The definition of legal risk and its management by central banks

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Currently, there are no international rules specific to central banks on what is to be understood by ‘legal risk’ and how it should be managed. In the context of the discussion on Basel II (the International Convergence of Capital Measurement and Capital Standards), it was considered that assessing, monitoring and mitigating legal risk may positively affect the way in which financial institutions conduct business. Basel II was transposed into Community legislation by means of the Recast Banking Directive and the Recast Capital Adequacy Directive which do not define the concept of legal risk but instead include it under the wider definition of operational risk. The concept of legal risk as applied by central banks may have some common ground with the concept as applied to credit institutions. However, when managing legal risk, the fundamental differences between central banks and credit institutions in terms of functions, risk profile, etc. and the roles of central banks as public entities and the risk of reputational loss related to their tasks need to be taken into account. Nonetheless, some elements of managing legal risk may be common to both central banks and credit institutions, depending on the special characteristics of the institution in question.

Introduction

In the aftermath of the corporate scandals of recent years, increased focus has been given to the importance of financial institutions’ legal risk management as part of their overall risk management. In this respect, the Recast Banking Directive which implements the Basel II accord implies that institutions must also dedicate resources to identifying and managing legal risks. More specifically, the Recast Banking Directive includes legal risk in the wider definition of operational risk.

Generally, establishing comprehensive and workable standards to assess and consequently mitigate legal risk in the financial markets is likely to have a positive effect on the conduct of the business of financial institutions. In particular, the soundness and the reliability of the operations of credit institutions will benefit from

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4 Article 4 defines ‘operational risk’ as ‘the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk’.
the implementation of such measures\(^5\). In this context, it is of particular interest that euro area credit institutions are as a rule eligible counterparties for Eurosystem operations\(^6\). Thus, standards for appropriate identification and mitigation of legal risk also have a bearing on the operational framework of the ECB and the central banks of the Member States which together constitute the European System of Central Banks (ESCB). However, the Recast Banking Directive does not apply to the ESCB\(^7\).

When addressing the question of legal risk in relation to the ESCB, certain special characteristics should be taken into account as the central banks are public bodies governed by primary Community legislation and, in the case of the national central banks (NCB), by the laws of the Member States for non-ESCB related matters. More specifically, the ESCB’s primary objective is to maintain price stability in accordance with Article 105(1) of the Treaty establishing the European Communities. Without prejudice to this primary objective, the ESCB must support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community. Moreover, the ESCB must act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources. In addition, Article 105(2) of the EC Treaty lays down the basic tasks to be carried out through the ESCB which are (i) to define and implement the monetary policy of the Community, (ii) to conduct foreign-exchange operations, (iii) to hold and manage the official foreign reserves of the Member States, and (iv) to promote the smooth operation of payment systems. Another difference between the members of the ESCB and the investment firms and credit institutions which are covered by the Recast Banking Directive, is that in achieving their objectives and carrying out their tasks, central banks have to follow a strictly conservative approach in the sense that their credit operations have to be based on adequate collateral\(^8\). Finally, it should be recalled that the ECB has regulatory competence\(^9\) and is subject to specific confidentiality requirements\(^10\).

In view of the above non-exhaustive list of special characteristics, it is clear that although central banks are also players in the financial markets, their objectives, tasks and risk profiles differ considerably from those of other market players. Although there is clearly increasing awareness of legal risk in the central banking community, it is also worth bearing in mind that reputational risk, which does not seem to be covered by the general concept of legal risk (see below), is a very important risk factor for central banks, since it relates to their credibility and thus

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\(^5\) According to Article 157 of the Recast Banking Directive, the Directive had to be implemented in the laws of the Member States by 31 December 2006 and applicable as from 1 January 2007. However, according to Article 157(3), the Member States may not apply the laws, regulations and administrative provisions necessary for the use of the Advanced Measurement Approach before 1 January 2008.

\(^6\) All supervised credit institutions, as defined in Article 4(1) of the Recast Banking Directive, which are established in the EEA, are admitted as participants in the Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET), from 19 November 2007 onwards replaced by TARGET2, which is a real-time gross settlement system (RTGS) for payments in euro. The RTGS systems of Member States that have not adopted the euro are allowed to connect to TARGET, if they conclude an agreement with the ECB and the national central banks of the Member States that have adopted the euro.

\(^7\) The first indent of Article 2 exempts ‘central banks of Member States’ from the scope of application of the Recast Banking Directive and Article 4(23) defines the term ‘central banks’ (as opposed to ‘central banks of Member States’) as including the ECB unless otherwise indicated.

\(^8\) See Article 18 of the Statute of the European System of Central Banks and of the European Central Bank (‘the ESCB Statute’).

\(^9\) See Article 110 of the EC Treaty and Article 34 of the ESCB Statute.

\(^10\) See Article 38 of the ESCB Statute.
their perceived ability to ensure price stability and market confidence in general. For this reason the adaptation of the definition and the application of the concept of legal risk to central banks involves some fundamental differences from investment firms and credit institutions, which should be taken into account.

Definition of legal risk

Neither the Recast Banking Directive nor the underlying Basel II documentation contain any detailed definition of legal risk. However, Basel II does provide some guidance since it states that operational risk includes ‘legal risk, but excludes strategic and reputational risk’. Moreover, it is stated that ‘legal risk includes, but is not limited to, exposures to fines, penalties or punitive damages resulting from supervisory actions, as well as private settlements’. However, as noted above, the Recast Banking Directive does not contain any definition but only refers to legal risk as being covered by the overall concept of operational risk.

In various publications practitioners have highlighted the main elements that could be classified under the heading of legal risk. However, this has mainly been by focusing on specific aspects but without approaching the issue systematically. The European Financial Market Lawyers Group (EFMLG) hosted by the ECB and the Financial Market Lawyers Group (FMGL) hosted by the Federal Reserve Bank of New York have undertaken some initiatives in this area, though without any conclusive results so far. Also the International Bar Association’s (IBA) sub-committee ‘E 8’ (on law reform) has embarked on analysing and making suggestions on the elements of legal risk in a somewhat more systematic way. This is an exercise which is still ongoing.

15 The definition suggested by the IBA Working Party on Legal Risk should be seen in conjunction with its accompanying notes (not replicated here), which affect how it should be interpreted. It reads as follows: ‘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’.
A generally accepted definition of legal risk, in the context of the operational risk framework, would clearly facilitate proper risk assessment and risk management as well as ensuring a consistent approach by European credit institutions. This would provide additional clarity as to whether the application of the general principles on the quantification of operational risk would be entirely appropriate in the case of legal risk.

However, it has proved difficult to establish a satisfactory definition of legal risk. The fact that most, if not all, types of risk (operational, credit, market and liquidity risk) contain a legal component makes the categorisation difficult. Moreover, not every issue containing a legal component should be defined as legal risk.

In addition, differences in jurisdictional cultures may play a role when identifying legal risk. In common law countries it seems fair to say that everything which is not specifically regulated by a contract is, by definition, a legal risk for the relationship between the parties. In civil law countries, contractual agreements exist in a legal environment where laws of general application apply to questions not specifically regulated by the contract, thus providing a supplementary source of law in the event of shortcomings in the contract. Moreover, contracts are to be interpreted and applied not merely using a literal approach, but they should be interpreted in the spirit of the agreement (i.e. by ascertaining the intentions of the parties), under the general principle of giving effect to the contract.

As regards institutional cultures, it is clear that these differ considerably between the ESCB members and credit institutions/investment firms in view of their different objectives, tasks and risk profiles, as described above. For the NCBs it would seem that such differences in institutional culture play less of a role than they do for financial institutions in general, in view of the NCBs’ special nature and the identical scope of their ESCB-related activities. Therefore, due to different long-standing traditions and considering the differences in jurisdictional and/or institutional cultures, any definition should be capable of being adapted to the requirements and cultures of the range of entities concerned.

Bearing in mind the above, it would be useful to elaborate on the elements of such a definition which could be applied by the credit institutions and investment firms covered by the Recast Banking Directive. It would also be useful for central banks to have such a definition for the purpose of risk management, other than in the area of capital requirements. Such a definition should only be applicable to legal risk as part of operational risk, since any deviation from the approach taken by the

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16 See also paragraph 55 of ECB Opinion CON/2005/4 of 17 February 2005 at the request of the Council of the European Union on a proposal for directives of the European Parliament and of the Council recasting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, (OJ C 52, 2.3.2005, p. 37), according to which ‘A general definition of legal risk would facilitate proper risk assessment and risk management, as well as ensure a consistent approach between EU credit institutions. It would also be worthwhile examining the extent to which one should take into account the fact that legal risks are inherently unpredictable and do not generally conform to a pattern. In addition, the management of legal risk would have to be consistent with the management of operational risk as a whole. For these reasons, the ECB suggest that CEBS should carry out further work to clarify the definition of legal risk’.

17 Identifying the sources of legal risk is a basic requirement for defining what legal risk is composed of. This cannot be addressed in detail within the scope of this article, but it would seem to cover the following main areas: (i) the behaviour of financial institutions; (ii) the nature of the financial markets; (iii) problems with the law; and (iv) interaction of law and finance. For a more in-depth analysis of these components see Johanna Benjamin, ‘Sources of Legal Risk for Financial Institutions’, App. 1 to a report of the IBA Symposium on Legal Risk (2003), in JIBFL (2004); and Roger McCormick, Legal Risk in the Financial Markets, Oxford University Press, 2006, pp. 123-156.
Community legislator would endanger its possible practical relevance and application.

Using the definition proposed by the IBA sub-committee ‘E 8’ as source of inspiration, the elements of a definition of legal risk could consist of the following general concepts:

- a) Validity and enforceability of contracts,
- b) External factors like (lack of) legal certainty and changes in law and/or jurisprudence,
- c) Incorrect compliance, or failure to comply with laws, and
- d) Asset protection: correct establishment and perfection of assets.

Any definition consisting of these elements should be non-exhaustive, non-prescriptive and, as already mentioned, adaptable to the different jurisdictional and institutional cultures of the financial institutions.

However, even if a definition were established, legal risk has the special characteristic that it is normally unpredictable and, as a rule, does not conform to any pattern. For these reasons, legal risk is difficult not only to identify with any certainty but also to evaluate. Any evaluation of capital requirements to cover the legal risk of credit institutions and investment firms should be based on experience, i.e. on historical data, as such data will give the best indication of the probability of legal risk materialising in the future. It is admitted, however, that historical data are not absolute indicators of the predictability of legal risk re-occurring for a specific instrument or situation, in view of the very uncertain nature of legal risk under normal circumstances.

**Legal risk management**

Legal risk management would help limit exposure to a whole range of criminal, regulatory and civil liability. Therefore, all in-house legal departments of financial institutions and central banks should consider establishing legal risk management programmes if they have not done so already. However, the success of any such programme would depend on the strengthening of or in some cases even the creation of a corporate culture that values legal risk awareness. Such a programme would necessitate the avoidance of conflicts of interest and the protection of the independence of in-house legal departments (e.g. by appropriate management responsibility structures and reporting lines), and include the allocation of adequate resources to the legal department for it to execute its tasks in a professional and satisfactory manner.

Basically, legal risk management can be broken down into four components:

- Identification – what are the legal risks?
- Assessment – this is difficult, as legal risks notoriously tend to have low probability and high impact,
- Monitoring – i.e. reporting mechanisms, and
- Control/mitigation – e.g. review of legal documentation\(^\text{18}\).

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Since the institutions concerned may have different jurisdictional or institutional cultures, they will have to take these into account when setting up a legal management framework, a factor which has been reflected in the Recast Banking Directive\(^{19}\).

In addition, the management of legal risk would have to be consistent with the management of operational risk as a whole. Yet, questions may arise as to the relationship between the roles of the in-house lawyer as risk-manager, the traditional compliance function and those who are charged with responsibility for risk generally\(^{20}\). Moreover, in certain circumstances it may not be appropriate or practical for an institution to act in isolation in response to a risk that may affect a broad range of market participants, and where the response may need to involve trade associations and other market participants.

Risk management programmes should address compliance with laws and regulations and anticipate exposures to new legislation. In some institutions certain legal compliance functions are the responsibility of non-lawyers, so that an effective programme will require coordination between non-legal and legal functions. In more concrete terms, the following non-exhaustive list of elements is offered as guidance for what such programmes could cover:

- In-house legal counsel should have detailed and continuous training in and knowledge of the relevant laws, jurisprudence and market documentation, and understand the practical limits of their application;
- In-house legal counsel should be client-oriented and closely integrated with colleagues who execute transactions, senior management and all other relevant business areas in order to effectively understand the legal risks they are mitigating;
- Relevant information about legal requirements should be distributed in a timely and operational manner to all employees it may concern;
- A central function could be established with responsibility for monitoring significant changes in market practices and related documentation, together with any relevant legal actions brought against other market participants;
- Training in how best to serve the client and the decision-making bodies in an ethical manner should be ensured;
- Procedures and staff training on when to seek external advice should be established, together with procedures for managing the execution of outsourced tasks;
- Procedures could be established to ensure that sufficient time is allowed to conduct a proper legal review of documentation;
- Procedures could be established to ensure that documentation with special sensitivity or high risk is thoroughly reviewed by senior management;
- Reporting lines for all internal and external legal counsel should be established;
- Standards for ensuring consistent advice could be established;
- Continuous re-evaluation of existing risks and the potential evolution of such risks should be carried out;

\(^{19}\) See Article 22(1) according to which ‘Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures’.

• Procedures could be established to monitor whether advice given has been followed and whether any conditions or qualifications attached to the advice have been appropriately dealt with; and
• Relevant control functions should be established; General Counsel should ensure that senior management/the Board understand their/its role in reviewing and endorsing the compliance programmes.

Finally, those setting up risk management programmes should avoid having a list of issues which will be easy to ‘tick off’ without the issues having been subjected to a thorough assessment of all potential risks and their possible implications.

**Conclusion**

The establishment of a generally accepted definition of legal risk in the context of operational risk management would clearly facilitate proper risk assessment and risk management as well as ensure a consistent approach by European credit institutions. Any such definition could also be applied by central banks for general risk management purposes, taking into account their specific objectives, tasks and risk profiles. Central banks should pay particular attention to managing reputational risk. The mitigation of legal risk could be achieved by setting up legal risk management programmes individually fitted to the institution, as part of its overall risk management. Such programmes would assist in strengthening a corporate culture that values legal risk awareness, thereby hopefully being an important element in the avoidance of future corporate scandals.

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**Description of the ECB’s activities**

According to Article 105(1) of the Treaty EC, the primary objective of the European System of Central Banks (the ESCB) is to maintain price stability. Without prejudice hereto, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community. Moreover, the ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources. Article 105(2) of the Treaty EC lays down that the basic tasks to be carried out through the ESCB shall be to (i) define and implement the monetary policy of the Community, (ii) to conduct foreign-exchange operations consistent with the provisions of Article 111, (iii) hold and manage the official foreign reserves of the Member States, and (iv) promote the smooth operation of payment systems.