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Dear Oleg,

## **Response to CEBS CP 24: High-level principles for risk management**

The UK industry welcomes and supports the high-level principles for risk management insofar as they reinforce good practice and raise the profile of the Chief Risk Officer (CRO) and the risk control function(s). We also support the consolidation of risk management principles for ease of reference. However, it is important for clarity and consistency that these principles be consistent with principles set by other international bodies.

We note there is scope to clarify further some of the language and objectives, and to consolidate some of the points in order to improve the effectiveness of the guidance, as well as to reduce some of the technical language in order not to obscure the key messages.

Finally, it would also be helpful if CEBS could outline the next steps on how it plans to apply the high level principles to a comprehensive guidebook as stated in paragraph 5 and who precisely is intended to take action on them.

We hope that our following detailed comments will be considered helpful in further strengthening CEBS's work on risk management. We summarise our key messages with regard to the principles below, and in the subsequent appendix we provide constructive suggestions on how the draft principles could be improved:

### **Key Messages**

#### The Principle of Proportionality

We support a principles-based approach and particularly welcome the principle of proportionality as highlighted in paragraph 8 to apply to all firms relative to their size and importance. However, we believe that the principle of proportionality should extend further than that and would like to see the language explicitly recognise that the principle of

proportionality applies to the overall approach to risk management, the role of the risk control function(s), commensurate with the risk profile and culture of an institution.

We note that the CEBS paper covers only some aspects of risk management; it might be advisable to clarify that it is not intended to be comprehensive or to perhaps also include elements on Risk Reporting and Management Information as well as on Training and Competence.

We hope these comments will be helpful to you. Please do not hesitate to contact us if you have any questions.

Yours sincerely,

## **Appendix – Detailed comments for High-level principles for risk management**

### **Governance and Risk Culture**

#### **Paragraph 9**

*“...comprehensive and independent risk management function under direct responsibility of the senior management.”*

It would be helpful if CEBS could clarify the meaning of “comprehensive.” We suggest that this means a risk control function should cover all the risk types, business lines and all material risks to which it is exposed. Further, as risk management in a firm may be organised across different functions reflecting different risk types, risk **control functions** should be referred to in the plural.

While we support independence as an important criterion for the risk management, we also maintain the importance of flexibility to accommodate firm-specific needs and structures, which have to be decided on by each organisation independently.

The meaning of “management body” as opposed to “senior management” should be clarified. Senior management oversight should be proportional to the risk.

#### **Paragraph 10**

*“It is therefore of the utmost importance that the management body have a full understanding of the nature of the business and its associated risks.”*

We believe that there are various levels of required understanding for the management body. While it should be expected that the CRO and Finance Director have a deeper understanding of risk models, it should suffice for other members of the management body to understand the key governance and internal processes for development and approval of models.

We therefore suggest in para. 10 to strike out “full understanding” and replace this term with “level of understanding commensurate with their responsibilities.”

The meaning of “management body” as opposed to “senior management” should be clarified.

#### **Paragraph 11**

*“Every member of the organisation must be constantly aware of his responsibilities relating to the identification and reporting of risks...”*

We wonder how practical it would be to implement this. Conceptually every person should know his or her responsibilities but it would be impossible to enforce or police this principle.

We suggest the wording of paragraph 25 (see below) is more appropriate and could be adapted here.

#### **Paragraph 12**

*“Institutions must implement a consistent risk culture and establish sound risk governance supported by an appropriate communication policy, all of which must be adapted to the size and complexity of the organisation and the risk profile of the institution or banking group.”*

Proposed language: Institutions must implement consistent risk control standards and principles. These standards and principles, and the governance structure should be communicated appropriately.

## **Risk Appetite and Risk Tolerance**

### **Paragraph 13-15**

We suggest that the paragraphs 13-15 be consolidated into one.

Also from paragraph 15 we assume that CEBS uses the terms ‘risk tolerance’ and ‘risk appetite’ interchangeably. This is an issue that we have debated with the regulatory community in the past: our understanding is that risk appetite is a phrase that is appropriate when a firm assesses how much risk it would like to take on – typically risk that it believes will ultimately be of a profitable nature for it. Risk tolerance, we have in the past argued, is a phrase that is relevant when discussing risk factors that a firm could never hope to eliminate entirely but must manage down to an acceptable level (operational risk for example). However, it is not clear that all readers of the CEBS document would necessarily share our understanding unless CEBS were to clarify this distinction.

### **Paragraph 14**

*“Institutions express their risk appetite in a variety of forms, including setting a target credit rating or a target rate of return on equity (sometimes, but not always accompanied by a target limit on the variance of that return). It is important both that institutions set such targets, and that the targets be consistent with one another as well as consistent with the institution’s obligation to maintain the risk of deposits within the constraints implied by capital and liquidity regulation.”*

CEBS should note in its concept of “targets” that there are pro-cyclical dangers (for example it is well documented that adverse change clauses attached to rating downgrades acted in a pro-cyclical manner in the recent crisis). We suggest that institutions be encouraged to align their targets with macroeconomic trends, but in a manner consistent with their risk appetite.

**Is this really a sensible comment to make as it would mean individual firms could be asked to take on the additional responsibilities of monitoring the economy and being perhaps accountable for their macroeconomic analyses? It has been suggested to delete this reference to para 14. Do members agree?**

### **Paragraph 17**

“The respective roles of the management body and senior management in the oversight of risks should be clearly and explicitly defined. The management body should be responsible for setting the institution’s risk tolerance level, and for reassessing that tolerance level regularly, taking into account the information provided by the risk management function or, where relevant, by the audit committee (or equivalent).”

We absolutely agree that the management body must be responsible for a firm’s overall risk tolerance. However, the processes for analysing and determining that tolerance are highly technical and specialised, so that we question whether, in practice, the management body will or could have the time and technical expertise to “set” the risk tolerance. We therefore suggest that the word “setting” be replaced with “approving,” as this would emphasise the role of the board to understand, challenge and take ultimate responsibility for the risk management of the firm, while not itself undertaking the underlying technical tasks. In the context of this discussion, it is important to recall also that a management body has to exhibit

a wide range of skills: and to weight the composition of the management body so that its members were all risk management technical specialists would not be in the overall best interests of the firm.

### **Paragraph 18**

“Senior management should be responsible for risk management on a day-to-day basis, under the oversight of the management body. Because of the volatile nature of the banking business and the economic environment, risk measurement should be constantly reviewed and scrutinised against the institution’s strategic goals and risk tolerance. In particular, senior management should ensure that the institution sets trading, credit, liquidity, and other risk limits that are consistent with the institution remaining within its overall risk appetite, even in a stressed economic environment.”

We believe that risk management oversight and review on a “day-today basis” or “constantly” should be further qualified in order to reflect a more realistic and achievable target. While senior management have day-to-day responsibility for risk management the actual oversight of specific risk factor should occur “as appropriate and proportional to the risk profile and commensurate with the rate of change of the underlying risk exposure.”

We therefore suggest the following wording in paragraph 18:

“Senior management should be responsible for day-to-day risk management ~~on a day-to-day basis~~, under the oversight of the management body. Because of the volatile nature of the banking business and the economic environment, risk measurement should be continually constantly reviewed and scrutinised against the institution’s strategic goals and risk tolerance, in a manner proportionate to conditions and to the nature and materiality of the risks involved. In particular, senior management should ensure that the institution sets trading, credit, liquidity, and other risk limits that are consistent with the institution remaining within its overall risk appetite, even in a stressed economic environment.”

The risk management oversight and constant independent review is achievable and necessary so long as the firm has an oversight function to assist the senior management in ensuring that the risk is adequately measured, monitored, and its impact on the business is understood, communicated, and controlled. The main responsibilities of the oversight function is to provide an independent and impartial challenge to the risk management process and also to provide an impartial review and confirmation that the firm is operating within agreed risk parameters and profiles.

## **The Role of Chief Risk Officer and the Risk Management Function**

### **Paragraph 21**

“The CRO should have expertise which matches the institution’s risk profile. He should play a key role in making the management body and senior management to understand the institution’s overall risk profile.”

We wonder what the test and approval process would be to measure the expertise of a prospective CRO. The CRO must know the principles and fundamentals of risk management from both the business and technical perspectives and should ideally have a broad work experience gained by dealing with different portfolios and sectors. However, we point out that there is also a learning process involved which requires a degree of competence. We therefore suggest that “expertise” be replaced “relevant skills and experience”. Also “which matches” should be replaced with “relevant and appropriate to.” Also, “making” should be replaced with “leading” or “bringing”, since it is ungrammatical to say ‘making .... to.’

Also, we note a lack of “He/She” in the CEBS paper.

**Paragraph 22**

“The risk management function should also have expertise which matches the institution’s risk profile. It should play a key role in identifying, measuring, and assessing the overall risks faced by the institution. Its responsibilities should include overseeing and approving internal rating systems and risk assessment models, and analysing the risks of new products and exceptional transactions.”

We agree that overseeing and approving internal rating systems and risk assessment models, and analysing the risks of new products and exceptional transactions should be the responsibility of the oversight function to ensure integrity, adequacy, and independence of managing risk. However, here it can be added that the risk function should have a leading role in ensuring adequate understanding of risk, as necessary and appropriate, throughout the organisation.

Adequate understanding of risk is essential and not an option which is what your note implies!

**Paragraph 25**

“The management of risks should not be confined to the risk management function. It should be a responsibility of management and staff in all business lines, and they should be aware of their accountability in this respect.”

This paragraph underscores our point under paragraph 11. We suggest that this paragraph replace paragraph 11.

**Paragraph 26**

*“The management body and senior management should be responsible for allocating resources to the risk management function”.*

At Board level no such detailed decisions would be taken but delegated onwards. We propose to say that the management body or senior management should ensure that sufficient resources are allocated.

**Risk Models and Integration of Risk Management Areas**

**Paragraph 27**

“Institutions should identify and manage all risks across all business lines at the portfolio and group levels, whatever the nature of the exposure (contractual or not, contingent or not, on- or off-balance sheet)..”

We believe that this paragraph in essence would fit better in paragraph 13 or 15.

**Paragraphs 28 and 30**

Paragraphs 28 and 30 are very similar and we believe that these could be more effective when merged together.

**Paragraphs 32**

“Internal procedures and information systems should be consistent throughout the institution and reliable, so that all sources of risks can be identified, measured, and monitored on a consolidated basis, and also, to the extent necessary, by entity, business line, and portfolio.”

Given the problems of legacy systems we believe that this principle should be proportional to the cost of implementing this in practice and the relevance and materiality of risk and to the risk control benefit derived from doing it. We suggest that “consistent” be replaced by “coherent.”

**New Product Approval Policy and Process****Paragraph 33 through 36**

The paragraphs 33, 34 and 36 should be consolidated to increase their effectiveness. Paragraph 35 can be deleted as it repeats principles in 33, 34 and 36.

We note that in some institutions there may be many different control functions which sign off on new business and products so there is not necessarily a "risk management" function which does. CEBS thus makes an assumption about how firms are organised in large central teams controlling everything rather than multiple de-centralised teams which have to coordinate the “risk management” responsibility along their main line of businesses decisions. It would helpful if the the CP could accommodate the latter organisational structure.