Risk Reward
riskupdate
The quarterly independent risk review for banks and financial institutions worldwide
Q2 – 2010

The Changing Face of Regulation

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THE MANAGEMENT OF OPERATIONAL RISK IN MARKET RELATED ACTIVITIES

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Background

On 23 June 2010 the Committee of European Banking Supervisors (CEBS) issued a revised consultation paper on the management of operational risk in market related activities (CP35 revised). This has as its precedent Article 22 if Directive 2006/48/EC (CRD) which states that "home Member States shall require that every credit institution have robust governance arrangements which include a clear organisational structure with well defined transparent and consistent lines of responsibility, effective processes to identify and manage, monitor and report the risk it is or might be exposed to, and adequate internal control mechanisms, including administrative and accounting procedures. These arrangements, processes and mechanisms shall be comprehensive and proportionate to the nature, scale and complexity of the credit institution's activities."

CEBS then state that "Past and present cases show that when institutions do not adhere to basic principles of sound internal governance, the severity of operational risk events in market-related activities can be very high, jeopardising the institution's earnings, the existence of the particular business area, or even the existence of the whole institution."

That there is a requirement for effective risk governance and operational risk management in all areas of the business is clearly evident and inherent in many of the recent Basel papers. In this article we look at CP35 revised and highlight a few of the key elements which complement the framework as set out by the Bank for International Settlements (BIS) in Basel 2 and its supporting papers.

Principle 1 The management body should be aware of the operational risks, actual or potential, affecting market-related activities. It should develop and maintain an organisational structure, internal controls and a reporting system suitable for the identification, assessment, control and monitoring of operational risks in market-related activities.

The supporting analysis provides guidance on the operation of control functions and roles, albeit there is very little that is new here.

Principle 2 The management body should promote, particularly in the front office, a culture designed to mitigate operational risks in market-related activities.

This principle takes the existing corporate governance requirements and explicitly aims them at the front office. CEBS are seeking professional and responsible behaviour, which is probably code for a reduction in the level of risk taken. The guidance emphasises traders requiring at least two consecutive weeks of holiday, with staff changing role between front, middle and back office and IT to be properly tracked. Clearly staff changing role is particularly high risk and could jeopardise the segregation of duties applied.

Principle 3 Senior management should ensure that they, and the staff in the control functions, have the appropriate understanding, skill, authority and incentive to provide an effective challenge to traders' activity.

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It is perhaps the focus on control functions which is an issue here. They are asking for the salaries of such staff to have different drivers to those of the traders, but at present there is a major divergence between these salary levels. It is hard for a control function to be effective when the pay differential could be as much as 80% - the level of authority is often not there. This tome needs to be set from the top to be effective.

Principle 4 Operational risk should be taken into account in setting objectives for, and in the assessment of, an individual's or business unit's performance in market-related activities.

The narrative focuses on risk tolerance, which is in the process of being systematically implemented in many firms. Clearly operational risk should be taken into account since to do otherwise could lead to a sub-optimal solution.

Principle 5 The proactive behaviour against fraudulent actions in market-related activities should be a key element of internal controls and reporting systems.

This is new in being an explicit requirement here. The narrative considers the use of fraud and scenario testing, although training and warning systems also need to be implemented. Modelling behaviour to identify the propensity of a person to commit fraud could also be appropriate.

Principle 6 Traders should initiate transactions only when these are compliant with the set terms of reference. Minimum standards for the initiation and conclusion of transactions should be followed.

CEBS explicitly add a voice recording requirement, but the focus here is on terms of reference. Clearly this reiterates existing guidance in terms of dealing with deviations.

Principle 7 Documentation requirements for trading activities should be properly defined. Legal uncertainties should be minimised, so that the contracts are enforceable as far as possible.

The background to this principle is rather weak and actually does not get to the heart of the issue. The variety of documentation and the linkage of the agreements and confirmations should be an important issue, but is not well dealt with here. All that is actually stated is really a reiteration of existing rules.

Principle 8 As a general rule, transactions should be initiated and concluded in the trading room and during trading hours.

The issue here is how to deal with out of hours trading which might be transacted from the traders home. The lack of detail in the background should not mask the general view that this should be avoided at all costs. If there is a telephone call in system after the trade has been conducted, then this only has the effect of providing a "confirmation" of the trade entered into. The original transaction and contract will not have been recorded.

Principle 9 Each position and cash flow associated with a transaction should be clearly recorded in the institution's accounting system, with a documented audit trail

The only additional requirement here is that CEBS want the responsible manager to be identifiable from the audit trail.

Principle 10 Institutions should ensure that they have an appropriate framework of controls concerning the relationships between traders and their market counterparts.

The requirement extends to internal trades, dormant accounts and dummy counterparts that are pending allocation. It makes clear that pricing issues, legal issues, trade and settlement queries as well as error and claims management should be directed to and carried out by the control functions.

Principle 11 Confirmation, settlement and reconciliation processes should be appropriately designed and properly executed

There is little that is either new or surprising here. CEBS state that the use of over-the-counter (OTC) contracts should be as standardised as possible – which may give some firms a problem. The standard break clause provisions may actually inhibit the use of the instrument for efficient hedging purposes. CEBS are looking for clauses that deviate from the model contract to trigger intervention, which is probably what would generally happen anyway.

Principle 12 Institutions should ensure that their margining processes are working properly and that any changes are reconciled with the relevant positions on their books.

This principle also addresses collateral calls. CEBS are seeking real-time credit systems able to calculate credit lines and usage information as trades are initiated, to aggregate exposures globally across all trading desks and to accurately reflect the effect of netted transactions. This is all quite demanding, not least given the credit risk in an instrument is likely to change in respect of OTC

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transactions intraday. For the credit system to appropriately address netting requires a close link between the documentation systems and the credit systems – which is often not the strongest part of the credit system.

Principle 13 Sources of operational risks in market-related activities should be properly identified and monitored with the appropriate level of scrutiny, intensity and timeliness.

There is nothing new here.

Principle 14 The nominal value of transactions/positions should be kept under strict control for monitoring operational and counterparty risks, through the definition of pertinent limits and/or participation in initiatives for the novation of contracts.

Basically CEBS want nominal and net limits with the concern being that net limits may not capture all counterparty and operational risks. Of course what they actually want are gross and net limits (somewhat different) to9gether with some form of stress limit based on value at risk, but that is not what is stated here.

Principle 15 Information systems in the trading area should be appropriately designed, implemented and maintained so as to ensure a high level of protection in market-related activities.

Nothing new here either.

Principle 16 The operational risk reporting system for market-related activities should be designed to generate appropriate warnings and should alert management when suspicious operations or material incidents are detected.

Of course the key issue really is whether the right issues are detected and this will depend on the nature of the software solutions implemented. Tight limit management will clearly help, but alone is unlikely to be sufficient. The rules here really replicate the existing BIS rules and have not mandated pattern recognition software, for example.

Principle 17 Institutions should ensure the quality and consistency of their internal reports and that they are appropriate to the needs of the recipients for which they are intended

Again little new here except the requirement for internal audit to follow up on corrective actions required as a result of reporting – which actually makes little sense as an explicit request.

So there we have a new 14 page guidance document which is applicable to all institutions and supposed to provide greater detail than is present in the BIS reports, but actually does not appear to achieve very much in terms of additional information or requirements. There is much that could have been included – so we view this as an opportunity missed and wonder why these principles were really considered necessary.

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