

Actuarial Society of South Africa

Paper A 2026

Subject F207|B200 — Banking

EXAMINERS REPORT

This subject report has been written with the aim of helping candidates. This report summarises the main points that the examiners were looking for and some common problems encountered.

QUESTION 1

You are an actuary working in the risk department of a domestically significant bank in a middle-income country with an open economy. As part of your risk evaluation, you are considering the following scenario:

Over the past five years, a small number of globally dominant “Intelligence Platform” companies have undertaken large-scale capital investment programmes in data centres, advanced computing capacity, and artificial intelligence (AI) systems. These investments were widely expected to generate significant long-term productivity gains across multiple sectors of the global economy.

Market valuations increasingly reflected expectations of:

- Sustained high revenue growth,
- Strong operating leverage (high fixed costs, with low marginal costs), and
- A structurally lower inflation environment driven by AI-enabled efficiency gains.

As a result, discount rates embedded in equity and credit valuations declined, and global capital flows were reallocated toward these firms and related sectors.

Recently, several of these companies announced that realised productivity gains and revenue growth have been slower and more volatile than projected. Capital expenditure requirements remain elevated, margins are under pressure, and forward earnings expectations have been revised downward. Global equity markets corrected sharply, credit spreads widened, volatility increased across funding markets, and some leveraged investment vehicles experienced significant losses.

- (i) Identify and explain the key characteristics of this scenario that could give rise to systemic financial risk at a global level [5]
- (ii) Explain how this shock could be transmitted to the banking system in your country, which has limited direct lending exposure to the affected firms. [7]
- (iii) Analyse the potential mechanisms through which the shock could be amplified within the domestic banking system, including interactions between market risk, credit risk, liquidity risk and capital adequacy. [7]
- (iv) Evaluate the role of stress testing in assessing risks arising from concentrated global investment themes such as this. In your answer, comment on scenario design, model limitations, and allowance for further second order impacts. [6]

Your regulatory authority has reached out to industry to provide recommendations on potential macroprudential and supervisory policy responses.

- (v) Discuss how macroprudential and supervisory policy responses should balance:
 - Financial stability,
 - Market discipline,
 - Innovation and productivity growth. [5]
- (vi) Discuss how a sustained shortfall in realised productivity gains (in comparison to expectations) could affect:
 - Inflation outcomes,
 - Interest rate expectations, and
 - Financial asset valuations.

Consider both short-run and medium-term effects. [5]

[Total 35]

Examiner comments:

Where candidates succeeded

Performance was generally stronger in parts (i), (iii), and (iv), where the structure of the question provided clearer guidance. In these sections, candidates were typically able to identify relevant mechanisms and, when prompted by explicit reference to risk types or stress testing frameworks, could organise their thinking more effectively. As a result, answers tended to be more structured and directionally correct.

Where candidates failed

(ii) Transmission (critical weakness)

Both examiners noted that this was a major area of weakness. Despite the question explicitly stating that the domestic banking system had limited direct exposure, many candidates still focused heavily on direct credit risk or counterparty exposures. This represented a clear misreading of the question. Furthermore, candidates frequently failed to identify the more important and realistic indirect transmission channels, such as funding market stress, capital flow reversals, exchange rate impacts, and broader macroeconomic spillovers. As a result, answers lacked depth and did not reflect system-level thinking.

The core gap demonstrated here was an inability to reason through indirect transmission mechanisms, particularly in situations where risks propagate through financial markets and macroeconomic linkages rather than direct balance sheet exposures.

(v) Macroprudential balance

Performance on this question was weaker than expected, despite the topic being relatively accessible. Many candidates provided generic responses that discussed financial stability, market discipline, and innovation in isolation, without analysing the inherent trade-offs or interplay between these objectives. Stronger candidates distinguished themselves by explicitly articulating how these objectives interact and may be in tension, whereas weaker candidates failed to move beyond high-level statements.

(vi) Macroeconomic relationships

This was one of the poorest performing sections across both examiners. Many candidates demonstrated an inadequate understanding of the relationships between productivity, inflation, interest rates, and asset valuations.

Answers were often too brief to score marks and lacked sufficient explanation of underlying mechanisms. In addition, candidates frequently failed to distinguish between short-term and medium-term effects, and many did not attempt the question at all, suggesting either weak understanding or time pressure.

Model answer:

Part (i) Systemic characteristics of the scenario

Firstly, significant valuation concentration in a small number of globally dominant firms. When a limited set of companies accounts for a large proportion of major indices, price corrections have disproportionate effects on global portfolios and benchmarked investors.

Second, valuations appear to be based on long-duration, uncertain cash flow assumptions, which are highly sensitive to discount rates and growth expectations. This creates convexity risk: small downward revisions in expected growth can lead to large repricing effects.

Third, the investment cycle is capital intensive, with high fixed expenditure commitments and long payback periods. If realised productivity gains lag expectations, firms may face margin compression and balance sheet strain.

Fourth, systemic exposure is magnified by cross-sector investor participation, including pension funds, insurers, ETFs, and other investment vehicles. This increases interconnectedness and correlated positioning.

Finally, leverage in certain investment vehicles and structured products introduces amplification risk. While banks may not be primary lenders to these firms, the financial system is exposed through funding markets, derivatives, and asset price linkages.

Collectively, these characteristics suggest a potential asset-price-driven systemic event, rather than a traditional banking-originated crisis.

Part (ii) Transmission to a middle income open economy's banking system

A sharp global equity correction would reduce the value of assets held by local institutional investors and in extreme cases impact solvency.

This may negative trigger wealth effects, reducing domestic consumption and investment. Lower aggregate demand weakens corporate earnings and increases credit risk within domestic loan portfolios.

Increased global risk aversion would widen credit spreads and increase wholesale funding costs. Local banks reliant on offshore funding may face higher costs or reduced access, compressing net interest margins.

Capital flow reversals could occur as global investors retreat to safe-haven assets.

This would place pressure on the exchange rate, potentially leading to depreciation and imported inflation. A weaker currency may force tighter monetary policy, further dampening growth and increasing debt servicing burdens.

Additionally, stress in global derivatives and funding markets may affect liquidity conditions, increasing costs of risk management though access to hedges OR even eliminating availability of hedges

Margin requirements may increase, and volatility spikes could affect trading and treasury functions through increased and costly liquidity calls

Finally, increased correlations during stress periods reduce diversification benefits, meaning that global market volatility may be more synchronised than historical models suggest.

Part (iii) Amplification within the domestic banking system

Once transmitted, the shock may be amplified through endogenous feedback loops. Mark-to-market losses on financial assets reduce capital buffers (constrain capital supply). Even if losses are unrealised, increased volatility can inflate risk-weighted assets (capital demand amplification), reducing capital ratios mechanically.

Higher funding spreads compress profitability, limiting internal capital generation. Reduced earnings weaken resilience over time.

Liquidity pressures may arise if collateral values decline and haircuts increase. Banks may need to post additional collateral, creating liquidity strain. In extreme cases, institutions may sell assets to preserve liquidity, potentially contributing to fire-sale dynamics.

Credit tightening is a further amplification mechanism. To protect capital ratios, banks may reduce new lending, particularly to higher-risk borrowers. This contractionary effect can exacerbate economic slowdown, increasing defaults and impairments.

Confidence effects are also important. Even solvent institutions may face higher funding costs if market participants perceive elevated systemic risk. This confidence spiral can amplify relatively modest initial shocks

Finally, model risk becomes acute during such events. Correlation assumptions embedded in capital models may underestimate tail dependence, leading to underestimation of stress losses.

The potential impacts on both capital demand and capital supply would impact the bank's capital ratios (e.g., CET1) and overall capital adequacy.

Part (iv) Role of stress testing

Stress testing is a critical tool for assessing resilience to concentrated investment themes.

Scenario design should incorporate a severe but plausible

- *equity correction,*
- *widening credit spreads,*
- *funding stress,*
- *exchange rate depreciation, and*
- *macroeconomic slowdown.*

Importantly, second-round effects must be included — such as reduced credit growth, rising defaults, and increased provisioning.

Stress tests should evaluate impacts on both capital and liquidity metrics, recognising the interaction between profitability, funding, and solvency.

However, stress testing faces limitations. Historical data may not adequately capture technology-driven investment cycles.

Model parameters such as correlations and volatility may be unstable under structural change. Reverse stress testing techniques may therefore be useful in identifying scenarios that threaten viability.

Strong governance and board oversight are essential to ensure stress scenarios are sufficiently severe and not constrained by optimism bias.

Evaluation of the limitations of the stress testing model should allow scope for a deliberation on overlay adjustment on a expert-judgment basis

Part (v) Macroprudential and supervisory balance

Regulators must balance financial stability with support for innovation and economic growth.

Countercyclical capital buffers can enhance resilience during benign periods, allowing banks to absorb losses during corrections. Liquidity requirements such as LCR and NSFR reduce vulnerability to funding shocks.

Supervisors should monitor concentration exposures and interconnectedness, particularly where structured products or derivatives increase leverage.

However, regulators should avoid suppressing productive technological investment. Innovation and productivity gains are vital for long-term growth. Premature or excessive intervention risks distorting capital allocation.

Communication is critical. Regulators must signal vigilance without inadvertently triggering market panic. Coordination with global regulators is also necessary, as asset price dynamics are globally determined.

Ultimately, the regulatory objective should be to ensure that the banking system remains resilient to valuation cycles, rather than attempting to manage asset prices directly.

Part (vi) Impact should productivity gains fail to materialise

The future output may be lower than embedded in prior inflation and interest rate expectations. This could raise unit labour costs and sustain inflation pressures.

Central banks may therefore maintain higher policy rates for longer, increasing discount rates and further compressing valuations of long-duration growth assets.

In the short term, however, demand contraction from asset price declines may be disinflationary (negative wealth effects and reduced direct investment), creating policy tension.

Inflation Effects

Lower productivity resulting in higher unit labour costs if wages persist with reduced potential output resulting in inflationary pressure relative to expectations

Interest Rate Expectations

Neutral rate may be higher than previously assumed with Central banks may maintain higher-for-longer policy rates

Asset Valuation Effects

Higher discount rates reduce present value of long-duration assets, coupled with growth assumptions revised downward resulting in reduced valuations

QUESTION 2

- (i) Explain the concept of conduct risk, using examples, and summarise the drivers of conduct risk. [5]

Scorpio Bank has recently experienced a decline in its retail market share, prompting management to explore strategies for recovery. In response, the CEO has proposed leveraging credit bureau data to pinpoint customers who are applying for loans with competing institutions. By identifying these individuals, Scorpio Bank aims to implement targeted marketing campaigns that encourage them to return and take advantage of the bank's offerings.

- (ii) Discuss the risks to the bank and its customers should the CEO's proposal be implemented. [10]
- (iii) Suggest ways in which the CEO's proposed approach could be adjusted and controls that could be implemented to ensure that the desired business outcomes are achieved without exposing the bank to undue risk. [5]

Examiner comments:

Where candidates succeeded

Candidates generally performed well in part (i), with most able to define conduct risk and provide relevant examples. This indicates that the foundational understanding of conduct risk concepts was broadly satisfactory.

Where candidates failed

(ii) Risks

Performance in this section was mixed, with many candidates struggling to identify a sufficiently broad range of risks. A common issue was that responses focused narrowly on credit risk, rather than recognising that the primary risk in the scenario was conduct-related, particularly regarding data privacy and customer treatment.

Additionally, some candidates misunderstood the nature of the scenario, incorrectly interpreting a targeted marketing campaign as equivalent to a lending decision, which led to misplaced analysis. Overall, candidates who performed poorly failed to align their answers with the conduct risk framing established in part (i).

(iii) Controls and mitigants

Performance in this section was closely linked to performance in part (ii). Candidates who failed to identify the correct risks, particularly those related to data privacy and conduct, were unable to propose appropriate controls.

Common issues included suggesting alternative business strategies rather than adjustments to the proposed approach, and focusing on mitigating credit risk instead of addressing the underlying conduct risks.

The core gap was an inability to translate risk identification into targeted, relevant controls.

Model answer:

Part (i)

Conduct risk can be defined as the risk of any action taken by a financial institution or individual that leads to the detriment of the customer, negatively impacts market stability, or hampers effective competition.

- Banks putting profits ahead of ethics*
- Treating disclosure at the point of sale as the end of the responsibility to ensure a good outcome for the customer*
- Taking tick box and legalistic approaches in dealing with customers, where compliance is limited to the letter rather than the spirit of the law.*

Drivers of conduct risk can be summarised as:

- Inherent: information asymmetries, biases and heuristics, inadequate financial capability*
- Structures and behaviours: ineffective competition, culture and incentives, conflicts of interest*
- Environmental: regulatory and policy changes, technological developments, economic and market trends*

Part (ii)

Privacy and Data Protection Concerns:

Using credit bureau data for targeted marketing may breach data privacy regulations and customer expectations

This would be of concern if customers have not consented to their data being used for this purpose.

The use of such sensitive data may also trigger customer complaints or regulatory investigations, further increasing compliance costs.

There is a risk that data could be accessed or used beyond the original intent, raising concerns about data minimization and purpose limitation.

Reputational Risk:

Customers may perceive the bank's actions as intrusive or unethical, leading to loss of trust and further erosion of the bank's brand image in the market.

Negative publicity or media coverage related to privacy breaches could have a lasting impact on customer relationships.

Loss of reputation may also deter new customers from choosing Scorpio Bank, impacting long-term growth prospects.

Regulatory and Legal Risks:

The proposal could violate data protection laws or local regulations, particularly regarding the use and processing of sensitive credit information for marketing.

Regulatory sanctions could lead to financial penalties, mandatory corrective actions, or restrictions on business activities.

Legal action by affected customers could result in costly settlements or penury judgment against the bank.

Customer Detriment:

Targeted marketing based on credit-seeking behaviour could exploit financially vulnerable customers.

This could encourage over-borrowing or unsuitable financial products, thereby contributing to poor customer outcomes.

Vulnerable groups may be disproportionately impacted, raising fairness and inclusion concerns.

Conflict of Interest

The bank's pursuit of regaining market share may conflict with its duty to act in customers' best interests, especially if marketing campaigns prioritize sales over customer needs.

Such conflicts can undermine the bank's ethical standards and long-term customer loyalty.

Operational Risk:

Implementing such targeted campaigns may require significant changes to data handling processes and IT systems, increasing the likelihood of errors, data breaches, or misuse of information.

System integration issues or technical failures could disrupt business operations and compromise sensitive data.

Customer Dissatisfaction:

Customers who become aware of this practice may choose to sever their relationship with the bank, resulting in further loss of business and negative word-of-mouth.

Disengaged customers might also share their negative experiences on social media, amplifying the reputational damage.

Competitors could capitalize on the bank's missteps to attract dissatisfied customers away from Scorpio Bank.

Ethical Considerations:

There may be ethical questions about the fairness and transparency of using personal financial data in this manner.

This could conflict with the bank's stated values and conduct risk framework.

A lack of transparency in data usage could erode stakeholder confidence, including that of employees and regulators.

The bank risks becoming misaligned with broader societal expectations around responsible data stewardship.

Part (iii)

Use aggregated and anonymised credit bureau data wherever possible for targeted marketing campaigns.

This approach preserves individual privacy and reduces the risk of breaching data protection regulations, while still allowing the bank to identify market trends and customer segments effectively.

Establish strict protocols for accessing and using credit bureau data, ensuring that all targeted marketing activities comply with privacy laws and relevant credit reporting regulations.

Obtain explicit, informed consent from customers before leveraging their credit bureau data for marketing purposes, and provide clear opt-out options for those who do not wish to participate.

Clearly communicate to customers how their credit data will be used in targeted campaigns, including the intended benefits and any potential risks, to promote transparency and foster stakeholder confidence.

Limit the use of credit bureau data strictly to marketing campaigns that align with the bank's core values and conduct risk framework.

Implement robust data security measures to safeguard credit bureau information from unauthorized access, breaches, or misuse throughout the marketing process.

Solicit feedback from customers regarding the use of their credit data in marketing efforts, and continuously refine strategies to address concerns, enhance accountability, and support responsible data stewardship.

[Total 20]

QUESTION 3

You are a strategic risk executive at Sison Bank, a full-service retail bank operating in Africa. The bank is considering acquiring MobiPurse, a fast-growing mobile wallet provider with:

- 20 million active users in Southern Africa,
- strong merchant acceptance in the informal sector,
- a cloud-based core platform with key outsourced providers
- no credit or insurance products

Mobile wallets facilitate transfers between mobile wallets, serving as a payment mechanism and a store of value.

- (i) Explain the likely strategic rationale Sison Bank has for the acquisition [7]
- (ii) Identify top risks inherent in the MobiPurse business model and what assessment a due diligence process should cover in context of these risks. [10]
- (iii) Outline key aspects a post-merger integration plan should address to mitigate risks associated with the acquisition should it be successful. [6]

The competition authority in one of the countries in which MobiPurse operates as publicly stated concern about market concentration in payments.

- (iv) Suggest remedies or deal structures for the acquisition that could mitigate this concern.

[2]

[Total 25]

Examiner comments:

Where candidates succeeded

Performance was generally strong in part (i), where candidates were able to generate a broad and relevant set of strategic rationales for the acquisition. Parts (ii) and (iii) were also reasonably well answered, with most candidates demonstrating a sound understanding of key risks and post-merger integration considerations.

Where candidates underperformed

Lack of business model specificity

While many candidates identified valid risks, weaker responses tended to be generic and not tailored to the specific characteristics of the mobile wallet business model. For example, candidates often failed to consider the implications of operating in the informal sector, the reliance on cloud infrastructure, or the unique risk profile of non-bank payment platforms, specifically financial crime implications.

Stronger candidates, in contrast, grounded their answers in the specifics of the scenario and demonstrated a clearer understanding of how the business model drives risk.

Missed key strategic insight

Few candidates recognised the strategic value of the transaction-level data generated by the mobile wallet platform. This was a key omission, as access to such data represents a significant opportunity for improving credit underwriting, pricing, and product development, particularly in data-sparse environments.

(iv) Competition remedies (major weakness)

This part was poorly answered. Very few candidates were able to suggest practical remedies to address competition authority concerns.

Some candidates defaulted to extreme solutions, such as abandoning the acquisition altogether, rather than proposing realistic regulatory remedies such as interoperability, pricing commitments, or structural adjustments.

Model answer:

Part (i) Strategic Rationale for the Acquisition

The acquisition should not be evaluated solely from a short-term earnings perspective, but rather from a broader strategic, financial, and competitive positioning standpoint. In particular, the transaction offers multiple sources of long-term value that extend beyond immediate profitability.

Firstly, the acquisition would strengthen the bank's deposit franchise.

Mobile wallets effectively function as transactional accounts that are used frequently by customers, thereby increasing engagement and interaction with the platform.

Although individual account balances may be relatively small, the scale of approximately 20 million active users creates a substantial pool of low-cost, sticky funding.

This enhances the stability of deposits, reduces attrition risk, and increases overall customer lifetime value. In a market where fintech disintermediation is growing and deposit competition is intensifying, controlling the primary customer payments interface is strategically critical.

Secondly, the acquisition provides significant data and credit expansion optionality.

The most valuable asset within the mobile wallet ecosystem is the transaction-level behavioural data, particularly for customers operating in the informal sector where traditional data sources are limited.

This data enables improved affordability assessments, alternative credit scoring models, and the development of embedded lending and merchant financing solutions.

Over time, this reduces reliance on traditional credit bureau data and significantly enhances risk-based pricing and underwriting capability in unsecured lending portfolios.

Thirdly, there are opportunities for fee income and payments ecosystem expansion.

MobiPurse generates revenue through multiple streams, including interchange fees, merchant service fees, and remittance charges. Payments businesses typically exhibit high operating leverage, as they require substantial upfront infrastructure investment but have very low marginal transaction costs.

As transaction volumes scale, profitability can improve materially, particularly when integrated into a broader banking ecosystem.

Finally, the acquisition has important strategic and defensive implications.

By acquiring MobiPurse, Sison Bank not only strengthens its own digital capabilities but also prevents potential competitors from acquiring a strategically valuable platform.

In addition, the platform provides access to a large customer base that can be targeted for cross-selling of credit, savings, and insurance products.

The strategic option value embedded in these opportunities may significantly exceed the immediate financial contribution of the business.

Part (ii) Key Risks and Due Diligence Considerations

The mobile wallet business model introduces a set of risks that differ in nature and intensity from those typically encountered in traditional retail banking. A comprehensive due diligence process should therefore assess these risks in detail.

A primary area of concern is regulatory and licensing risk. The due diligence process should confirm that MobiPurse holds the appropriate licences and operates in full compliance with applicable prudential and payments regulations in each jurisdiction.

This includes assessing the segregation of customer funds, safeguarding requirements, and the adequacy of capital buffers supporting stored value balances. Regulatory tightening or changes in licensing requirements could materially alter the economics of the business.

Another critical area is AML/CFT and financial crime risk.

Mobile wallets are inherently vulnerable to abuse due to rapid onboarding processes, the potential for structuring of transactions, and the use of mule accounts.

Due diligence should therefore evaluate the robustness of KYC processes, transaction monitoring systems, sanctions screening, and suspicious activity reporting frameworks.

Given increasing global regulatory scrutiny, deficiencies in this area could lead to significant regulatory and reputational consequences.

Fraud and cyber risk is also significant. Key threats include SIM swap fraud, account takeovers, API vulnerabilities, and social engineering attacks.

The acquiring bank should assess the maturity of the target's cybersecurity framework, including penetration testing results, incident response capabilities, and historical fraud loss trends. High or increasing fraud losses could have a direct impact on valuation and sustainability.

The business also carries outsourcing and cloud concentration risk.

If the platform relies heavily on a single cloud provider or outsourced technology partner, this creates dependency and concentration risk. Due diligence should therefore evaluate the resilience and reliability of these providers, as well as contractual protections such as audit rights, termination options, and data ownership provisions.

Exit and portability options are particularly important in mitigating long-term risk.

Operational resilience is another key consideration. Payments systems require very high levels of availability and reliability. The assessment should therefore cover system uptime, recovery time and recovery point objectives, redundancy mechanisms, and business continuity arrangements.

Any operational disruption could have immediate reputational and liquidity consequences.

Finally, conduct and data privacy risks must be assessed.

This includes how customer transaction data is used, the transparency of fees charged, and the fairness of any embedded financial products offered through the platform.

Compliance with privacy regulations across multiple jurisdictions is essential, and any misuse of data could lead to regulatory sanctions and reputational damage.

Part (iii) Post-Merger Integration Plan

A successful post-merger integration plan must strike a balance between preserving the agility and innovative culture of the fintech business and strengthening governance and risk control standards in line with the acquiring bank.

Firstly, a robust governance framework should be established. This includes setting up an integration steering committee, clearly defining accountability between the bank and fintech leadership teams, and aligning the acquired entity's risk appetite with that of the broader group. Strong governance is critical to ensure effective oversight without stifling innovation.

Secondly, there should be alignment of risk control frameworks. This includes integrating AML, fraud, and compliance systems, as well as applying the group's model governance standards to any credit-related capabilities introduced in the future. An independent risk review within the first 6–12 months can provide assurance that risks are being appropriately managed.

Thirdly, a phased technology integration strategy should be adopted. Rather than pursuing a full system migration upfront, the bank should maintain the platform as a standalone system initially, while enabling integration through APIs. This reduces the risk associated with large-scale system changes and allows for parallel running and reconciliation testing before full integration is considered.

Fourthly, cultural integration must be carefully managed. The fintech's agile and entrepreneurial culture should be preserved where possible, while introducing appropriate levels of prudential discipline. Retaining key technical talent, aligning incentive structures, and clearly communicating risk boundaries are all critical to long-term success.

Finally, service continuity must be prioritised. This includes maintaining redundancy during integration, stress-testing transaction volumes, and ensuring that customers experience minimal disruption. Given the scale of the user base, even small disruptions could have significant reputational implications.

Part (iv) Competition Authority Remedies

To address concentration concerns:

- *Maintain/ create interoperability with competing wallets.*
- *Remove any merchant exclusivity clauses.*
- *Offer open APIs to third parties.*
- *Commit to transparent and non-discriminatory pricing.*

QUESTION 4

You are the CRO of RetroBank Ltd, which is preparing to launch a new unsecured lending product aimed at low to middle income customers. The managing executive has set an aggressive launch date due to competitive pressure and revenue targets.

Two constraints emerge, firstly on timelines:

- The CEO wants the product in market within six weeks. Marketing has already spent the budget allocated on campaign materials and ads building up to the launch (an incurred and irrecoverable cost). Delays may result in losing early-year market share to two major competitors launching similar products.

The second constraint relates to quality concerns:

- The risk management team working on the implementation has identified anomalies in the data features used in the underwriting ratings and affordability verification systems, with data quality issues from one of the bank's partners affecting ~18% of the potential customer base.
 - (i) Outline further information you would require to allow a balance evaluation of the scenario. You may assume the product as designed complies with all local regulation [9]
 - (ii) Recommend a course of action, outlining residual risks inherent in your recommended course of action and recommend associated mitigating controls [11]

[Total 20]

Examiner comments:

Where candidates succeeded

Stronger candidates focused their responses on information that would directly influence the decision regarding whether and how to proceed with the product launch. They were able to link data quality issues to model performance, customer outcomes, and risk appetite considerations, demonstrating a practical and decision-oriented mindset.

Where candidates failed

(i) Information required

Many candidates struggled with this question, often providing either overly generic lists of information or focusing on less relevant aspects such as marketing spend, potential revenue loss, or legal recourse against the data provider.

Crucially, candidates frequently failed to focus on the most important issue, namely the impact of data quality problems on credit scoring and affordability assessments.

In addition, some candidates made unrealistic assumptions, such as the ability to clearly identify and exclude all affected customers upfront, which ignored the inherent uncertainty in data quality issues. The core gap was a lack of understanding of data and model risk in practice, and an inability to prioritise information that is critical for decision-making.

(ii) Recommendation and mitigants

A key weakness in this part was that some candidates continued to focus on gathering additional information rather than making a decision, despite the question clearly requiring a course of action under time constraints.

Candidates who performed poorly did not demonstrate an appreciation for the urgency of the situation or the need to implement practical mitigants quickly.

Stronger candidates distinguished themselves by proposing a controlled or phased launch approach, supported by specific measures to address model and data weaknesses, such as overlays, enhanced monitoring, and governance controls.

Model answer:

Part (i) Further information required

To conduct a balanced evaluation of the proposed product launch, it is essential to obtain detailed information across several key areas, particularly relating to the nature and impact of the identified data quality issues.

Firstly, there needs to be a clear understanding of the nature and severity of the data anomalies.

- This includes identifying which specific variables are affected, such as income, employment status, or credit bureau attributes, as well as analysing patterns of missingness, bias, data drift, and overall accuracy.*
- It is also important to determine how the affected data is distributed across customer segments, channels, and risk bands, particularly given that approximately 18% of the population is impacted.*

Secondly, model performance diagnostics must be reviewed.

- This includes recent monitoring metrics such as population stability indices (PSI), Gini coefficients, and calibration performance.*
- The impact of corrupted data features on probability of default (PD), affordability calculations, and expected loss estimates should be quantified.*
- Sensitivity testing should also be conducted to assess how outputs change when corrected or proxy data is used, and whether these differences are material.*

Thirdly, a stress testing assessment is required.

- This involves comparing outcomes under “clean” versus “affected” data scenarios, assessing the likelihood of originating value-destructive loans, and evaluating the probability of breaching risk appetite thresholds under both normal and stressed conditions.*
- Operational considerations are also important. The bank should assess the operational impact of the data issues, including the extent to which downstream processes such as pricing, limit assignment, and approval workflows depend on the affected data.*
- The capacity and feasibility of manual workarounds, including service level agreements and resource constraints, should also be evaluated.*
- A customer and regulatory impact assessment is critical. This includes estimating potential affordability breaches, the extent of customer detriment (such as mispriced loans or unfair declines), and any historical issues associated with the data partner.*
- Conduct risk implications and potential regulatory scrutiny must be carefully considered.*

Finally, the commercial implications of delaying versus proceeding with the launch should be assessed.

This includes quantifying the marginal revenue impact of delays, as well as understanding the constraints associated with marketing commitments and competitor actions.

Part (ii) Recommend action and mitigants

Recommendation: Proceed with a conditional launch, supported by time-boxed remediation, enhanced controls, and rigorous monitoring. This approach balances urgent commercial priorities with sound risk governance
[1 mark for a recommendation, 1 mark for balance]

The recommended course of action is to proceed with a conditional launch, supported by a clearly defined, time-bound remediation plan, enhanced risk controls, and rigorous ongoing monitoring. This approach balances the commercial urgency of the launch with the need for sound risk management and governance.

The primary risk relates to model and data integrity. Mis-estimation of PD and affordability metrics for approximately 18% of customers may result in inappropriate credit decisions or pricing.

To mitigate this, the bank should implement temporary credit overlays, such as tightening credit cut-offs, applying conservative pricing adjustments for higher-risk segments, and reducing maximum loan limits.

Manual review processes should be introduced for high-risk or anomalous applications until data quality improves.

There is also a conduct and regulatory risk, as inaccurate affordability assessments could lead to customer detriment and regulatory breaches.

Mitigating actions include strengthening affordability checks using alternative data sources, implementing weekly conduct monitoring dashboards, engaging proactively with regulators, and applying conservative buffers in affordability calculations.

From a prudential and portfolio risk perspective, there is a risk of higher default rates in early loan vintages and potential breaches of risk appetite.

To address this, expected loss estimates and stress testing assumptions should be updated conservatively, and close monitoring of early portfolio performance should be implemented. Escalation triggers should be established to enable rapid tightening or suspension of certain lending channels if required.

A key residual risk is that underlying data quality issues remain unresolved. This should be addressed through a structured remediation plan over a 6–8 week period, including correcting data feeds, recalibrating or redeveloping models, and conducting independent validation before removing temporary overlays.

Strong governance processes, including weekly review forums, are essential to ensure accountability and progress.

There is an operational risk associated with increased manual intervention, which may strain underwriting capacity and lead to inconsistent decision-making.

Mitigants include temporary staffing increases, clearly defined decision rules, and ongoing quality assurance processes to ensure consistency and control.