MARKET CONDUCT SUPERVISION OF FINANCIAL SERVICES PROVIDERS
A RISK-BASED SUPERVISION FRAMEWORK

THIS GUIDELINE NOTE WAS DEVELOPED BY THE AFI CONSUMER EMPOWERMENT AND MARKET CONDUCT (CEMC) WORKING GROUP TO PROVIDE GUIDANCE FOR POLICYMAKERS ON THE DEVELOPMENT AND IMPLEMENTATION OF SOUND MARKET CONDUCT SUPERVISION OF FINANCIAL SERVICES PROVIDERS.

Guideline Note No.21
August 2016

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ABOUT THIS GUIDELINE NOTE

This guideline note was prepared by the Institutional Framework and Supervision Subgroup (IF&S SG) of the AFI Consumer Empowerment and Market Conduct (CEMC) Working Group.

The purpose of this guideline note is to elaborate a supervision framework for financial supervisory authorities (FSAs) in developing and emerging countries with a particular policy focus on the financial inclusion of low-income populations. The framework presented here, the Market Conduct Risk-Based Supervision (MC-RBS) Framework, is based on an approach traditionally used by prudential supervisors. The MC-RBS framework describes the principles, concepts and core processes that FSAs may use to supervise the market conduct of financial services providers (FSPs). In this note, "FSP" includes any type of institution providing financial services to retail customers (deposits, credit, money transfers, etc.) and under the supervision of their country's FSA.

The framework covers all financial industries except securities market, given its complexity and unique nature. Also, a framework that includes the securities market tends to be more characteristic of developed economies.This guideline note will be especially helpful for policymakers and regulators who design their own market conduct supervision frameworks, guidelines and standards for financial consumer protection.

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Abbreviations

CG - corporate governance
CP - consumer protection
FSA - financial supervision authority
FSP - financial services provider
FTC - fair treatment of consumers
IC - internal control
IF & SG - Institutional Frameworks and Supervision Subgroup
MC - market conduct
MC-RBS - market conduct risk-based supervision
RBS - risk-based supervision
SA - significant activity

INTRODUCTION

The market conduct supervision framework outlined in this guideline note is based on the concept of risk-based supervision (RBS), which developed countries and a growing number of developing countries have been using in prudential supervision over the last two decades.[1]

Until recently, the main objective of an RBS approach was ensuring the safety and soundness of the financial system. Originally used for prudential supervision of banks and insurance companies, RBS has been modified for use in pensions and is now being considered for market conduct supervision. The challenges of supervising consumer protection are the same: deploying sufficient resources, focusing on both present and future risks, preventing risks from escalating and taking early corrective actions.

However, market conduct is unique, especially given the new national financial inclusion policies emerging alongside more traditional financial stability concerns. For example, a payment institution may not be systemically important from a financial stability perspective, but it may play an important social role in government-to-people (G2P) payments in rural areas, creating 'high impact' in terms of market conduct supervision, but not prudential supervision.

Since consumer protection is about the relationship between a financial services provider (FSP) and its customers, it has different criteria than prudential risk assessment (number of individual retail clients, the nature of consumer complaints, distribution channels, geographic coverage, etc.). Supervisory tools can also differ from those traditionally used in prudential supervision, such as mystery shopping, market monitoring and focus group research are more prominent in market conduct. The nature of market conduct requires a specific RBS framework to be elaborated for market conduct. Several FSAs have integrated market conduct in their prudential RBS frameworks, either as a separate inherent risk or as part of other inherent risks. However, market conduct in general, and RBS issues in particular, have not been sufficiently addressed and elaborated, at least in public documents. This guideline note intends to fill this gap and provide a more tailored RBS framework for market conduct supervision: a **Market Conduct Risk-Based Supervision Framework (MC-RBS)**.

No particular country model has been used as a basis for the MC-RBS framework, although relevant aspects were taken from public documents that describe the supervisory frameworks of developed countries.[2] To this extent, the framework can be considered a work-in-progress requiring regular updates and improvements.

The framework covers all financial industries except securities markets, which are complex, unique, and more characteristic of developed economies. The framework focuses on market conduct issues in developing and emerging economies that have made financial inclusion of low-income populations a policy priority.

1 See for example OECD, 2010.

2 Canada's Office of the Superintendent of Financial Institutions (OSFI) and Canadian Council of Insurance Regulators (CCIR), the Australian Prudential Regulatory Authority (APRA) - Probability and Impact Rating System (PAIRS), De Nederlandsche Bank (DNB) - Financial Institutions Risk Analyses Method (FIRM), the UK's Financial Conduct Authority (FCA) - Advanced Regulatory Risk operating Framework (ARROW), the Monetary Authority of Singapore (MAS) - Comprehensive Risk Assessment Framework and Techniques (CRAFT), the Central Bank of Ireland's Probability Risk and Impact System (PRISM). The frameworks are available on the official websites of the related FSAs.

CONCEPT OF RISK-BASED SUPERVISION (RBS)

RBS is a relatively new approach to addressing the supervisory challenges in an increasingly interconnected marketplace. It is a forward-looking approach, with a focus on evaluating both present and future risks, identifying emerging problems, and facilitating prompt intervention and early corrective actions by focusing on the inherent risks of an FSPs business model and product offerings. RBS replaces a compliance-based approach and is expected to become more inclusive, risk-based and data centric.[3]

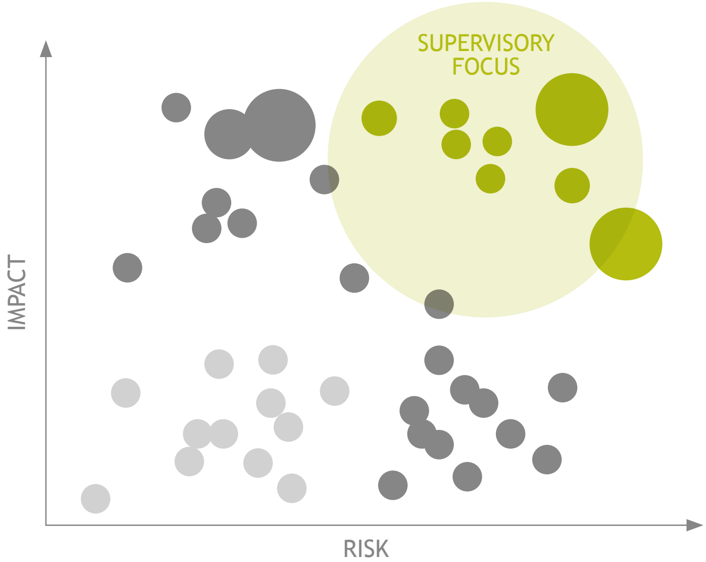
The guiding principle of RBS is to focus on areas that pose the greatest potential risk to the financial soundness of an FSP. An RBS approach maps FSPs based on their impact and risks, and allows scarce supervisory resources to be allocated efficiently. **Impact** has traditionally been considered the potential impact of the failure of an FSP on a country's financial system and economy. In the context of market conduct, impact can be understood as consumer confidence and trust in a well-functioning financial market, which in turn affects financial inclusion, poverty reduction, social well-being and the reputation of a country. Risks are those generated by an FSP's business activities, as well as the FSP's appetite for risk and the major mitigating factors it uses to manage risks.

Based on its impact and risk ratings, an FSA can determine the **supervisory strategy** and the **intensity of its supervision**. More resources are directed toward supervising systemically important institutions and institutions with higher risk profiles, and preventing and mitigating risks with early interventions. An FSA rated 'low risk-low impact', would take more reactive supervisory actions (e.g. off-site monitoring) or conduct thematic reviews. Based on its supervisory strategy and the intensity of its supervision, an FSP would then develop a supervisory plan and begin conducting supervision activities.

RBS has potential benefits for all parties— consumers, FSPs, regulators and governments. These benefits include: transparent regulation, better understanding of risks, alignment with corporate governance, a proactive approach to preventing or solving problems, a systemic focus on the marketplace and consumers, greater regulatory efficiency and lower regulatory costs for well-managed market participants.[4]

Despite the complexity of consumer protection regulations and the lack of international standards for consumer protection supervision, the familiar principles of effective prudential supervision are generally applicable and compatible with market conduct supervision. For instance, both prudential and market conduct supervisors expect financial institutions to have strong corporate governance standards, since transparent and well-governed institutions are more likely to adopt good business practices that do not harm consumers. Additionally, both prudential supervision and market conduct supervision seek to address the reputational risks FSPs face.

SUPERVISORY FOCUS



DEFINING MARKET CONDUCT

For the purpose of this guideline note, the **market conduct** of an FSP is defined as the manner in which an FSP designs its products and services and manages its relationship with clients and public, including the use of intermediaries (representatives or agents).[5] Market conduct refers only to financial services and products, and not to other services provided by an FSP (e.g. telecommunications in the case of mobile network operators) in a particular context.

Market conduct is influenced by many factors, including:

1. **Institutional framework** – law, infrastructure and institutions
2. **Supply-side factors** – established organization culture, best practices and conduct of FSPs
3. **Demand-side factors** – consumer expectations, consumer trust and financial capability.

FSAs use **market conduct policies** to enhance these three factors and create a more sustainable, fair and sound financial ecosystem for consumers. On the supply side, FSAs protect the public from unfair market practices by setting requirements and overseeing an FSP's market entry, market activities and market exit, through licensing, monitoring on-site examinations and other supervisory processes. Taken together, these regulatory practices constitute market conduct regulation and supervision.

3 Deloitte, 2014.

4 CCIR, 2008

5 Adapted from CCIR, 2008.

GOALS AND OBJECTIVES OF MC-RBS

MC-RBS is derived from, and intends to serve, overall market conduct policy. Market conduct policy goals, meanwhile, are broader and seek to achieve a sound financial system for the larger society. While it is not within the scope of this paper, it is important to formulate working definitions of market conduct public policy goals and overarching market conduct goals before setting up an MC-RBS framework.

Overarching goals[6] **of a market conduct policy** include ensuring the fair treatment of customers and building confidence and trust in financial markets, which in turn can lead to financial inclusion, sustainable (financially inclusive) economic growth and financial stability.

Market conduct public policy goals[7] create an enabling environment in which consumers (particularly disadvantaged and low-income segments of society) are confident they will benefit from the outcomes[8] of the collective actions of all market participants. These outcomes include: an inclusive and competitive marketplace, suitable products, proper transparency and marketing, proper ethics and professional standards, due care, safety and security and an enabling legal environment.

The goals of MC-RBS are to assess the significant risks to an FSP fulfilling its market conduct outcomes, to prioritize supervisory actions that prevent risk from escalating and take early corrective actions. If market conduct policy goals represent a set of outcomes that can be achieved through the collective actions of all market participants, MC-RBS goals are outcomes that are within the control of an individual FSP.

6 There are no overarching market conduct policy goals commonly accepted around the world. Overarching goals often framed as legal mandates include: financial system soundness, stability, and integrity; sustainable (financially inclusive) growth; a competitive marketplace; and protection of consumers. The OECD has set “confidence and trust in a well-functioning market for financial services” as an overarching goal, and expects that effective and proportionate financial consumer protection regimes will achieve that goal. These regimes aim to ensure fair treatment, proper disclosure, improved financial education, responsible business conduct by financial services providers and authorized agents, objective and adequate advice, protection of assets and data (including from fraud and abuse), competitive frameworks, adequate complaints handling and redress mechanisms, and policies that address, when relevant, sectoral and international specificities, technological developments and special needs of vulnerable groups (OECD/G20 2011).

7 Market conduct public policy goals can also be defined using well-known concepts such as financial consumer protection goals, consumer empowerment goals, etc.

8 All or some of these outcomes are, in one way or another, addressed by leading FSAs under the ‘Treating Consumers Fairly’ (TCF) concept. The TCF approach focuses on the extent to which regulated financial institutions deliver fair outcomes for financial customers, and applies a more proactive and interventionist approach by regulators and policymakers to deal with market failures. The UK’s Financial Conduct Authority has initiated a TCF program and set six consumer outcomes explaining TCF and 11 principles of FCA policy (FCA 2007). The Financial Services Board (FSB) of South Africa follows the UK example (FSB 2014). CCIR of Canada has set macro- and micro-level outcomes for market conduct regulation; the micro-level outcomes are within the control of individual firms or intermediaries, and broader systemic-level outcomes can only be achieved though the collective actions of the entire industry. It is expected that the micro-level outcomes must be achieved before the systemic outcomes can be fully realized (CCIR 2008). The Hong Kong Monetary Authority distilled it into five principles expressed in the Charter of TCF (HKMA 2013). The SMART Campaign elaborated seven principles with 30 standards of client protection for the microfinance industry (SMART 2013).

OVERARCHING GOALS OF A MARKET CONDUCT POLICY

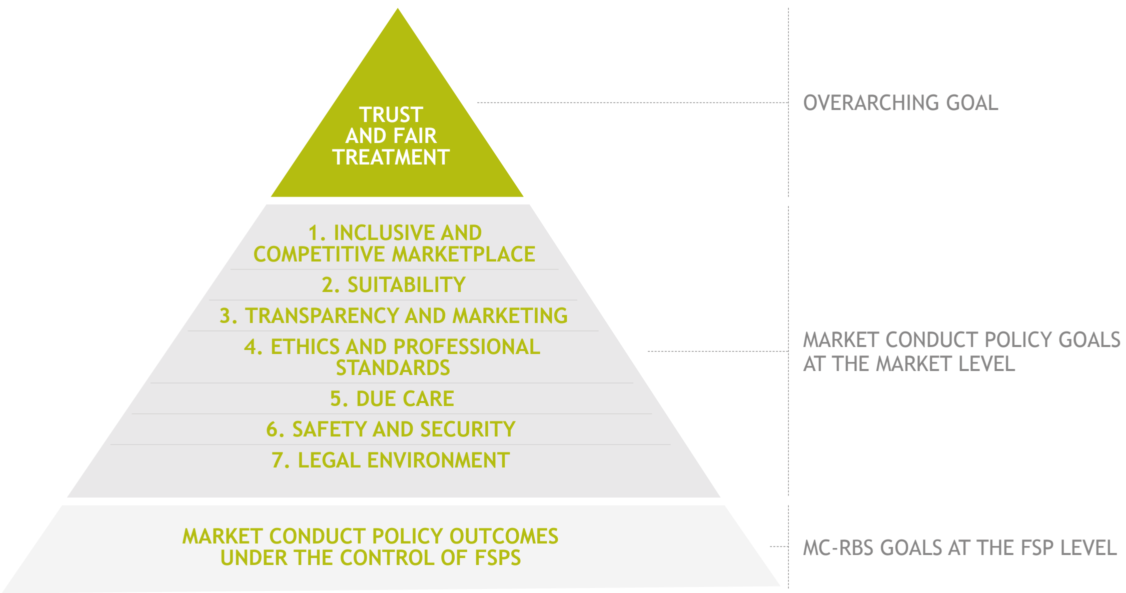


TABLE 1: MARKET CONDUCT POLICY AND MC-RBS OUTCOMES

	MARKET CONDUCT POLICY OUTCOMES Consumers (including disadvantaged and low-income segments of society) are confident they will benefit from these outcomes:	FSP MARKET CONDUCT OUTCOMES An FSP is able to provide the following outcomes:
INCLUSIVE AND COMPETITIVE MARKETPLACE	Consumers can easily find products that meet their needs, are affordable and suit their financial capability. They have choice, and can easily change products and switch providers.	> **Product and delivery design.** The FSP designs products for disadvantaged and low-income segments of society with responsible pricing. Products and delivery channels are designed to meet the needs of specific consumer groups and are targeted accordingly. > **Product complexity.** Develops products for specific target markets based on a clear understanding of the likely needs and financial capability of each group of customers. > **Penalties.** Product or service penalty schemes and levels are designed to support responsible consumer behavior, but not overburden them with debt. > **Entry and exit barriers.** The FSP[9] does not introduce unreasonable pre-sale and post-sale barriers to changing the product or switching providers.
SUITABILITY	Consumers are offered the product best suited to their needs and financial capability when they ask for it.	> **Suitable Advice**. The FSP provides clear and fair advice that is not misleading; the advice is suitable and takes the consumer's circumstances into account. The FSP takes reasonable care to ensure its advice and discretionary decisions are suitable for any customer that relies on its judgment.
TRANSPARENCY AND MARKETING	Consumers are at all times properly informed about the product to make effective and informed decisions. They are not misled. They are able to compare the nature, value and cost of products and make informed choices.	> The FSP provides consumers with free, clear, fair, not misleading information through appropriate channels, and keep them appropriately informed before, during and after the point of sale. > Consumers are not misled by the FSP's marketing practices and communications during promotions, advice, sales and after-sales activity. > The FSP must pay due regard to the information needs of its clients, and communicate information to them in a way that is clear, fair and not misleading.
PROFESSIONAL ETHICS AND STANDARDS	Consumers are served according to professional ethics and acceptable standards.	> The information FSP enhances and oversees standards of professionalism and the ethical behavior of its staff when serving customers and handling complaints, concerns and/or suggestions from consumers. Ethical and honest behavior should be the accepted norm. > **Conflicts of interest.** The FSP must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
DUE CARE	Consumers are treated fairly, with due care and diligence over the entire duration of product usage.	> **Responsible conduct.** The FSP conducts its business with due care and diligence. > Consumers are provided with products that perform as FSPs have led them to expect, and the associated service is of an acceptable standard that they have been led to expect. > **Responsible finance.** The FSP takes all reasonable actions to prevent the consumer from being overly indebted or harming consumers' financial well-being. > **Debt collection.** Debt collection practices are designed and delivered in a respectful way. > **Collateral realization.** Collateral realization should be conducted fairly with maximum possible value for consumer. Collateral should be properly appraised, and where the value of the collateral exceeds the loan amount, consumers should be duly informed and given the excess value.
SAFETY AND SECURITY	Consumers feel protected from harm and, if the FSP fails, have proper protection (including guarantee schemes). They are protected from the loss of personal assets and data, misuse and fraud or other unwanted intrusion.	> **Insurance.** The FSP has professional indemnity (errors and omissions) insurance. > **Safety schemes.** The FSP participates in safety net schemes (e.g. deposit insurance), if such schemes exist. > **Data protection.** Clients' data (including credit history) are accurately recorded, maintained and protected, including from fraud and abuse. > **Assets protection.** FSP must arrange adequate protection for clients' assets when it is responsible for them.
LEGAL ENVIRONMENT (COMPLIANCE)	Consumers are confident that the law protects their rights and interests.	> **Compliance.** The FSP complies with statutory, legal, regulatory and corporate obligations

The outcomes in these seven areas may overlap with prudential supervision goals. For example, data protection is important to the soundness of an FSP from a financial stability perspective, and market conduct supervisors can rely on the findings of prudential supervisors. However, prudential supervisors may not focus on market conduct; for example, an FSP may have a good data protection system, but its internal processes are not efficient or effective at updating inaccurate customer information. Supervisors should therefore cooperate to avoid duplicating activities.

9 And/or the FSPs intermediaries or agents, where appropriate.

OVERVIEW OF THE MC-RBS FRAMEWORK

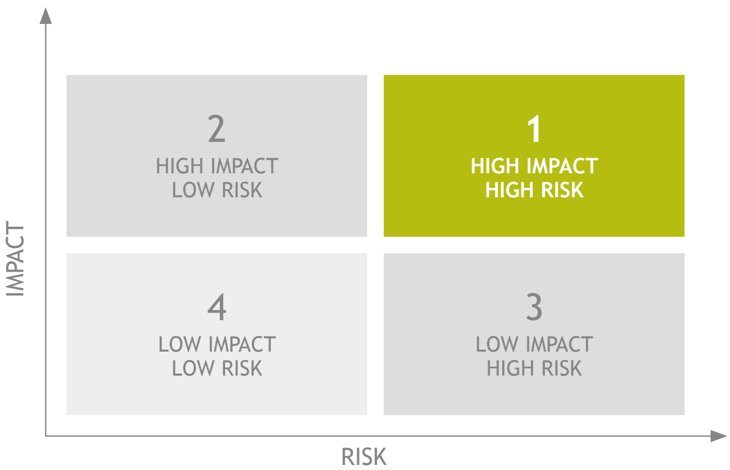
As with prudential supervision, the MC-RBS framework maps FSPs based on their impact and risks, allowing scarce supervisory resources to be allocated efficiently. Each institution would be assessed and assigned two ratings:

1. Impact rating measures the potential impact of the significant failure of an FSPs market conduct outcomes on consumer confidence and trust in a well-functioning financial market. This in turn can have a negative effect on the financial system, financial inclusion, the social well-being of a population, economic growth and the reputation of a country.
2. Risk rating assesses the overall riskiness of an FSP by assessing the inherent risks of its business activities, its ability to manage and control these risks, the effectiveness of its oversight and governance structure and whether its financial resources are adequate to absorb losses in the pursuit and delivery of market conduct outcomes.

Based on its impact and risk ratings, an FSP falls into one of four supervisory categories (Figure 1). More resources are directed toward supervising systemically important institutions and those with higher risk profiles. 'High risk-high impact' requires a high level of supervision (prevention, mitigation of risks, early intervention) and 'low impact-low risk' requires low resources and supervision levels, reactive supervisory actions or thematic reviews (off-site monitoring). All FSPs should have a standard, base level of supervision.

Impact and risk ratings should be periodically updated to reflect any changes in an FSPs impact and risk profile.

FIGURE 1: SUPERVISORY CATEGORIES OF FSPS



PART I. RISK ASSESSMENT

MAIN CONCEPTS OF RISK ASSESSMENT

The MC-RBS risk assessment process is guided by five main concepts: **significant activities, inherent risks, internal controls** (controlling factors at the institutional level and for each significant activity), **net risk** and **overall risk.**

Inherent risk can be defined as the probability (the likelihood of a particular issue or event occurring) of harm to market conduct outcomes arising from the undesirable market conduct practices of an FSP or its representatives/agents. Inherent risks are those associated with the FSPs **significant retail activities** (deposits, consumer credit, money transfers, etc.). While using the FSP's products, consumers are exposed to risks throughout the service process (pre-contract, contract and post contract), which can lead to failed market conduct outcomes. For example, they could be treated unfairly due to the misconduct of the FSP or its representatives.

However, the FSP mitigates and controls these inherent risks through its **internal control system**, which includes controls for every significant activity and institutional function (dispute resolution, corporate governance, internal audit and responsible crisis management). Internal controls include the internal processes designed to provide assurance that established market conduct outcomes will be achieved: effective risk measurement, management and control processes, effective day-to-day management and independent oversight of those processes.

THE MARKET CONDUCT RISK ASSESSMENT PROCESS

This process is illustrated in Figure 2 below.

The process begins by identifying the significant activities of an FSP. Then, the inherent risks and controlling factors for each significant activity are identified.

Based on this, the **net risk of each significant activity** can be calculated, which is the inherent risk of a significant activity once it has been mitigated by an internal control (inherent risk -/+ internal control factors for each significant activity). The sum of the net risks of all significant activities determines the institution's market conduct risk profile—its **net market conduct risk.**

An FSP's net market conduct risk can be mitigated by general risk mitigating factors, such as corporate governance, dispute resolution, internal audit and responsible crisis management. Once the FSP's net market conduct risk is calculated, the control factors at the institutional level can be assessed. Net market conduct risk mitigated by institutional internal control factors gives the **overall risk rating** (net market conduct risk -/+ institutional internal control factors).

SIGNIFICANT ACTIVITIES

The risk assessment process begins by identifying the retail activities (products, services, other activities) that are material to the institution, known as "significant activities." For example, an insurance company's significant activities may include motor insurance and microinsurance, whereas for a bank it may be deposits or consumer credit. Examples of other activities are financial education, corporate social responsibility (CSR) activities and internal/outsourced processes that may have an impact on market conduct outcomes, such as collateral evaluation, debt collection and agent delivery channel.
Some examples of the criteria used to identify significant activities are:

> **Quantitative:** number of customers, financial measures (assets, revenue, premiums, capital, etc.), staff headcount (number of representatives, salespersons, agents, number of complaints, etc.)

> **Qualitative:** brand value of the product, strategic importance, or whether it is critical to ongoing operations.

More guidance is needed on how to identify significant activities.

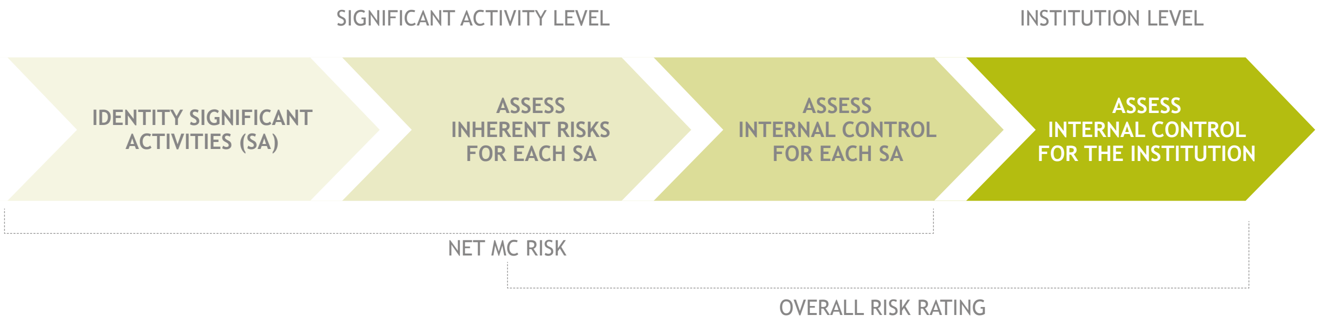
INHERENT RISKS OF MARKET CONDUCT

After defining the significant activities, the inherent risks of those activities to market conduct outcomes should be assessed. Based on the defined market conduct outcomes (Table 1), there are seven categories of inherent risks:

1. Inclusive and competitive marketplace
2. Transparency and marketing
3. Suitability
4. Professional Ethics and Standards
5. Due care
6. Safety and security risk
7. Legal environment (compliance)

More guidance is needed on how to assess each of these inherent risk groups.

FIGURE 2: THE MARKET CONDUCT RISK ASSESSMENT PROCESS



INTERNAL CONTROLS

After identifying the significant activities and inherent risks, the next step is to examine the ability of the institution to control these inherent risks. The FSP may mitigate the overall market conduct risk through controls at two levels: by significant activity and at the institutional level. Collectively, those control factors make up the FSPs internal control system.

Internal Controls for Significant Activities

The internal control of significant activities includes assuring proper internal processes are used to manage the risks inherent in, and arising from, each activity. In particular:

> **Risk measurement** – a supervisor determines whether an FSP has proper market conduct risk measurement processes in place for every significant activity.

> **Policymaking** – a supervisor verifies whether an FSP has processes for establishing policy (strategy papers, regulations, guidelines, etc.) pertinent to the significant activity, which are able to manage the risks the FSP poses to consumer protection and comply with legal and regulatory requirements.

> **Policy implementation** – a supervisor verifies whether the activities of an FSP in selected areas comply with the established policy.

> **Information management** – a supervisor verifies whether all data and documents related to a consumer are properly filed and managed. It is also important to have an internal communication system for managing all the significant activities, in order to assure a level playing field and integrate internal processes.

Internal Controls at the Institutional Level

In addition to managing and controlling significant activities, an FSP may be able to reduce its risks through proper risk management systems at the institutional level, including corporate governance, internal audit, dispute resolution and crisis management.

Corporate governance. Consumers should be confident they are dealing with FSPs that have the fair treatment of customers at the core of their governance and corporate culture, and feel assured of the continuity and certainty of their investments. An FSP should not focus on its own risks when doing so may be to the detriment of its customers. The approval of policy, oversight and governance rests with an FSP's board of directors and senior management. They are the custodians of good corporate governance and are responsible for ensuring the institution's activities are conducted in a safe and sound manner, and in line with high standards of professionalism and sound business practice.

Dispute resolution mitigates risk for an FSP. A good dispute resolution system can easily reveal problems within the institution (policy, processes, systems, etc.) and allow an FSP to solve them at an early stage and promote consumer confidence. The FSP can provide customers with reasonable channels to submit claims, make complaints, seek redress and not pose unreasonable barriers. Dispute resolution mechanisms should be objective, easy, available and timely. The procedures should allow complaints to be reviewed objectively without conflict of interest and be properly managed. The FSP should inform consumers of their right to seek further remedy or redress from FSAs or other channels.

Responsible crisis management. Many consumer rights violations happen during times of instability or crisis, such as large deposit withdrawals and exchange rate fluctuations. FSPs are often less responsive to addressing their customers' needs during a mass crisis, when large numbers of customers suffer losses as a result of the FSP's actions. During these difficult times, an FSP may miscommunicate, mislead or behave improperly with its customers. It is therefore important to have crisis management procedures in place that allow the company to provide timely, clear, objective communication with customers, and swift and objective dispute resolution for everyone. A supervisor should ensure that processes are in place to ensure that in times of macroeconomic instability, the FSP does not neglect or violate the rights of consumers, and strong communication to prevent them from panicking.

Internal audits provide independent oversight of an FSP's market conduct and consumer protection practices, and ensures practices are consistent across significant activities.

More guidance is needed on how to assess institutional internal controls from a market conduct perspective.

NET RISK OF SIGNIFICANT ACTIVITIES

The net risk of a significant activity is the inherent risk of every significant activity once it has been mitigated by control factors (inherent risk +/- control factor). Every significant activity has its own net risk scorecard that rates how high the inherent risks are, how well the FSP is controlling them and what direction the risks might take in the future (Table 2).

A four score assessment system (high risk (H); medium-high risk (MH); medium-low risk (ML); and low risk (L) may be used for both inherent risks and internal controls. Calculating net risk requires the subjective judgment of a supervisor and also depends on the market environment and the FSP's impact rating. The overall net risk of an FSP's significant activities may be calculated as the average net risk of all significant activities. Risk direction shows the potential change in the net risk of a particular significant activity: increasing, decreasing or stable. Risk direction is assessed based on current and potential changes and trends both within the FSP and in the external environment. In the example above, the overall inherent risk of Significant Activity 1 is low at the moment. However, internal controls are very poor, elevating the level of risk. This means that although the FSP is currently in a good position (probably due to the high motivation and professionalism of the manager responsible for SA1), inherent risks may increase with any changes in management since the sustainable institutional processes for risk measurement, information management, policy development and implementation are either not in place or not sufficient. Therefore, the FSP's net risk for consumer credit may be assessed as medium-high.

More guidance is needed on how to calculate the net risk of a significant activity.

OVERALL RISK SCORECARD

An Overall Risk Scorecard provides a detailed assessment and diagnostics of an FSP's consumer protection practices (Table 3). The scorecard is compiled based on the assessment of significant activities, inherent risks and internal controls.

Like net risk, calculating overall risk is not a simple mechanical subtraction; rather, it is based on the subjective judgment of a supervisor and depends on the market environment and the FSP's impact rating. In the example above, the Overall Inherent Risk of the FSP is medium-low, with important variations between significant activities. However, internal control is very poor for most of the significant activities, posing high risks in the near future. Moreover, internal controls at the institutional level are not sound.

Inherent risks may increase significantly if there are any changes in management or the external environment of the FSP. Therefore, the FSP's net risk for consumer credit may be assessed as H (high).

The overall risk scorecard provides a concise snapshot of an FSP's current significant activities and risk management procedures. The scorecard allows supervisors to be more flexible in their analysis of the FSP and the supervisory actions they could take, in particular:

> The horizontal estimates and the averages show the existing risk of a particular significant activity and the general picture of internal control for that activity.
> The vertical estimates show the average estimates of aggregate inherent risk, internal control system for the significant activities, institutional internal control factors, and overall risk.
> The overall rating shows the aggregate risk level for market conduct outcomes.

More guidance may be needed on how to assess internal controls for significant activities.

TABLE 2: SIGNIFICANT ACTIVITY NET RISK SCORECARD (EXAMPLE)

CATEGORIES OF INHERENT RISKS	INHERENT RISK RATING	SIGNIFICANT ACTIVITY INTERNAL CONTROL RATING					NET RISK	RISK DIRECTION
		RISK MEASUREMENT	POLICY	IMPLEMEN-TATION	INFORMATION MANAGEMENT	AVG		
INCLUSIVENESS AND COMPETITIVENESS RISK	L	H	H	H	H	H	MH	
SUITABILITY	L	H	H	H	H	H	MH	
TRANSPARENCY AND MARKETING RISK	L	MH	MH	MH	MH	MH	MH	
PROFESSIONAL ETHICS AND STANDARDS RISK	ML	ML	ML	ML	ML	ML	ML	
DUE CARE RISK	ML	H	H	H	H	H	MH	
SAFETY AND SECURITY RISK	L	H	H	H	L	H	MH	
LEGAL COMPLIANCE RISK	L	H	H	H	H	H	MH	
OVERALL NET RISK	L Low risk	H High risk	H High risk	H High risk	H High risk	H High risk	MH Medium-high risk	Increasing

TABLE 3: OVERALL RISK SCORECARD (EXAMPLE)

SIGNIFICANT ACTIVITIES	INHERENT RISKS	INTERNAL CONTROL OF SIGNIFICANT ACTIVITIES			INTERNAL CONTROLS AT THE INSTITUTIONAL LEVEL					OVERALL RISK
		SA INTERNAL CONTROL	NET RISK	RISK DIRECTION	DISPUTE RESOLUTION	CORPORATE GOVERNANCE	INTERNAL AUDIT	CRISIS MANAGEMENT	AVG	
SA 1	L	H	MH	increasing	-	-	-	-	-	-
SA 2	H	L	ML	increasing	-	-	-	-	-	-
SA 3	H	H	H	increasing	-	-	-	-	-	-
...	...	...	...	...	-	-	-	-	-	-
SA N	L	H	H	increasing	-	-	-	-	-	-
OVERALL RATING	ML	H	H	increasing	L	H	MH	H	MH	H-

PART II. IMPACT ASSESSMENT

Impact assessment is the second pillar of the MC-RBS framework. It allows supervisors to separate systemically important FSPs and prevent the risks they pose by watching closely and intervening early. It also allows them to allocate supervisory resources effectively—first to systemically important and risky FSPs and only afterward to others.

Impact rating measures the potential impact of the significant failure of an FSP's market conduct outcomes on consumer confidence and trust in a well-functioning financial market. This in turn would have a negative effect on financial inclusion, economic growth and the reputation of a country.
Impact ratings can be measured through several sets of indicators:

1. **Consumer coverage:** number and share of consumers in product markets (loans, deposits, assets, etc.), geographical coverage, vulnerable groups involved (farmers, illiterate, etc.), etc.
2. **Nature of products:** technology, innovation, variety, complexity, high impact on the well-being of consumers (mortgage), tied to poor infrastructure and technology, etc.
3. **Market power:** product market share, pricing, substitutability of products and infrastructure, know-how of business/technology, etc.
4. **Intermediation:** scale, model, channels, etc.
5. **Interconnectedness:** impact of the supply chain on other suppliers, product markets, intermediation channels, reputation, etc.

Special focus is needed to assess the impact of an FSP that belongs to local or international financial groups.

More guidance is needed on how to assess the impact of an FSP.

PART III. SUPERVISORY STRATEGY

A **supervisory strategy** is developed based on the impact and risk ratings of an FSP, as well as the FSA's appetite for risk. More resources are directed toward supervising systemically important institutions and institutions with higher risk profiles. 'High risk-high impact' requires a high level of supervision (prevention, mitigation of risks, early intervention) and 'low risk-low impact' requires reactive supervisory actions or thematic reviews (off-site monitoring). The amount of supervisory resources required varies (see Figure 1). All FSPs should have a standard, base level of supervision.

A **supervisory strategy** should help a supervisor understand areas of supervision, resources to be allocated, internal processes, supervision tools, action plans, progress monitoring, reporting and other aspects of supervising an FSP.

More guidance may be needed on how to determine the supervisory strategy of an FSP.

CONCLUDING REMARKS AND NEXT STEPS

This guideline note presents a new framework, MC-RBS, for supervising the market conduct of FSPs. This represents a major milestone in the development of an effective consumer protection regime.

The framework presents principles, concepts and core processes that may be used for market conduct supervision. In particular, the framework identifies the following components:

1. Seven categories of policy outcomes and corresponding inherent risks: Inclusiveness and Competitiveness, Suitability, Transparency and Marketing Risk, Professional Ethics and Standards, Due Care, Safety and Security, and Compliance
2. The concept of significant activities within an FSP
3. Four internal controls to mitigate the risks of significant activities: risk measurement, policy development, policy implementation and information management
4. Four internal controls to mitigate market conduct risk at the institutional level: dispute resolution, corporate governance, internal audit and responsible crisis management
5. A scoring system for calculating the overall market conduct risk of an FSP
6. An impact assessment of FSPs
7. A supervisory strategy for FSPs

The next step for the CEMC WG will be to develop more detailed guidelines on how to implement these components of the MC-RBS framework.

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