

Fiona Campbell
Prudential Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

30 June 2011

Dear Ms. Campbell,

Comments on Chapter 5 CP11/9

The following response to your request for comment in relation to CP11/9 is provided in my capacity as a representative of Avantage Reply, a pan-European specialised risk and capital management consultancy firm. It addresses points in relation to Chapter 5, "*CEBS Guidelines on the management of operational risks in market-related activities*".

Q12. Are the references to the CEBS guidelines clear?

We believe that reference to the CEBS Guidelines in the proposed amendment to BIPRU 6.3, 6.4 and 6.5 are clear. We do however note that the purpose of the CEBS Guidelines and BIPRU fundamentally differ, the former providing focus as to appropriate governance and control, the latter providing focus on financial regulation. We question whether reference should additionally be made in SYSC in order to reinforce the control requirement behind the CEBS Guidelines.

Q13. Do you agree with our assessment that the requirement for a CBA does not apply as the increase in cost estimates because of these guidelines is negligible or of minimal significance?

In our experience we would agree that most firms with trading-related activities operate a level of governance, control and reporting that reflects the intentions behind the CEBS Guidelines.

We would note however that smaller firms or smaller scale trading operations of larger firms often do not employ the complete range of tools and techniques addressed by the CEBS Guidelines. While both CEBS Guidelines and FSA acknowledge the principle of proportionality, this concept frequently proves difficult to interpret and apply in practice, particularly in relation to consideration of control environments around the significant risks typically represented within trading-related activities. While the CEBS Guidelines articulate a set of practices that firms should "consider", we believe that these will be appropriately viewed by the management of firms and trading operations of all sizes as minimum requirements irrespective of the notion of proportionality. As such, in the short term, the implementation of the CEBS Guidelines may result in limited additional cost to smaller firms or firms with smaller scale trading operations as they carry out gap analysis and remedial activities to bring their existing controls up to the level described in the CEBS guidelines. More generally, we include the following observations noted from Avantage Reply's experience that you may care to consider in relation the FSA proposal to give effect to the CEBS Guidelines:

- i) Principle 3 aims to ensure that senior management, and staff in control and support functions, are able to provide effective challenge to trader's activities. The principle requires appropriate skill, authority and incentive to this end. The measures recommended by CEBS focus on knowledge, qualification and incentive, but make no specific recommendation in respect of authority.

It is our experience that traders often hold senior status within their firms: witness the ratio of the number of director to managing director grades in front office to total front office staff relative to that found for support functions in most firms with trading-based activities. Additionally, heads of trading or business activities, often ex-traders themselves, have a primary focus in the commercial priorities of their business activities and their front office staff. Consequently, it is not untypical for staff in support functions, even if knowledgeable, qualified and incentivised, to find particular difficulty in raising challenge to traders. The staff in support functions may also not necessarily benefit from a clear access to the independent risk management and internal control functions, of which they are usually not hierarchically dependent due to segregation of duties.

Appropriate counter-balances to this effect include the existence of an appropriate governance structure (reporting lines) and escalation procedures: Control functions should report independently of the businesses that they control while mechanisms should exist to permit support staff to raise concerns counter-to the direction of senior management). For example, the Risk function may report in to the Audit Committee, while staff should be able to avail themselves of whistle-blowing procedures.

- ii) Many of the principles and measures articulated in the CEBS Guidelines (e.g., Principle 4, calling for operational risk adjusted performance assessment in market related activities) require a high level of knowledge in trading-related activity on the part of those designing the controls, performing the controls, and/or testing control effectiveness.

Such a level of knowledge is commensurate with those who undertake the trading activities that the controls seek to address, in which case persons with such relevant knowledge are likely to be traders rather than work within control functions, not least because incentives are generally larger.

In consequence it is, in our experience, often practically difficult for firms to achieve a level of knowledge within the support and control functions for particularly innovative or complex products that is commensurate with the knowledge level of those undertaking the trading activities that they aim to control.

We also draw a parallel between Principle 4 with the risk alignment principle expressed in the CEBS Guidelines on Remuneration Policies and Practices of December 2010, whereby the control functions (risk management, compliance and internal audit) are to exert a key influence on the incentives given to risk-taking units. Beyond the consideration of setting up the relevant metrics incorporating operational risks, risk aligned compensation is still an area which poses significant cultural and governance challenges to many organisations.

- iii) It is noted in respect of Principle 12 that CEBS highlights this in note 12 as being an area for potential further consideration. The Principle addresses the design, implementation and maintenance of information systems in the trading area, while recommended measures focus exclusively on system security.

In our opinion, a particular concern in relation to trading and settlement systems should additionally be availability. An event that occasions the loss of access to key systems must be promptly and effectively addressed to maintain regulatory and market confidence in the ability of the firm to meet its obligations. As a minimum this requires capacity to promptly and accurately establish open positions, to promptly be able to execute relevant hedging or close-out strategies against those positions, and the ability to identify and promptly effect material cash payments. Such capabilities are found in the Business Continuity Plans of firms, a topic on which the CEBS guidance remains silent.

While September 11 represents an extreme example of an event that gave rise to such a requirement, it is in many respects untypical given its scale and the necessity of regulators, markets, firms and clients to pull together to re-establish market presence. A more representative example would be the loss of trading capability by Credit Lyonnais in 1996 as a result of fire in the trading room of its Paris headquarters and the resultant loss of its principal IT capability as a result of water damage occasioned by the efforts of firemen to address the conflagration. In this case Credit Lyonnais had appropriate business continuity arrangements and were able to establish market presence within a short timeframe and provide the market with confidence in its ability to honour its commitments.

I hope that you find the above points a constructive contribution to discussion of the implementation of the CEBS Guidelines. We would be pleased to offer further clarification of any of the points raised in this letter.

Regards,

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