

## The Pragmatic Implementation of an Operational Risk Control Framework in Market-Related Activities



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**O**perational Risk Management was the focus of the Avantage Reply December 2011 business breakfast in response to the FSA's adoption of the Committee of European Banking Supervisors' Guidelines on the management of operational risk in market-related activities, published in October 2010.<sup>1</sup>

The business breakfast specifically discussed market-related operational risk events that are often associated with rogue trading, unauthorised operations, complex instruments, new products, the rapid increase in the number of operations, etc.

Contributions from the UK Financial Services Authority ("FSA"), industry and Avantage Reply subject matter specialists highlighted regulatory expectations, industry developments and subsequent challenges.

<sup>1</sup> The European Banking Authority ("EBA") took over all existing responsibilities from the Committee of European Banking Supervisors ("CEBS") from 1 January 2011. Within this document, CEBS is referred to as EBA.

## Regulatory Expectations

The FSA adopted EBA Guidelines within BIPRU 6, *Operational Risk*. The Guidelines provide 17 specific principles and implementation measures for identifying, assessing, controlling and monitoring operational risk in market-related activities.

Principles address governance mechanisms, internal controls, and internal reporting.

### *Scope of 'Market-Related Activities'*

The EBA Guidelines do not provide a prescriptive definition of 'market-related activities'. Our interpretation is that this lack of prescription intentionally forces financial institutions to adopt a wide-ranging definition that extends well beyond trading rooms.

### *Evidencing Compliance with EBA Guidelines*

In meeting the general risk management standards, banks and investment firms that undertake market-related activities should be able to demonstrate to the FSA that they have considered the EBA Guidelines.

This requirement applies irrespective of whether the firm uses the Basic Indicator, the Standardised, or the Advanced Measurement Approach for Operational Risk.

## Industry Developments and Challenges

Despite recent high-profile operational risk events, BIPRU 6 has remained off the radar in many institutions' Front, Middle, and Back Office management functions.

Our experience suggests that when institutions do not adopt basic principles for the management of operational risk, including a sound governance framework, the severity of operational risk events in market-related activities can be very high from either a financial and/or reputational perspective, thus jeopardising earnings or even the existence of the institution.

Given UK regulated institutions are now required to demonstrate compliance with EBA Guidelines, some have undertaken a gap analysis exercise with the defined principles. This has provided an opportunity to reinforce throughout financial institutions the importance of operational risk management on the profitability and even viability of market-related activities. The recent, high-profile rogue trading events have served to reinforce the potential consequence of not getting risk management right.

Our experience has shown that there is often reluctance from Front Office managers to conduct risk management gap analyses and implement additional layers of controls. It is no surprise, Operational Risk managers, therefore, need to demonstrate value and seek out executive sponsorship to ensure engagement from the Business.

Before conducting the gap analysis, one should expect several challenges to arise. In particular, we have observed:

- The Front/Middle Office staff often requires risk management training to ensure a common understanding of risks, defining controls, etc.;
- Back Office staff are often not experienced in Front Office activities and lose credibility and business buy-in;
- Many Front Office controls, tests and evidence are difficult to define in very specialist market-related activities. This includes implementing consistent key controls across diverse trading desks due to local variations in business practices and regulatory requirements;
- Regulatory requirements are often defined as being "proportionate to the institution"; however, how can Operational Risk management be taken seriously if events such as rogue trading continue, regardless of financial impact;
- Market-related activities are not confined to a 9-5 working day, and often not always conducted within a controlled trading room environment; and
- The misalignment between regulatory requirements and employee incentive schemes.

These challenges, amongst others, raise concerns and should be addressed before engaging the Front/Middle Office to conduct the gap analysis helping ensure momentum and buy-in is maintained.

## Evaluating and Demonstrating Compliance

Whether developed internally or sourced externally, a tool to evaluate all elements in the EBA Guidelines is important to the gap analysis process. Such a tool provides structure for considering the Guidelines, facilitates assigning ownership and creates a baseline upon which areas for improvement can be identified, prioritised and tracked.

Avantage Reply have developed such a tool (within Avantage Reply's proprietary suite, IPRM™) to assist regulated institutions who either currently engage or intend to engage in market-related activities and wish to assess their controls activities.

IPRM™ serves to establish managerial perception of the breadth of implementation and depth of embeddedness of the principles and measures to mitigate operational risks resulting from market-related activities as advocated by the EBA Guidelines.

In addition, the IPRM™ tool's capability provides a delivery framework with the depth of BIPRU 6 in mind and can be utilised to highlight compliance gaps, including functionality to capture evidence of how the recommended measures are being addressed by an institution, and action plans where evidence suggests it may be deficient. It also provides an appropriate record

of consideration of the EBA Guidelines as required under BIPRU 6.

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