and other retail banking products<sup>24</sup>, implementing these principles uniformly across EU jurisdictions remains a challenge. Still, the benefits of fair variable pay schemes (and non-monetary benefits) can hardly be overstated, as the latter may prove a powerful tool to prevent the mis-selling of banking products and to ensure that bank employees act in the consumers' best interests.

- *Encourage whistle-blowing and the reporting of misconduct events* – Insiders are well-placed to help in the early detection of inappropriate corporate policies, and sometimes are eager to come forward and report misconduct episodes, when they see a risk that their institutions (and jobs) are put in jeopardy by reckless managerial choices. Directive 2013/36/EU (also known as CRD4) requires that supervisors establish reliable mechanisms to collect reports of potential or actual breaches of CRD4 (and its companion Regulation 575/2013, known as CRR). Such mechanisms must ensure that employees reporting breaches committed within their institutions are protected against discrimination and unfair treatment, and their names are kept confidential unless judicial proceedings require otherwise. Similar mechanisms must be deployed within banks. It is unclear, however, whether such provisions have been implemented uniformly and effectively across member states<sup>25</sup>. While the SSM has set up a website to collect anonymous reports concerning any breach of “relevant EU law”, either by institutions or by supervisory agencies<sup>26</sup>, other national authorities seem less keen to go down this avenue.
- *Remove grey areas by improving the clarity of regulations* – While some misconduct cases clearly originate from willful disregard for ethics and good management rules, many violations arise because banks find it hard to keep pace with complex and ever-changing rules on customer protection, internal controls and governance. Hence, EU-wide harmonization of misconduct-related rules should not be pursued by imposing additional layers of regulation, but rather by replacing national standards with a stable, unified pan-European framework, to be applied and enforced consistently across the whole European Union. Indeed, EU legislators have already met such an ambitious target in several areas (see again Table 6 above), e.g. by setting uniform rules on market manipulation crimes or inducements paid to investment managers and advisors. Such efforts should continue and address further areas (e.g. usury) that remain governed by national law. By promoting a clear and unambiguous set of rules, EU lawmakers can reduce grey areas and discourage borderline practices that, after being perceived as acceptable for many years, turn out to expose the banking system and its stakeholders to the risk of huge, unexpected legal costs.

<sup>24</sup> (European Banking Authority, 2016d; European Securities and Markets Authority, 2016)

<sup>25</sup> Additionally, the reference to *employees* makes it unclear whether the protection granted to whistle-blowers by CRD4 also applies to dissenting *board members*, who should also be protected against retaliation to ensure that they are free to report inappropriate behaviours to supervisors.

<sup>26</sup> See <https://www.bankingsupervision.europa.eu/about/ssmexplained/html/whistleblowers.en.html>.

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