LEGAL RISK IN THE CONTEXT OF THE REVISION OF THE BASEL CAPITAL ACCORD

1. Legal risk

In the context of the revision of the Basel Capital Accord (Basel II), intended to be implemented in December 2006, reference is made to a concept which was previously not known in the context of capital adequacy. This is the notion of “legal risk”, which is understood to be a segment of the wider notion of “operational risk”.

The framework of Basel II establishes operational risk as a new regulatory capital risk category. Firms will be able to choose from three approaches to operational risk. The first is a basic indicator approach (BIA), where the capital requirement will be based on a fixed percentage, currently 15% of gross income. The second is a standardised approach (TSA), where the firms’ activities are divided into different business lines, each with a specified percentage capital charge. The third is the advanced measurement approach (AMA), where the firm calculates its operational risk capital requirement according to its own internal model. The AMA is likely to produce the greatest capital efficiencies for firms, but its use is subject to a number of requirements. These consist of “qualitative criteria on the assessment and management of operational risk internally by a firm; quantitative criteria for the modelling and measurement of minimum regulatory capital requirements; and the validation criteria which enabled the regulatory authorities to obtain assurance on the firms compliance with the entry criteria and assess consistency of the application between firms”.

Within this category of operational risk, a reference to legal risk is contained. However, so far, no comprehensive definition of what constitutes legal risk has been provided, even less so any suggestions how to quantify legal risk, e.g. for specified percentage capital charges under the capital adequacy rules.

Because operational risk includes legal risk, these criteria cannot be satisfied without an analysis of what legal risk is.
2. Attempts to define legal risk

Given the emphasis being put on the notion of “legal risk”, it is surprising that so far, there has been no comprehensive assessment on how legal risk should be defined and assessed.

Only some articles by practitioners have highlighted the main elements that could be classified under the definition of legal risk, however, without approaching the issue in an analytical manner¹.

In a more systematic approach, recently, the IBA sub-committee E 8 on law reform has started to analyse and suggest the constitutive elements for legal risk² (see Annex).

3. General considerations

It needs to be noted that legal risk exists in any activity of a financial institution. Risks can never be fully excluded.

The fact that a situation or activity might be a source of legal risk does not mean that it has to be avoided by all means. For example, financial innovation is generally something which is fundamental for the proper functioning of the financial markets and thus should be encouraged, however, innovation always entails legal risk. However, excessive legal risk is undesirable. It may lead to business disruption or reputational losses.

Yet, it may appear that the quantification of legal risk might prove difficult, if not impossible. A proper framework to reduce legal risk will involve efforts by the financial institutions themselves (by means of internal controlling and management) as well as by external legal counsel and regulators.

One of the main problems that will appear in the context of the Basel Accord will be how to allocate quantifiable numbers (capital charges) to legal risk in the context of calculating adequate capital requirements. To this extent, both a theoretical analysis and an historical analysis based on data stemming from past transactions could possibly be taken into account.

One element that might require further scrutiny is that ongoing initiatives (for example the IBA activities) are led by English law oriented players. Although it is acknowledged that both London as a financial centre and English law are key elements in the set up of the international and European financial markets, not all aspects that are problematic under English law or in the London markets might easily be transposed in other financial centres or jurisdictions.

¹ for example, Andrew Whittaker “Lawyers as Risk Managers”, JIBFL (2003) 5.
² see draft working paper “Sources of legal risk for financial institutions” prepared by Joanna Benjamin (LSE, Clifford Chance).
As a general issue, establishing comprehensive and workable standards to assess, and consequently mitigate, legal risk in the financial markets is likely to positively affect the conduct of business of financial institutions.

The soundness and the reliability of the operations of credit institutions would certainly benefit from an implementation of those measures. In this context, it is of particular interest that the euro area credit institutions are at the same time the counterparties for Eurosystem operations. Thus, and in addition, standards for an appropriate identification and mitigation of legal risk might also affect the way the Eurosystem is modelling its own operational framework.

4. **Comments on a possible definition**

Legal risk comprises the sum of the risks of particular legal problems that may arise, such as unenforceable contracts, regulatory sanctions and so forth. The definition concerns these aspects of legal risk, focusing on the immediate cause of losses that may be regarded as legal.

In this connection, proper attention has to be paid to the potential sources of such legal risk. For example, contracts may be rendered unenforceable by an unforeseen judgement, and a firm may be exposed to regulatory sanctions where it enters unfamiliar regulated markets. The chain of causality may be long and complex.

Legal authorities, regulators and market participants may have to analyse these indirect causes, so that they can identify the legal, professional and commercial adaptations that may be needed to reduce legal risk over the medium term.

It is acknowledged that the legal risk must be identifiable with certainty and measurable to the extent possible. However, the work undertaken by financial institutions should not be limited to formal exercises but should be creative and forward looking. One aspect that may require particular attention is that any explicit and detailed definition of elements of legal risk might solicit the so-called ticking of boxes, i.e. risk managers inside financial institutions will limit their activity to just pro forma checking what is required by a list of issues to be checked but would not go beyond and conduct a case-by-case analysis of a specific or inherent legal problem.

5. **Sources of legal risk**

There are four main strands which the ongoing discussion have identified as being sources of legal risk:

- The behaviour of financial institutions;
- The nature of financial markets;
- Problems within the law; and
- Interaction of law and finance.
a) As to the *behaviour of financial institutions*, a number of factors play a role. For example, there might be *limited legal awareness* on the side of financial institutions. There are limits to the legal knowledge of those active in the financial markets. They may believe they know the law but they are mistaken. Other risks are associated with obtaining external legal advice. Finally, it might be operational impractical to involve lawyers in every aspect of an institution’s day to day business.

A further element is *implementation failure*. Even where legal advice has been obtained, it may not be followed. Such implementation failure may or may not reflect management policy. This can be due to many factors. The best possible legal protection available within a commercial relationship may be imperfect or impracticable. Provided legal uncertainty is clearly understood, it may be addressed commercially, for example by pricing. It would be undesirable to oblige firms to always behave in a legally conservative manner. Some measure of legal risk tolerance is normal in commercial life, and a necessary precondition for a thriving commercial sector. Indeed, a possible legal exposure which is still acceptable and prudently taken is hardly excluded from the definition of legal risk.

Of course, there are clearly circumstances where failure to follow legal advice would fall short of normal standards of prudent business behaviour. One example is possible criminality.

One other aspect that is in particular often found in English dominated institutions is to *follow the letter but not the spirit of the law*. This happens in particular where financial institutions try to limit compliance to the letter of the law as opposed to its spirit. This could be addressed to a certain extent by adopting a functional approach to rules by placing substance over form. However, in an English law environment the general practice gives supremacy to the wording of a contract over its spirit. These aspects have to be taken into account as well.

A further problem might stem from the trend in the financial industry to *outsource* parts of the activities of financial institutions. This involves the delegation of normally non-core business functions which are generally involved in providing services to clients in circumstances where these functions were previously performed in-house. Outsourcing can create risk, both for outsourcing institutions and their clients. This is because it may create a mismatch between the operational and legal relationships involved in the provision of services. In contractual terms, the agreement for the provision of services is made between the institution and the client. However, the provision of services is an operational responsibility of a third party. It is important to establish who bears the risk that the third party may fail to provide the service properly.

b) A further strand that requires attention is the *nature of financial markets*.

The key element here is *financial innovation*. Financial practice is highly innovative and rapidly evolving. The law normally evolves slowly, leading to a mismatch between settled law and practice. For this reason, the most dynamic development of commercial practice has historically been associated with high levels of legal uncertainty. There are two broad aspects to financial innovation. The first is the development of new and increasingly complex financial transactions, the second is operational change.
Both are important factors in the success of financial markets. However, both types of financial innovation are also important sources of legal risk.

An additional element is new market sectors. Legal risk arises when existing financial products and services are offered in new market sectors. An important example of this is the recent tendency of banking groups to engage in business traditionally undertaken by insurance companies and fund managers and for insurance groups that are engaged in business traditionally undertaken by banks.

Convergence is the industry wide consequence of the entry by financial institutions into new markets discussed in the previous section. The financial markets have traditionally been divided into sectors in many jurisdictions. The major trend in recent years has been the convergence of these sectors, i.e. the creation of conglomerates. However, convergence raises categorisation problems.

Furthermore, the number of problems stem from the growing relevance of cross-border business. This might be seen as the major source of legal risk in the financial sector. Taxation, insolvency, contract and other commercial law provisions differ considerably from jurisdiction to jurisdiction. Differing languages also add to this complexity.

The primary answer to this legal fragmentation is to promote the international harmonisation of domestic and private and international law. Many activities are undertaken by international institutions such as the Hague Conference, UNCITRAL, UNIDROIT, the EBRD or the IBA. Within the EU, the financial services action plan is a major initiative for the harmonisation of the legal and regulatory regime affecting the financial sector.

c) There might be problems within the existing law.

There may be circumstances where there are differing or inconsistent legal requirements. Examples are potentially conflicting obligations of the money laundering and the data protection regimes.

Another angle to this is policy concerns. The provision of financial services are regulated. The interests of financial institutions regularly conflict with the interests of their clients. To balance these interests, regulation is being issued.

Furthermore, law is not always certain of its application. The application of a rule in a concrete situation needs to be clear. However, no gesture of a legal provision can foresee the full range of possible future situations in which the rule might apply. This is a source of legal risk.

In many instances, a further source of legal risk can stem from unpredictable judicial reasoning. There is no country where the decisions of judges can be fully predictable. Related source of legal risk is uncertainty in the evolution of new rules.

d) The last category of possible source of legal risk stems from the interaction of law and finance.

One element here is the existence of hard and soft law. In addition to codified financial law and court rulings, in many instances “hard law” is supplemented by a so-called “soft law” which comprises legal guidance provided by non-legal but nevertheless competent agencies. These include trade associations, credit-rating agencies and regulatory authorities. These agencies have an important role in shaping the
response of the financial institutions to legal questions. In particular, trade associations develop market standard practices on documentation. Yet there may be occasions where trade associations get things wrong. This may create legal risk.

Another angle is *globalisation*. Many of the important financial innovations of recent decades have originated in New York. Transactions such as securitisation, repos and credit derivatives as well as services such as global custody are now widely used throughout the world’s financial markets. Such arrangements often involve Anglo-Saxon legal and commercial structures that may not accord with traditional law and practices in civil jurisdictions. Such techniques may sometimes be experienced as an alien approach, which might threaten local legal culture. ”

As well as financial practice, globalisation also affects the practice of *litigation*. The example of the US litigation culture has relatively affected financial institutions and other jurisdictions.

*In respect of the attempts to find a suitable definition of legal risk, the support by and experience of the members of the European Financial Markets Lawyers Group might prove helpful to give a fair and balanced reflection of the European financial markets as a whole in the ongoing discussions.*
1. suggested definition of legal risk

(NB: This definition needs to be read with the accompanying notes, which affect how it should be interpreted).

Legal risk is the risk of loss to an institution which is primarily caused by:-

(a) a defective transaction; or

(b) a claim (including a defence to a claim or a counterclaim) being made or some other event occurring which results in a liability for the institution or other loss (for example, as a result of the termination of a contract) or;

(c) failing to take appropriate measures to protect assets (for example, intellectual property) owned by the institution.

The reference to a defective transaction in (a) above includes:-

(i) entering into a transaction which does not allocate rights and obligations and associated risks in the manner intended;

(ii) entering into a transaction which is or may be determined to be void or unenforceable in whole or with respect to a material part (for whatever reason);

(iii) entering into a transaction on the basis of representations or investigations which are shown to be misleading or false or which fail to disclose material facts or circumstances;

(iv) misunderstanding the effect of one or more transactions (for example, believing that a right of set-off exists when it does not or that certain rights will be available on the insolvency of a party when they will not);

(v) entering into a contract which does not, or may not, have an effective or fair dispute resolution procedure (or procedures for enforcement of judgements/arbitral decisions) applicable to it;

(vi) entering into a contract inadvertently;

(vii) security arrangements that are, or may be, defective (for whatever reason).
All references above to a transaction shall include a trust, any kind of transfer or creation of interests in assets of any kind, any kind of insurance, any kind of debt or equity instrument and any kind of negotiable instrument.

All references to entering into a transaction include taking an assignment of a contract or entering into a transaction in reliance upon a contract which is itself a defective transaction.
NOTES:

1. The consultation paper of 1 July 2003 issued by the EU Commission Services contains a “Working Document” setting out proposed risk-based capital requirements for financial institutions. Article 106 of that document states: “Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.”

   It is arguable therefore that a legal risk which has been deliberately and prudently taken would not fall within the concept of legal risk described in Article 106 (since it would not result from inadequate or failed internal processes, people or systems) unless it can in some sense be attributed to an “external event”.

2. The document referred to in note 1 above does not offer any definition of “legal risk”.

3. The attached definition should not be regarded as prescriptive. Each institution may wish to adapt the definition for its own particular purposes and, especially, to reflect any allocation of responsibility within that institution (for example, to the legal department) which may not be consistent with the definition as it stands. Any specific views of regulators, as they become known, will also, obviously, need to be taken into account.

4. With regard to paragraph (b) of the definition, institutions may wish to make a distinction between claims which reflect a risk that has been anticipated (but nevertheless deliberately taken) and claims which come as a genuine “surprise”. It is not thought necessary to make any distinction between contractual, tortious or other claims in this context (but see 5 below). However, the prevailing view (and, it is submitted, best practice) is that risks which arise from wilful or reckless behaviour (including fraud) - although they are operational risks - should not properly be regarded as legal risks.

5. It is suggested that the risk of loss caused by contractual commitments to pay money (e.g. indemnities or guarantees) entered into voluntarily should not be regarded as legal risk. The risk of loss caused by a breach of contract is a more difficult question. It is suggested that each institution is likely to have its own procedures for ensuring that clear contractual commitments (e.g. to pay a sum due on a due date) are properly complied with, and may take the view that failure to follow those procedures is primarily a non-legal operational risk. However, it is arguable that extremely complex contractual arrangements might give rise to a more technical risk of breach simply on the grounds that the requirements of the contract have not been fully appreciated. Institutions may, in appropriate cases, regard such situations as an example of legal risk.
6. Situations may arise in the context of paragraphs (a), (b) or (c) which have strong political overtones and may more properly be regarded as examples of political risk or at least a combination of legal risk and political risk. Whether or not any such situation is to be treated as legal risk will largely reflect the allocation of responsibility within any given institution and may also reflect how that institution perceives political risk in any particular country. It is suggested, for example, that outright confiscation of assets by a governmental authority is, generally, pure political risk and not legal risk. On the other hand, some institutions might regard political interference with the judicial process as a form of legal risk. (See also paragraph (v) of the definition). How responsibility is allocated will no doubt reflect the institution’s own judgement as to which departments or officers are best placed to provide advice on such risk situations.