

The Director General delegate

Paris, March 30<sup>th</sup> 2010

**FBF comments on the proposed implementation guidelines on the management of operational risk in market-related activities - CEBS Consultation paper CP 35**

Dear Sir,

The French Banking Federation (FBF) is the professional body representing over 450 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

The FBF is pleased to take this opportunity to comment on the proposed implementation guidelines on the management of operational risk in market-related activities (CEBS Consultation paper CP 35). The FBF welcomes the initiative of the CEBS to introduce specific principles and implementation measures for the identification, assessment, control and monitoring of operational risk in market-related activities.

The FBF agrees on both the purpose of CP 35 and the principles exposed in the document, and considers that these principles are a significant contribution to improve the management of operational risk. Implementation of the proposed framework should contribute to a reduction of operational risks.

However, the FBF perceives some elements of the Consultative Paper as being too prescriptive, especially when setting precise and detailed organizational standards that financial institutions should implement to comply with principles.

You will find in the attached annex our detailed comments on the proposals.

The French Banking Federation wants to see the instigation of healthy competitive conditions and believes the only way to do is to establish appropriate regulations. The FBF remains at your disposal for any further discussion on these matters.

Yours sincerely,



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## **Response to CEBS Consultative Paper 35**

### **Operational risk management in market related activities**

The Committee of European Banking Supervisors (CEBS) has launched a consultation on its draft guidelines on the management of operational risk in market-related activities: CEBS introduces specific principles and implementation measures for the identification, assessment, control and monitoring of operational risk in market-related activities.

#### **GENERAL COMMENTS**

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Members of the FBF workgroup on Operational Risk agree on both the purpose of CP 35 and the principles exposed in the document. They consider that these principles are a significant contribution to improve the management of operational risk in market related activities of trading portfolio. Implementation of the proposed framework should contribute to a reduction of operational risks.

However, one could perceived some elements of the Consultative Paper as being too prescriptive, especially when setting precise and detailed organizational standards that financial institutions should implement to comply with principles. Financial institutions should remain responsible for designing and evolving their organization in order to comply with CP 35 principles.

Beyond this overall position, participants to the FBF workgroup on Operational Risk have three types of additional comments:

- Disagreement with some propositions: implementation of some of the propositions would introduce drawbacks or limitations that could lead in fact to less precise and effective operational risk management. We propose alternate recommendations.
- Necessity to clarify some wordings: the wording of some propositions could be clarified in order either to increase practicability of the framework or to lighten organizational constraints imposed on framework implementation.
- Proposition to add new elements to the framework.

An additional consultation period could be granted after the review of the initial consultation paper.

Depending on whether or not remarks on the Consultative Paper will be taken into account by CEBS, an additional delay may be needed regarding the implementation date.

## **2. Governance mechanisms**

**Principle 1.** The management body should have full awareness 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.

- Principle 1: “full awareness” of the management body should be replaced by “appropriate” or “adequate awareness”.
- Principle 1, paragraph 13: this proposition is quite prescriptive in terms of organization of controls and could be interpreted as a strong incentive to centralize controls. Instead of focusing on fragmentation, emphasis could be put on:
  - Having a clear definition of roles and perimeter of control units, in order to avoid gaps and overlaps in the control framework ;
  - Encouraging institutions to have an overview of the results of controls produced by control units.

We propose the following wording for the Consultative Paper:

*“13. The fragmentation between .... To this end:*

- *Clear process owners should be identified for each key process*
- *A clear statement of the responsibilities and scope for each control unit should be establish, in order to avoid gaps and overlaps in the control framework and guarantee accountability for each control unit on its perimeter.*
- *Organization should encourage and promote the capability of the institutions to have an overview of the results of controls produced by control units. Banks should define and document to which extent, depending on types of controls and organization in place, they want to have a balance between operational proximity and control centralization.”*

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

- Principle 2, paragraph 15: mandatory absence policy should be implemented, but this should be done in accordance with local labor regulations.

We propose the following wording for the Consultative Paper:

*“15. Appropriate policies...should be developed, implemented and regularly monitored according to local labor regulations.”*

**Principle 5. The fight against fraudulent behaviour in market-related activities should be a pivotal element of internal controls and reporting system.**

- Principle 5: fight against fraudulent behavior should be a “*key element*” of internal controls and reporting systems, instead of “pivotal”. Internal controls and reporting systems should be designed to address the full scope of operational risks, with specific emphasis on fraud risks, which is one operational risk among others.
- Principle 5, paragraph 24: “regular fraud testing” could be replaced by “*regular fraud scenario analysis*”. Actual fraud testing, i.e. creation of fictitious deals in systems for instance, cannot be carried on a regular basis, since they could generate significant operational risks. External fraud scenario analysis and back testing, however, are necessary.
- Principle 5, paragraph 25 and 26: local regulation should be taken into account for the definition of notification process and thresholds.

We propose the following wording for the Consultative Paper:

*“25. A duty to notify the appropriate level of management should be instituted for incidents exceeding pre-determined risk tolerance levels, with appropriate escalation process.*

*26. The supervisory authority should be notified of cases of fraud exceeding a given threshold or having certain characteristics (making use of ad hoc templates required by the supervisory authority or adopting COREP templates where they have been introduced) in accordance with local regulations”.*

**3. Internal controls**

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

- Principle 6, paragraph 27: verifications should be rather on the nature and volume of the financial instruments used, than on their nature and number.

We propose the following wording for the Consultative Paper:

*“27. The existence of precise terms of reference circumscribing the activity of each trader is an essential prerequisite for the sound management of market-related operations. It gives to each of*

*the parties involved – traders, managers at all levels and controllers - the means of verifying that the nature , volumes and overall size of the position of the financial instruments used are within the limits and strategy defined by the institution’s management. “*

**Principle 7.** Documentation requirements for trading activities should be properly defined. Legal enforceability of the contracts should be assured.

- Principle 7, paragraph 33: local regulation should be taken into account, since “closeout” netting and settlement netting may not be authorized locally.

**Principle 9.** Each cash flow associated with a transaction should be clearly recorded in the institution’s accounting system, with a documented trail.

- Principle 9, paragraphs 36 and 37: emphasis should be put on the existence of an *audit trail process* rather than on the existence of an *audit trail*. It is key that financial institutions are able to produce an audit trail making it possible to trace cash flows both upstream and downstream. However, this result can be achieved through a secured process and does not require a readily available “push button” audit trail.

We propose the following wording for the Consultative Paper:

*“Principle 9. Each cash flow associated with a transaction should be clearly recorded in the institution’s accounting system, with a reliable audit trail process*

*36. The audit trail should make it possible to trace cash flows both downstream and upstream - from the trader to the external counterpart – at least on demand. The accounting for the cash flows requires very strict monitoring and control.*

*37. Extended audit trails, to identify transaction from the point of origin by each trader, is necessary and must be demonstrated on demand when needed, for the institutions’s systematic ex post control and reconciliation, both by internal controllers and external auditors, of the operations carried out.”*

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

- Principle 10, paragraph 39: proposition should precise that only “*relevant commercial issues*” are concerned and not all commercial issues. On some issues, it is acceptable or even suitable that front office negotiates or interacts with its client.

**Principle 11. Confirmation, settlement and reconciliation processes should be correctly designed and properly executed.**

- Principle 11, paragraph 40: “without involving the front office” should be deleted from the proposition. Confirmation, settlement and reconciliations processes must be carried out directly among the control functions. However, control functions have to interact with the front office during this process, to obtain additional information, liaise with the counterpart or put the pressure on it in order to accelerate the global process.

We propose the following wording for the Consultative Paper

*“40. Confirmation, settlement and reconciliation processes should be defined to prevent gaps and significant points of weakness and to help identify and resolve breaks. The control functions must remain accountable for the global process.”*

- Principle 11, paragraph 41: reference to the confirmation of transactions within “usually a few hours after the conclusion of the transactions and, at the latest, before the end of the day” should be amended. Especially for exotic OTC transactions which often require several days to be confirmed, according to the nature and complexity of products traded and to the type of counterparts involved, such and objective, not only may be very difficult if not impossible to reach, but also, may lead to inadequate control, confirmations made without the right time and exchange between counterparties could lead to misunderstanding and wrong statements, therefore increased risks..

We propose the following wording for the Consultative Paper:

*“41. Institutions should have a rigorous and reliable process for confirming the terms and conditions of transactions that they have entered into with external counterparts in a timely and with unambiguous meaning, so as to avoid the accumulation of unreconciled transactions which represent a major source of risk. A proper reporting of un-affirmed and un-confirmed deal should be performed at the appropriate level. For certain types of operations, and especially flow business, confirmations before the end of the day must be an objective.”*

- Principle 11, paragraph 42: proposition could be reworded as follows:

*“42. Pending the completion of full documentation and confirmation processes, consideration could also be given to the use of affirmation processes. Affirmation process is intended to demonstrate the existence of the transaction, in order to mitigate fraud risks”.*

Financial institutions should decide to implement this process depending on the types of products traded and should be able to specify media used for this purpose (oral or not).

- Principle 11, paragraph 44: last sentence of this paragraph is too prescriptive regarding the organization of controls. It should focus on the principles that must drive the organization, i.e. independence of control units. Financial institutions should be responsible for the design of the control organization on settlements.

- Principle 11, paragraphs 45 & 46: nostro balance projections on a real-time basis, including amendments and cancellations appear neither as a practical nor a suitable target. Real-time reconciliations with nostro institutions to process the cancel & amend do not take into account the netting process that is part of the payment process. This proposition should be superseded by three principles:
  - Cancel & amend monitoring
  - Nostro accounts reconciliations
  - Treasury monitoring

We propose the following wording for the Consultative Paper:

*“45. Financial institutions should design and implement a control framework over amendments and cancelations, given their potential use for fraudulent purposes.*

*46. Financial institutions should set-up cash reconciliation processes with an appropriate frequency. Daily cash reconciliations could be regarded as a suitable target.*

*47. Financial institutions should be able to produce and monitor their economic treasury position, with an appropriate update frequency. Real-time updating could be regarded as a suitable target.”*

- Principle 11, paragraph 48: definition of internal trades should be clarified as trades between two legal entities belonging to the same group (intercompany transactions). Intercompany transactions should be subject to the same procedures and conditions as those in place for external counterparts. This proposition does not concern transactions between desks of the same legal entity (intra-company transactions).
- Principle 11, paragraph 49: proposition should be amended to mention that the use of secure commercial trading platforms is to be encouraged only when such platforms are available.

**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.**

- Principle 12, paragraph 50: margin and collateral calls cannot be traced to a trader, since they are globalized for some counterparts. However, when an anomaly is identified, financial institutions should be able to produce an audit trail and to trace the issue back to the transaction level, and therefore at the trader level.
- Principle 12, paragraph 53: instead of analyzing margin and collateral calls cannot be traced to a trader, since they are globalized for some counterparts. However, when an anomaly is identified, financial institutions should be able to produce an audit trail and to trace the issue back to the

trader level. Additionally, an analysis of the treasury position could be performed instead of an analysis of gross and net cash flows.

We propose the following wording for the Consultative Paper:

*“53. Consideration should be given to the analysis of treasury position, on the one hand, and whether these can be understood in the context of the trader mandate, positions and reported P&L, on the other hand. Financial institutions should design and implement a workflow that could ensure appropriate investigation of disputes over collateral.”*

**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.**

- Principle 13, paragraph 57: frequency of monitoring should be set according to the sensitivity of the activities, books, products or processes monitored. Financial institutions should be responsible for setting the appropriate monitoring frequency, with reference to the proportionality principle. Moreover, examples mentioned in proposition may not be relevant. For instance, provisions should be monitored on a daily, weekly or monthly basis, depending on their sensitivity. Also, it must be noted that for some types of controls, a too short periodicity may lead to the impossibility to track relevant anomalies, and therefore inappropriate risk control.

**Principle 14. In addition to the monitoring of net amounts and sensitivity measures, the gross notional amounts of transactions 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.**

- Principle 14, paragraph 59: this proposition should be amended to advocate for an ex post monitoring of ceilings on gross notional amounts at the desk level, for a limited perimeter of products.
  - Real-time monitoring would not increase significantly financial institutions' ability to detect fraudulent behaviors. Rogue trading cases have demonstrated that hidden positions took time to build (several months in general). We think that the systematic real time monitoring of limits would not only be extremely difficult to implement, but also could imply very important investment of control resources which could be better employed on other issues.
    - there is no real time reconciliation between F/O systems (where risks are computed) and B/O systems; this means in particular that a rogue trader may hide a position until the end of the day even if risks are monitored in real time
    - trading tickets constituting one set of transactions are not necessarily entered in the system at the same time; in particular, complex OTC trades usually take longer to



enter than their vanilla hedges; this time lag generates a lot of false alerts on an intra-day basis

- in the case of options books, it is necessary to recompute the risks (delta,..) in order to monitor the limits, which is at best difficult and sometimes impossible (in particular for exotic products that require long computation times)
  - the validation of risk indicators by the Risk teams requires a fair amount of time in order to ascertain their accuracy, and take decisions on right analysis
  - For these practical reasons, and because large operational losses are rarely generated over one day but rather over a period of time, we consider that risk monitoring is more efficiently done on an overnight basis
- Monitoring at the trader level would not be practical. However, in case of anomaly or suspicion, financial institutions should be able to focus on a specific trader and to produce an audit trade at the trader level.
  - Perimeter should be limited since limits in terms of gross notional amounts may not be a relevant indicator of risks related to transactions for some products. Also, market activities are followed by desks, P&L are defined by desks, market limits are therefore also defined by desks. We agree that traders must know and validate the limits that are assigned to them, but they must not be specified on a trader basis.

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

- Principle 15, paragraph 62: proposition should be reworded into *“the level of security of these systems should be regularly tested and monitored in order to prevent non-authorized access”*. Prevention of identity usurpation stricto sensu would require the use of biometric devices that may not be available or authorized by local regulations.

#### **4. Internal reporting system**

**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.**

- Principle 17, paragraph 66: reports aiming to detect operational risks in market related activities should be produced under the responsibility of the control functions, rather than by the control functions. Some reports cannot be directly produced by control functions. However, in these cases, control functions should design, specify and control the reports and should be held accountable for them.

- Principle 17, paragraphs 67: monitoring of key operational performance indicators should be performed “at an appropriate level” rather than “at a trader level”. It is neither possible nor suitable to monitor all key operational performance indicators at a trader level: some indicators can be or should be monitored at the desk level for instance, whereas others should be monitored at the product family level. However, in case of anomaly or suspicion, financial institutions should be able to zoom at the trader or even deal/trade level to investigate the issue. Financial institutions should be responsible for setting the appropriate monitoring level for their key indicators.

**Framework could be complemented with additional propositions**

- Principle 17, paragraph 68: additionally to calls for corrective actions, reports should also contain a follow-up of the implementation of corrective actions.
- Principle 17: documentation and implementation of an alert and escalation procedure could also be included in the scope of CP 35.