Comments on CEBS CP35

Management of Operational Risks in Market Related Activities

Introduction

The Institute of Operational Risk (IOR) is pleased to comment on the CP35. The IOR has the objective of promoting and developing good practice and technique in the field of operational and strategic risk management. It also sets out to reflect many years experience of experts and practitioners in risk management.

From time to time, the promotion of good practices may lead to a professional institute putting forward significantly different views from how firms and their associations see corporate interest best served in new regulatory measures.

This note is written from the point of view of the interests of our profession and membership.

Key points

We respond to specific Paragraphs in the section after this. However in reviewing the Consultation Paper there are three underlying points.

1. Effective operational risk management in market-related activities must recognise the potential for losses these risk events can create through causing unexpected market risk exposures. (This is the distinguishing feature of operational risks in this area.) Frequently this does not happen, because either:
   a. Market movements may negate the unexpected exposure, or the firm is able to eliminate or hedge most or all of the unplanned exposure, or
   b. If a loss does arise, it is recorded as a market or credit loss, and is not attributed to the operational risk cause.

   Nevertheless firms must assess operational risks according to the potential for market or credit losses, and not just for the immediate P&L costs that arise.

2. The decision to introduce some measures of risk management and of control should be based on a risk-based assessment of the potential exposures and the costs of the measures to limit the risk. Without this, financial services firms could develop too high a cost base. Increased costs in firms lead to greater frictional costs in the financial system.

3. It is important that when any changes are made or new activities introduced, a review of the new of increased operational risks should be undertaken. This needs more emphasis in the Principles.

The principles should be incorporated in the Supervisory Review Evaluation Process (SREP) outlined in Pillar 2 of the Basel accord.

Specific Paragraphs

Paragraphs 2, 8 and 10: The end of Paragraph 2 should emphasise that the significance of many operational risks in market-related activities is bound up with the unexpected market risk exposure or actual loss.

Paragraph 8 should emphasise that, notwithstanding the Guidelines on the Scope of Operational Risk and Operational Risk Loss, it is essential that when assessing an operational risk and the controls appropriate to the scale of the exposure account is taken of the possible market losses that might arise. Moreover, whilst loss recording in the accounting systems after the event may show the loss as a market loss, management need to be advised that the loss originated in an operational risk event.

In Paragraph 10, Proportionality should take into account the scope for the risk to create actual market losses or high levels of unplanned market risk exposure.

Paragraph 12: Training and competence is very important. It should be regarded by firms as essential before a person is given authority by the firm to deal in particular products or use particular Front Office systems. Training and competence should be in the explicit scope the management body should concern themselves with.

Paragraph 16: The requirement for absence should explicitly include reference to not using mobile devices that can provide access to secure systems.

Paragraph 17: The reference to senior management having a good knowledge of products and techniques for product evaluation and risk assessment should be extended to include an understanding of the risks associated with making appointments as envisaged in Paragraph 16, and especially the second bullet therein.

Paragraph 20: The balance sought should also include recognition of the potential for significant market losses from operational risk events, and the degree to which this should be and has been avoided or mitigated.

Paragraph 21: Institutions <u>should</u> set objectives in the terms set out in the Principle. The need to recognise the potential for operational risk to cause losses and large unplanned market risk exposures should be included.

Paragraph 23: Among examples of fraud detection and prevention should be included the setting of triggers for reviewing operational risks. There are decisions and events that merit a revalidation of the operational risk profile.

Paragraph 24: Escalation should be independent of the immediate supervisor of the suspected person. A firm must protect itself from the possibility of complicity.

Paragraph 33: It is important that the facility for trading outside the business premises must be subject to operational risk review (eg security issues) in advance.

Paragraphs 43, 44 and 48: These should state that the consideration of measures, including monitoring, should be based on risk-based assessments of the circumstances.

Paragraph 53: Monitoring should include recognition of the potential and actual market risk losses.

Paragraph 55: This provision should also apply to cases where the reason for using a technical account is not adequately clear to Middle and Back Offices.

Paragraph 57: Determining the appropriate frequency should be done on a risk based assessment.

Paragraph 58: In the event of exceptions and exemptions, there should also be an escalation process so management can take appropriate action.

Paragraph 62: The regularity of testing and monitoring should be determined on a case by case basis based on risk analysis.

Institute of Operational Risk
19/21 Billiter Street
London
EC3M 2RY

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Enquiries to:
Edward Sankey: ESankey@IOR-Institute.org