

- CHAIRMAN -

To the
Members of the
EFMLG

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Dear Colleagues,

Legal risk and the Commission's draft proposal for a revision of the Consolidated Banking Directive and the Capital Adequacy Directive implementing Basel II¹

During the EFMLG meeting held on 18 September 2004, a brief exchange of views was held as regards possible areas of legal concern in the Commission's above-mentioned proposal and how the EFMLG member's institutions practically intend to implement the requirements on legal risk. It was noted in particular that legal risk may arise in different connections, for example as part of credit risk management, operational risk or otherwise. It was felt that in many cases institutions may have already elaborated tailor-made definitions of legal risk. Members also stated that for instance national regulations might prescribe divergent concepts of legal risk unless there is a harmonised definition on a European level.

On this basis, it was agreed by the members of the EFMLG, to the extent possible and on a fully confidential basis, to provide the secretariat of the EFMLG by the end of October 2004 with a copy of their internal definition of legal risk. Such definitions would be re-packaged and re-circulated to the members of the group on a strictly anonymous basis. Moreover, in view of the fact that the proposed recasted Consolidated Banking Directive incorporating the Basel II accord does not define legal risk (but, as it is recalled, simply lays down that legal risk is included in the concept of operation risk), the group could consider whether it wishes to embark on a project to establish a common definition which could be

¹ (COM(2004) 486 final – Volumes I/III).

submitted to the Community legislator as a contribution to the establishment of a possible definition of legal risk eventually by means of level 2 legislation.

In view of the above, five members of the EFMLG have replied to the request to submit their internal definition with a view to making a comparative study. In two cases, no such definition exists. As regards the three definitions received, they differ substantially in terms of scope and the level of detail, as follows from the below (slightly redrafted for presentational reasons):

Definition 1

“Legal risk is risk from uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulations.”

The EFMLG member submitting this definition noted that in order to comply with Basle II in the future, all costs resulting from the said definition are currently under evaluation in order to find a narrower scope by evidencing all types of legal risk irrespective of whether they stem from operational risk or credit risk.

Definition 2

This internal definition is divided into three separate principles, which should be read in conjunction:

“- Legal risk is the risk of financial loss resulting from the non-enforceability of a contract.

- Liability risk is the risk of loss due to the bank being held responsible for a contractual or legal claim, debt or legal action based on the breach or default of a contract, commitment of a tort, violation of criminal law, infringement of trademarks or antitrust action.

-Compliance risk is the financial or reputation risk incurred by the Bank by not adhering to the applicable laws, rules and regulations, local and international best practice (including ethical standards) and our own internal standards.”

Definition 3

“An operational risk incident of a legal nature (*legal operational risk*) occurs when an actual event resulting from:

- (i) inadequate or failed internal processes, is of a legal nature, has legal effects, or
- (ii) external event with legal effects,

has, could or could have (near miss) led to a loss, a gain or an opportunity cost.

An *internal process* is defined as a series of co-ordinated activities calling on human resources, an infrastructure, technology and procedures carried out with the aim of achieving a given objective.

Re. (i): Inadequate or failed internal processes that constitute a legal operational risk:

A legal operational risk may result from internal processes in the following cases:

- failure or inadequacy in the legal processes themselves, and
- failure or inadequacy in other internal processes resulting in a legal risk.

Legal processes are the internal processes that enable an entity to accomplish its legal assignments, notably preserving optimal legal security for senior management, operational managers and group assets, defining and co-ordinating legal policies, monitoring legislative change and handling disputes.

Failure or inadequacy of internal legal processes consist notably of:

- failure to take adequate measures to protect the bank's assets (for example insufficient collateral for outstanding debt or the protection of the group's brands in the area of intellectual property); or
- non-compliance with a legal obligation when this results in an operational risk incident.

Claims brought against the bank that reveal the failure or inadequacy of internal processes leading, or which could lead, to a loss constitute a failure or inadequacy of internal processes resulting in legal risk.

Re. (ii): External events with legal effects include notably legal changes that have not been correctly anticipated, whether these are jurisprudential, legal or result from the regulations of a professional body, a regulatory and/or supervisory body or from an arbitration award.”

Basically, where the first definition does not focus on the result of legal risk but more on the uncertainty deriving from legal actions or the applicability/interpretation of contracts, laws or regulations, the focus of the two other definitions is the result of loss either due to the (i) non-enforceability of a contract or non-compliance with laws and standards or (ii) a distinction between inadequate/failed *internal* processes or *external* events with legal effects. In the latter case, these effects will derive from either failure to take adequate measures to protect the bank's assets/non-compliance with legal obligations or from legal changes (jurisprudence/legislation) which have not been correctly anticipated.

All of these individual elements would seem to be covered by the description of legal risk as laid down in the issues paper on legal risk presented during the EFMLG's 13th meeting on 18 February 2004. At the

same time, it is also the case that these definitions – obviously – are composed to fit the individual needs of the institutions having drafted them, for which reason a combination of the said elements into one generic definition, which could be used as a template for other institutions, would presumably not be useful for other institutions. Moreover, any such combination of elements would not take into account the possible need of some institutions to have a definition covering elements currently not represented.

Taking the above into account, the basis for making a thorough comparison across institutions with a view to facilitating an overview of the concept as applied in the sector, which possibly could have assisted in elaborating a basis for a common definition in the future, would seem to be premature. It is assumed that in many cases the non-submission of an internal definition may be due to the fact that such internal definitions do not yet exist since the financial institutions throughout the Union have either not been able or obliged, at this stage, to implement the new capital regime as suggested by the Basel Committee on Banking Supervision.

The definition of operation risk embracing legal risk in Article 4 of the recasted Consolidated Banking Directive is to be transposed into the legislation of Member States by 31 December 2006 (c.f. Article 157). In view thereof, it is **suggested that the issue of legal risk and the possible contribution to a definition of this type of risk is only addressed by the EFMLG in due course.** Meanwhile, ongoing work by other foras such as, for instance, the working party of the IBA will be monitored and the group will be debriefed where relevant on such work. **This suggestion could be discussed during the next meeting of the EFMLG.**

With best regards,

[signed]

Antonio Sáinz de Vicuña

Chairman