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Oleg Shmeljov
Committee of European Banking Supervisors
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10th July 2009

Dear Oleg,

Sent by e-mail to cp24@c-ebs.org

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 aligned with principles set by other international bodies such as the Basel Committee on Banking Supervision.

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. We have made some suggestions in this regard.

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 which applies the principles to all firms depending on their size, nature and complexity. 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 firm's overall approach to risk management and the role of the risk control function(s) which should reflect the risk profile and culture of an institution.

Risk Management and the Risk Control Functions

The paper would benefit from a clear differentiation between responsibilities for all staff to reflect risk in decision making, the general approach of a firm to risk management, the specific role of independent risk control functions, and the responsibilities of risk management oversight bodies.

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 and that significant aspects of risk management and control are not covered.

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

Yours sincerely,

Katharine Seal	Simon Hills	Edward Duncan
Director, LIBA	Executive Director, BBA	Head of Risk and Reporting, ISDA

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 risk control functions which 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** function**s** should be referred to in the plural.

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

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. We therefore suggest in paragraph 10 to strike out "full understanding" and replace this term with "level of understanding commensurate with their responsibilities." This better serves the principle of proportionality.

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."

We propose to replace the above with the following language:

"Institutions must implement consistent risk control standards and principles with sound governance arrangements. 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
We suggest the following changes to Paragraph 14:

"Institutions express their risk appetite in a variety of forms, <u>such as</u> 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 <u>targets</u>, 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 <u>while also recognising regulatory constraints</u>."

We also suggest adding the following wording:

"Further, the targets that define risk appetite should be set within a framework that is part of an explicitly stated, coherent strategy. This strategy should describe what the firm seeks to achieve, by region and business line, and outline the institution's risk appetite to include target metrics for capital usage and return on capital, aligned to those objectives."

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 <u>setting</u> 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 itself 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 business 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 <u>day-to-day basis</u>, under the oversight of the management body. Because of the volatile nature of the banking business and the economic environment, risk measurement should be <u>constantly</u> 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-to-day 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 goals of the institution and remain within its overall risk appetite, even in a stressed economic environment."

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 understand the institution's overall risk profile."

We point out that there is a learning process involved which requires a degree of competence. However, proportionality requires that nothing more is said on expertise other than it should be relevant and appropriate. We therefore suggest that "expertise" be replaced with "relevant skills and experience". Also "which matches" should be replaced with "relevant and appropriate to." Also, "making" should be replaced with "leading" or "bringing" while inserting "to" before "understand", as 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 risk control functions to ensure integrity, adequacy, and independence of managing risk. Hence, 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.

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 downwards. We propose that the principles be amended 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."

We suggest that "consistent" be replaced by "coherent", however, 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.

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.

For new product approval and policy, it is more effective to involve relevant specialists/line of business control functions in the discussion. A new product approval committee in large institutions in particular, requests those specialists to review proposals and advise, in order to supplement risk management