

BNP PARIBAS ANSWER TO CEBS CONSULTATIVE PAPER 35
ON IMPLEMENTATION GUIDELINES ON THE MANAGEMENT OF
OPERATIONAL RISK IN MARKET RELATED ACTIVITIES

31 March 2010

BNPP welcomes the opportunity to respond to the Committee of European Banking Supervisors' Consultation Paper 35 on its proposed implementation on the management of operational risk in market-related activities by which CEBS introduces specific principles and implementation measures for the identification, assessment, control and monitoring of operational risk in market-related activities.

We believe that the principles and purpose of the Guidelines as exposed enhance the management of operational risks in an area that showed in the past years some deficiencies and, learning the lessons from past frauds and the like, required a need for risks mitigants identified and developed on an harmonised approach. As a matter of fact, CEBS's CP35 is a reminiscence of French regulation Comité de la Réglementation Bancaire n° 97-02 and echoes the French Minister of the Economy and Finance C. Lagarde's Report which implements in France a robust framework for operational risks under the supervision of the French supervisors.

BNP Paribas has taken on board operational risks as a key element of its internal organisational structure making the function of Compliance and within it, Oversight of Operational Permanent Control a major participant in the overall framework for monitoring operational risks. Therefore the CEBS's initiative is welcome and supported. BNP Paribas is also fully supportive of the FBF response to the Consultation Paper which expresses a number of concerns and serves as a base of our present position. Therefore we shall restrict our comments to some additional concerns and amendments to the draft guidelines.

We would like to emphasize one specific concern which relates to requirements on trader's level view or consolidation. Market activities are run at book or portfolio levels and operations organisation is mainly driven per type of financial instruments or flows. Views per trade make sense on some specific items but willing to generalize this kind of consolidation in the control framework may lead to a level of complexity that would exceed benefits.

Although we reckon the benefits of such guidelines, we are concerned that the guidelines may be too prescriptive with regards to the necessary flexibility to adapt to the business model of each institution, in that the outcome would generate significant costs for implementing the framework in the timeline proposed by CEBS. In particular and given the delays granted, we would plead for additional room in the calendar to allow institutions to implement smoothly and at reasonable expenses such framework within the constraints in the organisation of each institution, and allow the guidelines to adapt to the current market standards and practices.

Many general principles described in the Draft Guidelines raise questions and issues especially in their enforcement and implementation. We highlight hereunder for CEBS's perusal a few items we believe should be clarified.

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Introduction - § 1. line 2 - Page 1: We would like CEBS to specify that "every credit institution" clearly apply to all types of financial institutions including investment banks, such institutions active on the capital markets.

Introduction - § 2 - Page 1: Human error should be included in the Operations Risk events.

Principle 4 - § 21 - Page 5: This section questions about the acceptable level of exposure and related compensation issues. Setting operational risk objectives or limits can be very difficult if not impossible, given the variety of operational risk events.

We suggest amending as follows: "...institutions must closely monitor the operational risks exposure of business managers and traders and/or take into account the way the business managers and traders manage such exposure in the attribution of their variable remuneration".

Principle 5 - § 24- Page 6: "...regular fraud testing": This broad terms should be more specific in particular reflect Basel language. We would encourage CEBS to elaborate on the mentioned principle with a practical or methodological approach.

Principle 6 - § 30 - Page 7 "... immediately after the conclusion of trades, the relevant data": It must be clearly specified that the immediacy of the action only concerns the transmission of data, not the confirmation of the transaction, settlement etc.

Principle 6 - § 31 - Page 7: "...transactions should be taped": This principle should to be applied in compliance with the applicable legal environment according to each jurisdiction, and this criterion must be clearly stated in the guidelines.

Principle 7- § 32 - page 7: The requirements are not determined ahead of trading in the examples mentioned of TPP and prime brokerage give ups.

Principle 9 - Page 7: We would like CEBS to clarify the definition proposed of a "documented" audit trail and elaborate on what is expected from institutions.

Principle 9 - § 36 - Page 7: "audit trail....starting with the trader": We insist that many controls are at the level of the book or portfolio and not at the trader level for the reason that traders can share books. We would like to emphasise that the reconciliation against the general ledger is not straightforward due to the accounting structure. For instance, the PnL is recorded based on the nature of the costs and profits and further analysis must be undertaken in order to integrate the different components of incidents (funding, cost of fails, fees, realised PL/accruals ...), the reconciliation can be partial (gains, losses, undisclosed breakdown information, different cut off period, amounts paired off not flagged and manually re-aggregated or aggregated amounts directly recorded in the accounting system.

We suggest to draft as follows: "audit trail (...) at a sufficiently granular level, books or portfolios, to be able to identify the responsible manager".

Principle 11- § 40 - Page 8: We would be grateful if CEBS could clarify the terms "gaps and point of weakness".

Principle 11- § 41 - Page 8: We should make the difference between issuance of a confirmation and fully achieved confirmation process. Issuing some kind of a confirmation, even partial, "at least before the end of the day" can be acceptable as a target, but achieving confirmation within this timeframe is impossible. The timeframe for achieving all confirmations below one day or "at the latest before the end of the day" can be quite constraining and is more restrictive than industry standards (like the so-called fed standards). Reconciliation for credit activities is done at T+3 for electronic deals and T+5 for structured paper deals, whereas the market standards are T+10 and T+30 respectively. Timeframe often depend upon the responsiveness of the counterpart, which differs greatly between the sell-side and the buy-side, not to mention novation agreements. Moreover, they and cannot be enforced if the regulations are different from one jurisdiction to another, or from local or regional market practices,



dependant on the quality and technology of systems. Syndicated trades incur also a much longer settlement window than one day delay and these differences should be taken into account.

We suggest to draft as follows: " all confirmations must be done within industry standards (like the so-called fed standards) and taking into account local regulations. It is however acknowledged that they often depend on the responsiveness of the counterpart (which be very different on the buy-side) and must also take into account constraints such as novations. Issuance of a first level of confirmation before the end of the day is strongly recommended."

Principle 11- § 43 - Page 8: The terms "all transactions must be confirmed" could be misleading as defined as such. Bonds should be excluded specifically as not relevant to the case.

Principle 11- § 45 - Page 8: "Nostro balance projections should be made on a real time basis": The frequency should be changed to "at least, daily", as real time basis including amendments and cancellations appear neither practical nor a suitable target. We would suggest CEBS to clarify the guidelines as to whether the scope specified applies to all bank's activities. In particular, the mention Amends and Cancels should be clarified

Principle 11- § 47 - Page 9: Please see our comment on Principle 9 - § 36 infra.

Principle 11- § 48 - Page 9: confirmations with internal counterparts are not systematic and may be replaced by automated reconciliations and internal controls (with a sufficient level of details) in the case of inter-company transactions. Applying the same procedures and conditions as for external counterparts would be inefficient and very costly. The workability of the process should remain the main driver for all types of organisations and should not incur unnecessary costs. It should be specified that the proposition does not concern transactions operated between desks of the same legal entity (intra-company transactions)

We would suggest CEBS to specify in the guidelines that "transactions with internal counterparts must be confirmed or internally reconciled and controlled with a level of detail providing the same comfort".

Principle 11- § 49 - Page 9 - (second paragraph): Checking of novation agreements may appear very unlikely with certain type of customers located on the buy side or hedges funds.

Principle 11- § 49 - page 9 - (fourth paragraph): The outsourcing should be more specifically detailed to be included in any control framework

Principle 13 - § 54 - Page 10: A detailed breakdown of PnL is not always possible to compute especially in respect of structured products, and for instance typically correlation products.

Principle 13 - § 56 - Page 11: "...and the capture of operational risk losses in the treasury activities". We must insist that we do not see any merit in making a specific mention on capturing of operational risk losses on the treasury activities.

Principle 13 - § 67 - Page 13: the monitoring of trading activities is done at the book level or portfolio level. Having consolidated views at a trader level may induce a very high level of complexity and cost to efficiency ratio.

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In conclusion, the points addressed in the Consultative Paper are sound principles, but raise serious concerns in their implementation as they require a substantial investment in systems, people, and a cultural shift for individual/organisations/markets mind set. A too drastic or too rapid implementation of some points highlighted above can expose organisations to even larger operational risks, such unintended effect to be avoided.