FSA BIPRU 6.3.16 [G], 6.4.1A [G] & 6.5.5A [G]:

The Management of Operational Risk in Market-Related Activities

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Operational risks related to market-related activities continue to make media headlines at a time when public confidence in, and approval of, the financial sector remains low, not least due market volatility which can itself act as a catalyst of operational risk.

Market-related operational risk events are often associated with rogue trading, unauthorized or leverage operations, complex instruments, new products, model risks and the rapid increase in the number of operations. The continued evidence of publicised losses from such operational risks suggests that while most firms have focused their attention across the range of risk types, some have yet to recognise sufficiently the importance of appropriate operational risk management.

Guidelines issued by the Committee of European Banking Supervisors (CEBS) in 2010 aim at ensuring the appropriate governance, control and reporting of operational risks arising from the market-related activities of firms now regulated by members of the European Banking Authority (EBA).

In this paper we look at how the FSA has enshrined the CEBS guidelines in BIPRU 6, consider the impact and steps that should be taken by FSA regulated firms engaged, or proposing to engage, in market-related activities, and note the practical assistance that we can offer to our clients in helping them to meet these requirements.

Introduction

On 12th October 2010, CEBS published its 'Guidelines on the Management of Operational Risk in Market-related Activities'. A response to specific large loss events incurred by a number of major European banks, publication of the Guidelines is consistent with the increase in activity by regulators aimed at strengthening and defending banks against inappropriate risk-taking, including operational risks, in the wake of prolonged turmoil within the financial sector and recent volatility of financial markets.

Originating as a discussion paper in late 2009, proposals have been subject to two-rounds of market comment. The resultant guidelines offer a principle-based approach consistent with, and complimentary to, the framework established through preceding publications, namely 'Guidelines on the Application of a Supervisory Review and Evaluation Process under Pillar 2' (25 January 2006), 'High-level Principles for Risk Management' (16 February 2010), and 'High-level Principles on Remuneration Policies (20 April 2009).

With its formation on 1st January 2011, the European Banking Authority (EBA) became the authority behind the Guidelines on the Management of Operational Risk in Market-related Activities, a consequence of the EBA assuming all of the existing and ongoing tasks and responsibilities of CEBS. European regulators have remained subject to the implementation timetable originally specified by CEBS within which to give effect to the Guidelines within their rulebooks. The FSA implemented the Guidelines through its revision of BIPRU 6 in August 2011.

The aim of this document is to set out the FSA's proposals, and to examine what is expected of the firms it regulates in relation to the CEBS Guidelines.

What the CEBS guidelines require?

The objective of the guidelines is to complement its previously published framework of high-level guidelines – notably those comprising high level principles on internal governance, risk management and remuneration policies - with more specific principles and implementation measures for the identification, assessment, control and monitoring of operational risks in market-related activities.

It advances 17 principles categorised under the following functional headings:

Principles 1 – 5: 'governance mechanisms'

CEBS notes that past and recent cases show that when institutions do not adhere to basic principles of sound internal governance, the severity of operational risk events in market-related activities can be very high, jeopardising the institution's earnings, the existence of

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the particular business area, or even the existence of the whole institution.

Principles 6 – 15: 'internal controls'

Principles 16 – 17: 'reporting systems'

The implementation measures noted against each principle aim to highlight supervisory expectations relating to specific arrangements, procedures, mechanisms and systems in trading areas that could prevent or mitigate operational risks events.

What BIPRU requires?

In defining their approach to the adoption of the CEBS guidance, the FSA noted that the principle-based approach of the guidance would not sit comfortably with current structure of the FSA Prudential Rulebook. The FSA has therefore establish a single statement of guidance relevant to the firms that it regulates who engage in market-related activities requiring that they consider the CEBS guidance in relation to their own operations.

Who is affected?

The requirement applies to all FSA regulated credit institutions engaging in market-related activities, irrespective of whether those firms adopt an Advanced Measurement Approach (AMA), The Standardised Approach (TSA), or the Basic Indicator Approach (BIA).

Market-related activity is not specifically defined, but is deemed to principally address any form of trading activity associated with a financial market.

CEBS note that the guidelines are applicable to all firms: nonetheless they recognise the requirement to balance control with nature and scale of a firm, and highlight that the principle of proportionality should be taken into account in their application. The level of sophistication of governance mechanisms, internal controls and reporting systems for the management of operational risks in market-related activities should be commensurate with the complexity and magnitude of those activities within the individual institution.

The FSA's paper should be read by:

- all FSA regulated firms engaging in market-activities;
- significant investment firms engaging in market-related activities; and
- all such firms planning to engage in market-related activity.

What happens next?

CEBS set the expectation that their guidance be implemented by its members by 30 June 2011. Following a period of consultation the FSA established its guidance under BIPRU 6. This has been effective since 1 August 2011.

Notwithstandin the 'guidance' status of BIPRU 6.3.16, 6.4.1A and 6.5.5A, FSA regulated firms engaging, or proposing to engage, in market-related activities should be able to demonstrate that they have considered the CEBS guidelines in relation to their own governance, internal control, and reporting arrangements.

How we can help

Avantage has developed a capability to assist regulated firms who either currently or intend to engage in market-related activities assess controls in relation to those activities.

At the heart of this capability is an assessment tool that 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 CEBS guidelines. Functionality to capture evidence of how the recommended measures are addressed by a firm, and to establish action plans where evidence suggests it may be deficient, provide an appropriate record of consideration of the CEBS guidelines as required under BIPRU 6.

Our consulting team are experienced with a range of firms, enabling us to provide a balanced and pragmatic view of what is appropriate in the context of individual firms. As such we are ideally placed to assist you in the planning, project management and implementation of necessary improvements in governance, internal controls, or reporting arising from assessment of your current or planned market-related activities. We will be happy to discuss specific requirements with you.

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