Summary of the Public hearing

Consultation Paper CP 35
Operational risk management in market related activities

London, 09 March 2010

CEBS

Committee *of* European
Banking Supervisors

Agenda

Public hearing 9 March 2010

Operational risk management in Market related activities

- 10:00 – 10:30 Opening remarks
- 10:30 – 12:30 Comments of Participants
- 12:30 – 13:00 Closing remarks

CEBS public hearing 9 March 2010

- The following slides contain a summary of the introduction made by Marco Moscadelli, Bank of Italy, who chaired the meeting and a summary of the comments received
- 33 persons participated in the public hearing

Background information

- Article 22 of dir 2006/48/EC requires to "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 risks** it is or might be exposed to, and **adequate internal control mechanisms**, including sound administrative and accounting procedures."
- In the light of large operational risk losses in the trading area more detailed guidelines were needed

Lessons Learned

- Importance of operational risks in market activities and in particular fraud
- Measurement : Internal historical data not sufficient (expected losses versus unexpected losses), use of external data and scenarios
- Risk management : essential, with a strong involvement of the board and the management body.

Objective → Increase resilience and financial stability of firms

Consultative Paper 35

The guidelines aim to highlight supervisory expectations related to specific arrangements, procedures, mechanisms and systems in trading areas regarding:

- Governance mechanisms
- Internal controls
- Reporting Systems

Governance mechanisms

Principle 1 – 5, enhance internal governance

- Full awareness of the management body on operational risks affecting market-related activities
- Design a culture of front office to mitigate operational risks (even through the identification of objectives for business managers and traders in terms of a maximum acceptable level of operational risk)
- Control functions with the appropriate skill, authority and incentive to challenge the traders’ activities
- Oprisk recognised when business objectives are set
- Control functions to fight against fraudulent behaviour in market-related activities.

Internal Controls

Principle 6 – 15, enhance internal controls

- Transactions to be in line with terms of reference
- Definition of documentation requirements
- Sound processes for transactions (use of trading room, accounting, confirmation, settlement, margining)
- Controls and procedures applicable to the relationship between traders and their market counterparts
- Identify potential sources of operational risks in market-related activities (see also next slide)
- Quality of the information systems designed for trading areas

Internal Controls

Principle 13 and 14, possible sources of OpR

- gross notional amounts
- unusual and remarkable transactions
- anomalies in confirmation and reconciliation processes
- errors in recording, processing and settling transactions
- cancellations, amendments, late trades
- off-market rates

Internal reporting system

Principle 16 – 17, enhance internal reporting

- Generate appropriate warnings and alerts for management when suspicious operations or material incidents are detected

- Reports having sufficient quality, consistency

- Appropriateness for the recipients to which they are intended

Comments received by industry participants

- Overall the participants agreed to the content and purpose of the CP 35
- Participants considered the 17 principles contained in the document as significant steps to improve the management of operational risk in market-related activities. However a few participants felt that the guidelines are too prescriptive regarding some parts that explain how to comply with the principles.
- Participants asked for clarification that the document applies to larger banks, as it would be too burdensome to implement all principles in smaller banks.
- Participants asked for international harmonisation and coordination, especially regarding the US regulatory authorities and other supervisory bodies (e.g. BCBS - SIGOR).
- It was suggested to have an additional consultation period after the review of the initial consultation paper.
- Participants wanted clarification regarding the implementation date.

Comments received by industry participants

Some issues have been raised regarding the clarity of the guidelines and, in a few cases, their level of practicability and usefulness. In particular:

- Participants have been worried that all the tasks described in the principles have to be undertaken by an independent operational risk management function.
- Principle 4, Paragraph 21: Participants asked for clarification what a “maximum acceptable level of operational risk” should be and what should be done to “set objectives for traders that do not violate regulation on the protection of personal data and other relevant legislation”.
- Principle 5, Paragraph 24: Participants asked to provide examples for fraud prevention measures.
- Principle 9 focuses on cash-flows; sometimes the cash-flow is delayed. These transactions need to be considered as well.
- Principle 10, Paragraph 39 requires - inter alia - a “ review of the relationship between market counterparts and front office staff”. Participants considered this as not practical.

Comments received by industry participants

- Principle 11:
  - Participants commented that the confirmation issues (Paragraphs 43 and 44) need to be clarified. Not all positions are confirmed on a daily basis. The market standards must be recognised. Exceptions to the general criteria in specific situations should be allowed;
  - The wording “real-time” in paragraph 45 should be avoided. Some participants suggested deleting paragraphs 45 and 46, referring to “nostro accounts”.
- Principle 14, Footnote 3 and Paragraph 67:
  - The monitoring of gross positions at trader level is neither practical nor useful when positions are not assigned to a single trader, they are rather booked and controlled at product or portfolio level;
  - Paragraph 59 asks to set limits in terms of “Greeks”, this is typically part of market risk management. The Guidelines should avoid to deal with controls that are not pertinent to operational risk management.

CEBS response

- The CP35 has been shared with the BCBS Standard Implementation Group Operational Risk (SIGOR) before being issued for consultation.
- The implementation date in the CP35 is directed at supervisory authorities. They are required to implement the guidelines in a “comply or explain” approach by the given date and apply them to institutions afterwards.
- The principle of proportionality applies to the guidelines.
- The formulated principles need to be read together with other guidelines on operational risk management, in particular with the guidelines on the “Scope of operational risk and operational risk loss” (compiled in the “Compendium”), which address the boundary issues between operational risk and market risk.

CEBS response

- Not all the tasks described in the principles need to be done by an independent operational risk management function. Besides, this function usually contains centralised and decentralised parts and may delegate tasks to staff within the business units.
- As to the specific comments raised, CEBS will review the CP35 in the light of the results of the public hearing and the written comments.
- Participants have been kindly requested to hand in by 31 March comments in writing or by email (cp35@c-ebs.org)
- CEBS will publish the revised guidelines together with a feedback table explaining how the comments have been accommodated, including a reasoning for this.

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