RSM

Draft
Discussion Paper

THE MANAGEMENT OF LEGAL RISK BY FINANCIAL INSTITUTIONS

Introduction

> *"Banks that have already started risk management programs view Basel II as a change agent. They use the new accord to focus bankwide attention on efforts to achieve risk-management leadership. Basel II is also good news for banks whose risk-management efforts, begun with the best of intentions, have languished through inattention. CEOs should recognize that moving so many parts of a bank – most business units as well as the treasury and other corporate-center functions-to best practice involves a huge effort. We know from long experience that it will fail if top management doesn't take the lead and ensure that benefits from a well-developed business case are captured."*
>
> *McKinsey*

> *"Ultimately, the key question is not whether the operational risk charge is calibrated at this or that percentage, nor even whether it is dealt with in Pillar 1 or Pillar 2, but rather whether banks see the management of operational risk as an additional regulatory intrusion or as an opportunity to assess and price their business in a new, more coherent fashion. We must hope it is the latter."*
>
> *Ralph Nash*
> *(member of BCBS Secretariat)*

As is now well known, the new proposals for the regulation of banks put forward by the Basle Committee on Banking Supervision ("BCBS") known generally as "Basle II", place much greater emphasis on operational risk as an issue for banks in the context of regulation than any previous regulatory regime. This has been stimulated by a number of things, including the alarming number of major frauds which have been suffered by banks in recent years, giving rise to very significant losses and in at least one case, the financial ruin of the institution itself. Operational risk is only loosely defined in the proposals, but it is clear that it is intended to include legal risk, a concept for which no definition has been provided at all. This paper is concerned with how institutions might implement the management of legal risk under the new regulatory regime.

Although it may have a number of special features, the management of legal risk should be consistent with the management of operational risk as a whole. In this regard the BCBS paper of February 2003 on "Sound Practices for the Management and Supervision of Operational Risk" is highly relevant. The comments that follow are based to a significant extent on the contents of that paper ("the BCBS Operational Risk Paper").

References to “Principles” are references to the principles set out in paragraph 10 of the BCBS Operational Risk Paper.

Legal risk management can be broken down into the component parts (suggested by BCBS) of identification, assessment, monitoring and control/mitigation. For any of these functions to be effective, it is important that legal risk, as part of a firm-wide definition of operational risk, is appropriately defined (see Principle 1). Opinions may differ as to whether certain risks are properly to be regarded as “legal risk” (for example, in relation to risks on the borderline with political risk or fraud), but one would expect, over time, a consensus of opinion to develop as to what “legal risk” generally means (see attached IBA definition). The definition may be *applied* in different ways to reflect the different businesses of different institutions. Some institutions, for example, may feel that certain kinds of legal risk are so unlikely to affect them that they feel it appropriate to discount them in their risk management procedures. This ultimately must be a matter of judgment for the management of the institution.

Identification, assessment, monitoring and control/mitigation are taken in turn below.

1 Identification of risks

1.1 Identification of legal risks is partly a by-product of the process of defining what the expression means and partly a result of the application of that definition to the day to day business of the institution. In practical terms, the institution needs to identify where it is most likely that legal risks will arise (given that it is impossible to prevent such risks arising completely). The two broad categories of (a) claims against the institution and (b) defective documentation are likely to be relevant to most institutions. These categories need to be broken down further. For example, in relation to documentation, the institution needs to have a comprehensive analysis, which is kept up to date, of the kinds of documentation used in its business, how “tried and tested” that documentation is (and what is the process for testing it) which documents are of particular financial significance in terms of both exposure and asset protection, who is responsible for the legal effectiveness of the documentation and so on. In relation to claims being made against the institution, a similar analysis would involve examination of the different jurisdictions in which the institution does business and/or has potential liabilities, the nature of the potential legal exposures in those jurisdictions (whether for breach of contract, tort, statutory or regulatory liability or otherwise), the litigation “culture” of the jurisdiction and potential financial exposure, including the extent to which an adverse judgment might result in excessive or penal damages. Such an analysis cannot take place in a vacuum. It needs to be by reference to the products and services offered in each jurisdiction and the risk profile of those products and services taking into account both objective and subjective criteria, including the institution’s own experience in offering those products and services.

1.2 It is possible that the identification process may result in review of decisions as to whether or not particular products or services should be offered (which may in turn depend on the legal environment in particular jurisdictions). The institution might decide to refrain from a particular line of business (whether or not by reference to a particular jurisdiction) on the grounds of risk *avoidance* coupled with an assessment of the risk/reward ratio and other relevant factors.

1.3 Identification of risk is a function and objective to be established in conjunction with the use of risk indication, as described in para 3.4 below. Identification ("these are the principal risks which we are concerned about") is the first step. Determining the situations which are indicators of a risk arising is the second.

2 Assessment of risks

2.1 An earlier version of the BCBS Operational Risk Paper referred to risk measurement, but that concept has been dropped in favour of risk *assessment*. This change, amongst other things, recognises the fact that it is impossible to ascribe rigid mathematical measurement formulae to operational and legal risks. Notoriously, they tend to have low probability/high impact characteristics (for example, the numerous fraud cases of recent years). Assessment is by its nature a somewhat vaguer concept than measurement. It is also more flexible and better suited to the objectives and realities of legal risk management. Senior management need to develop an understanding, shared throughout the different businesses of any institution, of what assessment involves in the context of legal risk. Factors that could be taken into account include the following:

- The legal infrastructure of any particular jurisdiction where the institution conducts business, including the independence of judges, the sophistication of contract and corporate law concepts, enforcement of judgments and arbitration awards and risks associated with transactional and contractual certainty (for example, the risk that courts may re-characterise important transactions to which the institution is commonly a party);

- Whether relevant sources of law (typically, case law or legislation) together with market practice are reasonably firmly established with respect to the legal issues most likely to affect the institution's business in a given jurisdiction;

- To the extent there is any legal uncertainty, the "worst case scenario" if the uncertainty was resolved in a manner adverse to the institution;

- The historical track record of other institutions in the same business in the same jurisdiction (so far as publicly available) in relation to adverse claims or defective transactions;

- The institution's own knowledge and confidence in relation to the regulatory environment, especially in relation to the marketing of a new product;

- Whether or not the market for any new product or service is a consumer market or a professionals market;

- The risk of "collateral damage" if the risk materialises; for example, reputational issues and political implications;

- Whether the documentation (and legal regulatory environment) is relatively easy to understand (or exceptionally difficult to understand) when viewed from the perspective of the individuals who will be involved in the marketing and selling; and

- Whether the activity is likely to increase the chances of conflict of interest allegations.

2.2 Who should be responsible for assessment? It would seem that in the first place this role would fall to the legal department. It is, however, a separate question as to who should take commercial decisions based upon the assessment (although one would expect some legal contribution to that process). Institutions might find it helpful to involve some form of "scoring" process in the assessment exercise so that, as a track record is built up, it is easier to compare like with like when looking at a new decision and comparing it with decisions taken in similar circumstances in the past. Such methodology should not be confused with *measurement* nor should it be regarded as being especially precise since the exercise inevitably involves a degree of subjective judgment. Nevertheless, a scoring system is likely to have some benefits, including the provision of a more detailed rationale for the more difficult risk assessment decisions. The BCBS Operational Risk Paper recommends score cards and scoring generally in the context of risk assessment (see Principle 4).

2.3 A model for (or at least an example of) legal risk assessment and scoring can be found in a recent publication of a multilateral development bank. In its "Transition Report 2003", the European Bank for Reconstruction and Development included a "legal indicator survey" which is intended to be "a new way of measuring legal progress" in its countries of operation (principally central and eastern Europe including the former Soviet Union). In the context of an analysis of various countries' laws regarding secured transactions, the Bank in effect assesses how successful these countries have been in reforming their laws and "the extent to which legal rules comply with international standards". Various charts are included in the survey which develop a form of scoring system for different aspects of the laws. The scoring system is, in some respects, fairly basic e.g. "scores range from 1-3 where 1 indicates no significant problem, 2 indicates a relatively minor problem and 3 indicates a major problem". The survey is of interest in relation to legal risk since it not only identifies various countries that have "legal infrastructure" problems of varying magnitudes, but it also sets out a number of concepts that financial institutions would generally regard as relevant to the effectiveness of law in almost any context. For example, in reviewing the effectiveness of laws relating to enforcement of security, the survey considers (in relation to 26 countries) how a country might be scored on issues such as the impact of corruption within the court system, the ability for the debtor to prevent slow down or otherwise obstruct enforcement proceedings and the reliability of courts and "other institutions necessary to support the enforcement process". The results of the survey provide useful material for any general counsel concerned with the assessment of legal risk in the countries in question, especially in relation to transactions involving the provision of security. It is, amongst other things, good example of a methodology for how legal risk can be assessed in a particular context. Rating agencies, in connection with projects in developing countries, use a comparable benchmark scoring system.

2.4 Parallels could also be drawn with the methodology used by Euromoney in connection with its "global political risk map" (which scores the countries of the world for political risk by reference to five different grades). The document, amongst other things, identifies the industries which are considered to be most at risk from political interference and also draws distinctions between corruption risk, political violence risk and convertibility risk. Use is made of the Transparency International Corruption Perceptions Index (in itself another example of scoring). The methodology involves the attribution of a weighting to nine separate categories i.e. (1) Political Risk, (2) Economic Performance, (3) Debt Indicators, (4) Debt in Default or Rescheduled, (5) Credit Ratings; (6) Access to Bank Finance; (7) Access to Short-term Finance; (8) Access to Capital Markets, and (9) Discount on Forfeiting. The resulting map is of course intended as a guide to political/financial issues rather than legal issues but the relationship between political risk and legal risk is so close that its results should perhaps be taken into account when assessing the legal risk of doing business in particular countries.

3 Monitoring

3.1 Monitoring involves the regular reporting of material information to those who can assess its significance and ultimately to senior management. In relation to legal risk, it raises questions as to which departments should be responsible for the implementation of the monitoring procedures and which parts of management should receive and assess the information as and when it is produced. As with all aspects of risk management, it is important that the individuals and departments involved are able to perform the function in a manner which is not likely to result in distortions caused by conflicts of interest or other factors which might inhibit the free flow of clear factual information.

3.2 As regards the in-house lawyers themselves, it is particularly important that they have sufficient independence within the organisational structure to allow a rigorous approach to the relevant procedures (whether or not this amounts to "whistle blowing" in more extreme situations). It is also important that the lawyers have access to the necessary information. In this regard, it is interesting to note that the lead counsel to Parmalat's administrator (Bruno Cova) recently observed "there was a legal department in Parmalat with perfectly good lawyers – but they were not given the opportunity to understand what was going on… before a general counsel accepts a job in any company, they must make sure that they report directly to the Chief Executive or the Chairman. All other lawyers within the company should report to the general counsel so that the general counsel can understand what is going on. Parmalat did not have those reporting lines. Lawyers only reported to the operation they were working for, and so the general counsel was not put in the situation where he could help".

3.3 It is not of course necessary (possibly not even desirable) that the monitoring function be carried out entirely by in-house lawyers even though it may be primarily concerned with legal risk. Lawyers will obviously be needed in order to provide technical legal advice in a wide range of areas and although it is likely to be advantageous that lawyers make some contribution to decision making, it would be unlikely that lawyers would have sole control over all decisions that the monitoring process gives rise to. But the allocation of responsibilities and reporting lines have to be crystal clear. (See generally Principle 6). Furthermore, the effectiveness of this function, as well as other aspects of the risk management framework, will need to be subject to comprehensive internal audit by operationally independent personnel (Principle 2). The fact that the procedure exists and that those involved in its implementation are guaranteed independence should itself be a substantive benefit in maintaining what the BCBS Operational Risk Paper describes as "high standards of ethical behaviour at all levels of the bank" (see paragraph 11).

3.4 In establishing monitoring procedures, institutions will need to think about the appropriate risk *indicators* in the context of legal risk. Entry into new markets should always point to a rigorous risk assessment in any event. There are other, fairly obvious, indicators. Bill Lytton, the Senior Vice President and General Counsel of Tyco recently said "it is a warning sign if there is a meeting going on and as a lawyer, you are not allowed to go. There should be no meeting which a general counsel cannot go to – especially now, when general counsel are recognised as having more of a central part in management decisions than before". Notwithstanding some of the more obvious warning signs, the identification of legal risk indicators is likely to vary significantly from institution to institution, depending on its range of businesses. The following are suggested as possible examples:

- New legislation (including proposals for new legislation);
- New case law;
- Significant changes in market practice and related documentation;
- Changes in key personnel
- Feedback from regulators or other market participants which indicate hitherto unidentified legal risks
- Legal actions brought against other market participants that potentially might be brought against one's own institution
- Legal actions or other circumstances affecting market participants that might have a direct or indirect impact on the institution (whether or not involving litigation)
- Political changes which might be expected to result in a change in how laws or regulations are applied
- A significant change in advice received from external legal advisers on a material point
- The use of unfamiliar advisers
- Unusual qualifications or assumptions in formal legal opinions
- Significant changes to the availability, or cost, of insurance cover
- The use of "old" standard documentation.
- Erosion of rules concerning lawyer-client privilege (see Three Rivers D.C. v Bank of England)

3.5 It is of course virtually impossible to draw up an exhaustive list. It is likely that an understanding of the role of risk indicators and the development of a more finely tuned approach will evolve as institutions increase the level of sophistication applied to the risk management process.

4 Control/Mitigation

4.1 Commercial insurance is an obvious method of controlling or mitigating loss caused by legal risk. As many have pointed out, it is unlikely that commercial insurance will be available to cover all forms of legal risk and it is vitally important that the limits and conditions of particular insurance policies are properly analysed and understood. Similar issues arise with other mitigation instruments in the form of hedging transactions, derivatives etc. Such mitigation tools give rise to issues of their own and, as has often been said, may simply replace one risk with another risk. Nevertheless, they have value.

4.2 In relation to control, institutions will wish to develop (and many will no doubt have done so already) advance strategies to deal with at least the more predictable risk scenarios. However, much of legal risk not only has the low probability/high impact characteristics, but also a quality of unpredictability. Controlling the loss resulting from legal risk will involve, at the legal level, a review of impact on documentation, establishing resources to defend (or prosecute) claims and an analysis of the likely financial impact. Decisions as to how to react to the financial impact will ultimately be for management. The methodology will depend to a significant extent on the facts. It is important, however, that the control mechanism enables as swift a reaction as possible given the extremely rapid means of deal execution that is now to be found in the financial markets. Depending on the nature of the transaction, the control/response may also need to involve trade associations and other market participants. It may not be appropriate or practical for an institution to act in isolation in response to a risk scenario that affects a broad range of market participants (for example, a defect in market standard documentation or a new legal case that has implications for many participants).

4.3 Day to day control of legal risk will, amongst other things, involve periodic review and updating of documentation used by the institution. Sound practice would suggest that documentation should be reviewed both in response to specific events (e.g. new case law or legislation) that might require amendment and also on a regular basis in order to ensure that the institution remains in step with market practice and legal developments that might otherwise have escaped attention. Depending on the resources of the in-house legal department, it may be appropriate to use external legal resources for all or part of such review. (See also paragraph 22 of the BCBS Operational Risk Paper).

4.4 Documentation reviews should not, however, be carried out in isolation from the procedures and practices in which the documentation is used. The review procedure needs to have an appreciation of how transactions are typically concluded, when and how market standard documents (or master agreements) are used, telephone commitments made, confirmation notes despatched. The contractual significance of such events may vary from jurisdiction to jurisdiction. It may be appropriate for non-legal personnel involved in deal making to be regularly updated as to any important legal issues that might flow from the manner in which they execute deals. Here, as in other procedural aspects, there will be close relationships with aspects of the compliance function.

5 Opinions and similar documents

5.1 In appropriate circumstances, reliance will be placed on formal legal opinions from external counsel. However, such opinions needed to be treated with extreme caution. They are commonly directed towards very specific sets of circumstances (and documents). They also tend to be based on precisely crafted assumptions and qualifications, many of which are of a highly technical nature. If reliance is to be placed on the opinions, the assumptions need to be examined and, where appropriate, checked out. (If the assumption is incorrect, the legal opinion may be valueless; similarly, unusual qualifications may mean that the institution does in fact have a significant risk exposure notwithstanding the opinion). Care needs to be taken also that the opinion is addressed to the institution that is relying on it or there is a clear statement in it that the institution may rely upon it. The fact that the opinion might be addressed to another company in the same group as the institution may not be sufficient.

5.2 The practice of obtaining “due diligence” reports in connection with major transactions also needs careful review. The degree of protection such reports or similar documents provide against legal risk may be far from comprehensive. For example, the reports will usually have to be based on certain assumptions as to facts and, as with legal opinions, such assumptions will have to be checked out if the due diligence is to be of value. It is also frequently the case that the due diligence report, quite rightly, raises various questions that appropriate personnel in the institution should be required to investigate. Who should be responsible for such investigation and how is the thoroughness of the investigation itself monitored?

5.3 The obtaining of formal legal opinions may be contrasted with the use of external legal advice generally. In a sense, the former is a sub-category of the latter. However, the use of external legal advisers involves an exercise (the provision of appropriate instructions, the discussion of the issues involved, the analysis and research on both questions of fact and law and, possibly, the provision of written legal advice) which is more likely to be tailored to the specific needs of a specific situation. Of course, this may be more expensive than reliance on an opinion which has already been obtained. However, it may be the more prudent course to follow.

6 Clarity of lawyer roles

6.1 Due diligence and the procedures associated with it are an example of legal risk issues that can arise as a result of, or at least be associated with, the relationship between in-house lawyers and external lawyers. As with all advisory functions, the responsibility for advice and communication to and from the client needs to be absolutely clear. There is an inherent danger that responsibility for advice and the implementation of advice "falls between the cracks". The in-house function needs to be alert to this and take steps to minimise the risk of it happening. The problem is further accentuated where there is a multiplicity of external advisers (not uncommon on complex cross border transactions) with no clear single point of responsibility to the institution.

6.2 Where in-house counsel assumes a more "hands on" role in transaction management (even where external counsel has been appointed) this may have certain commercial advantages but it can increase the risk of confusion as to responsibility. This is particularly the case where there may be some risk of the "true" client misunderstanding advice provided by external counsel or, for whatever reason, failing to implement it. These risks have, arguably, not been made easier to handle by the predominant use in recent years of electronic communication and the degree of informality and imprecision in language that such communication frequently involves. Traditional practices such as the keeping of attendance notes in relation to the provision of advice and the confirmation of important advice in formal letters is, it would seem, less common. Given the pace and complexity of negotiations in major transactions this may be understandable, but it does have risk implications in that it can result in less effective record keeping in relation to responsibility for advice. In this connection, it is important for the institution to appreciate that not only is the provision of correct legal advice a risk sensitive issue, but also is the record of responsibility for that advice.

6.3 Care needs to be taken as to the terms upon which external advisers are retained. Formal documentation (whether in the form of letters or contracts) has become more common. This can have some benefits insofar as it clarifies the role of the external adviser. However, it is not unusual for the external adviser to take the opportunity to include limiting language in such documents which may not only affect the role and responsibility, but also the financial liability, of the adviser. Law firms may, also, in certain cases, seek to disclaim responsibility for highly technical aspects of documentation, including the effectiveness of complex mathematical formulae.

6.4 It would be comforting to believe that external legal advisers would be, perhaps, in a better position to provide a detached and objective view of an institution's position where legal risk issues arise. However, the in-house lawyer should not take objectivity and detachment for granted. The de-regulation of the legal profession has had a number of effects, many of them positive, but it has not reinforced the ability of the external adviser to remain "aloof" (an attitude which is currently decidedly out of fashion). As noted in a recent article by David Gold and Adam Johnson (Herbert Smith) in "The European Lawyer":

> *"Law firms routinely express their desire to get close to their clients, to understand the business better and to provide an improved service. While these sentiments may make sense, the risks of getting too close should not be ignored. Close involvement between a lawyer and the client company which fails or which is found to have been carrying on illicit business practices will inevitably result in closer scrutiny of the lawyer's role…"*

6.5 In the same article, Gold and Johnson draw attention to the dangers of lawyers accepting roles on the board of directors of clients and the potential conflict of interest that can result from this. They note that "this practice, which has traditionally been seen as a vote of confidence in the company which hires a lawyer as director, but which is perceived by common law practitioners as a continental tolerance of an obvious source of conflict, should be a subject of careful review for firms who are concerned about managing risk in the post-Enron and Parmalat world."

6.6 Questions of conflicts and clarity of responsibility may be accentuated in transactions where the institution's legal adviser is appointed (and paid) by its customer. In such cases, the financial terms of the appointment (which might involve risk-sharing) merit scrutiny by the institution to whom the external lawyer is intended to owe a duty of care.

7 Some Provisional Conclusions

7.1 The management of risk is not an especially precise science. The management of legal risk is particularly difficult in this regard. For example, many have argued and will no doubt continue to argue that legal risk should not be perceived as a risk which is truly separate from other risks (whether operational risks, credit risks or otherwise). There is something in this argument, in that legal risks rarely become a significant problem unless an associated risk (typically the risk of a counterparty being unwilling or unable to pay or the risk of an employee "going off the rails") also manifests itself. However, the argument can also be made that at least certain kinds of risks (for example, defective documentation) may give rise to difficulties in their own right. A security interest which turns out to be invalid in the context of the customer's insolvency is almost certain to result in loss for an institution and the root cause of the loss is likely to be, essentially, a defect in procedure or behaviour which is in the nature of legal risk. In any event, it would be an extremely robust institution which, in the light of the Basle II proposals, decided to give no independent recognition to the management of legal risk as such.

7.2 There are clearly implications for the role of in-house lawyers, especially insofar as the issues raised or referred to in this paper would suggest that this role will become further involved with risk management rather than simply the provision of legal advice. The traditional legal training and experience acquired in the early years of practising law do not necessarily develop risk management skills of the kind that may be required.

7.3 Nor does the traditional position of the in-house lawyer as employee necessarily equip him or her for the consequences that are likely to flow from legal risk management within any complex financial institution. A degree of independence, perhaps quite a considerable degree, would seem to be essential if the in-house lawyer is to be able to perform the role effectively. It is not clear that the financial world has yet adjusted to this requirement.

7.4 Questions also remain as to the relationship between the role of the in-house lawyer as risk-manager, the traditional compliance function and those who are charged with responsibility for risk generally (as opposed to legal risk alone). How will market practice in this area evolve? The role of regulators is likely to be crucial not merely as "supervisor" and "enforcer" in the traditional sense, but also as an effective cross-pollinator of ideas. This was traditionally one of the more valuable aspects of the "old fashioned" approach to regulation and the now somewhat discredited "light touch". Financial institutions can learn a good deal from those who are able to see how the market as a whole is responding to new challenges. This does not necessarily involve the acceptance of unnecessary intrusiveness. It does, however, involve an acceptance of the possibility that other institutions might have even better ideas than one's own. It is in the nature of competitive endeavour that the best ideas are not always readily shared. However, enlightened self interest would suggest that a degree of knowledge and experience pooling, perhaps through the medium of the regulator, would in the long run benefit the market as a whole and everyone who benefits from its smooth operation.

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IBA WORKING PARTY ON LEGAL RISK

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; or

(d) change in law.

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 (d) 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.

7. "Change in law" has been added as paragraph (d) in order to cover situations where such a change (whether as a result of statute or case law) does not also lead on to a loss under paragraph (a) or (b). It should be noted that, in certain contexts, a change in law may be more properly regarded as a political risk event rather than true legal risk (see 6 above).

Roger McCormick: February 2004