

LEGAL RISK IN BANKING OPERATIONS

Abstract

This paper analyzes the legal risk in the banking operations and the necessary steps for prudent management of this kind of risk.

These paper consists of five (5) parts, that are:

1. Introduction;
2. Operational risk in banking;
3. Legal risk in banking;
4. The management of legal risk; and
4. Conclusion.

In the first part: “Introduction”, we define and explain the subject of our research.

In the second part: “Operational risk in banking”, we analyze the concept and the management of the operational risk.

In the third part: “Legal risk in banking”, we analyze in detail the legal risk and individual variations through which it is manifested in the banking operations.

In the fourth part of this paper “The management of legal risk”, we analyze the process of managing the legal risk.

Finally, the fifth part of this paper is the “Conclusion”, in which we are giving our basic conclusions that arise from our paper.

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The management of legal risk in the future should include implementing the policies, structures, processes and culture that are directly aimed at building effective management of potential opportunities for minimizing the legal risk. In the Republic of Macedonia, the future compliance of the commercial bank with current legislation should provide protection and elimination of all consequences that may arise as a result of non-compliance and improper application of the regulation.

Keywords: *risk, bank, operational risk, legal risk, risk management.*

1. Introduction

The subject of this paper is an analysis of the legal risk in the banking operations that includes the definition and the identification of the forms in which the legal risk manifests itself in practice, as well as the analysis of the legal risk management.

Given the fact that the Republic of Macedonia is a country with a financial market that mostly relies on the banking sector, it is very important to provide the successful management of all risks that commercial banks face every day in their work, and among them is also the legal risk. The well drafted legislation that would be consistently implemented in practice is a very important premise and framework for prudent risk management in the banking sector.

The events that occurred at the beginning of the first decade of the 21st century, i.e. the global financial (economic) crisis, prompted thinking about threats and vulnerabilities that come and actually can be controlled by the entity. Legal risk in banking operations especially gained significance just during this financial crisis, which

contributed to the adoption of new and more stringent regulations, which in turn directly or indirectly necessitated the management, compliance and manage legal requirements and problems in institutions.

Therefore, *the objective* of this paper is to point out the significance of legal risk in banking operations and its prudent management generally speaking, and also giving emphasis on the legal risk management of commercial banks in the Republic of Macedonia.

2. Operational risk in banking

According to our legal system (i.e. the legal system in the Republic of Macedonia), the risk in banking operations, is likely an activity or event that has a direct negative impact on the profits of the commercial bank and/or the underlying assets, and thus cause difficulties in achieving its goals².

Besides the Law on the National Bank of the Republic of Macedonia and the Law on banks, as key acts that are pillars of the Macedonian legal banking system, the basic bylaw in this segment that is prescribed by the National Bank of the Republic of Macedonia is the Decision on risk management in banking. So, according to *this Decision* certain *types of risks* that are covered, i.e. *defined* in the normative framework in the Republic of Macedonia are: credit risk, liquidity risk, market risk, currency risk, interest rate risk, operational risk, legal risk, country risk, reputational risk and strategic risk.

The operational risk in the legal system in the Republic of Macedonia is defined as: "the risk of loss that may be incurred as a result of the incompetence of the staff, or

² Народна Банка на Република Македонија, "Одлука за управување со ризиците", („Службен весник на РМ“ бр. 42/2011), глава II, точка 3, став 1.

their malfunctions, the inadequacy of the internal process in the commercial bank, or because of some external events, i.e. the use of outsourcing”³.

However, despite many definitions of what constitutes operational risk and why it appears in the banking operations, the Basel Committee on Banking Supervision under Basel II, defines the operational risk as⁴: *the risk of loss due to misfits, inadequate or failed internal processes and systems or external events*. This definition includes the legal risk, but does not include strategic risk and reputational risk because it comes to risks that are difficult to quantify, that is difficult to determine the amount of losses for the commercial bank in the case of realization of these risks. This definition of the Basel Committee is fully accepted in our legal system, and in the Republic of Macedonia the operational risk includes also: the legal risk, the risk of money laundering and terrorism financing, and the risk of non-compliance of the information system.

During *the global financial (economic) crisis* the evident in practice were the most important subspecies of the operational risk, namely: the illegal commercial activities, and unauthorized trading with the financial instruments, theft and mismanagement, unethical behavior, increased legal risk, financial reporting and inaccurate information before the governing bodies of the commercial banks that were specific to these financial institutions.

Therefore the reforms of the regulation were needed, in order to download the necessary measures and actions to mitigate the consequences of the financial crisis. But, even in some cases this can lead to the increased operational risk, namely its subspecies - the legal risk as a result of non-compliance with the regulation or due to the negative effects of new regulation on the commercial banks and on the decisions that were previously made.

³ Народна Банка на Република Македонија, “Одлука за управување со ризиците”, („Службен весник на РМ“ бр. 42/2011), глава II, точка 3.

⁴ Basel Committee on Banking Supervision, “*International Convergence of Capital Measurement and Capital Standards – A Revised Framework Comprehensive Version*”, BIS, June 2006, p.144.

Therefore, *the effective operational risk management* is of paramount importance particularly in the prevention of financial crises. This prudent corporate governance requires the choice of model for the calculation of capital required for operational risk (i.e. the elaboration of the advanced access model that will produce less real need for additional capital to cover operational risk), as well as making legal acts and comply with regulatory requirements in this area, namely the real commitment and the real implementation of the operational risk management.

3. Legal risk in banking

Given the fact that in theory there is no single definition for this type of risk faced by the commercial banks in their operations, certain institutions (mostly the central banks) give their own definitions and explanations of what constitutes a legal risk.

So, for example, the Central Bank of the United Kingdom (Bank of England), defines the legal risk as "the risk that unexpected interpretation of the law or the legal uncertainty will expose the payment system or its participants to the unforeseen financial losses and other possible losses"⁵.

One of the definitions which was proposed by the Working Group on legal risk, established by the Subcommittee E8 of the International Bar Association (IBA), said that: *"the legal risk is the risk of loss for the institution."*⁶ Further it submit the sources of legal risk: *"...primarily caused by: faulty transaction; or charges (including response to a complaint or counterclaim) or occurrence of an event that results in legal liability for the institution or other loss (e.g. as a result of breach of contract); failure to take appropriate measures for the protection of property (e.g. intellectual property) owned by the institution; or changes in the law."*⁷

⁵ Bank of England, „*Oversight of the payment systems*“, Bank of England 2000, pp.1-10.

⁶ Guernsey Financial Services Commission, „*Legal Risk Guidance Note for Banks*“, Attachment: IBA Working Party on Legal Risk, Suggested Definition of Legal Risk, 2004, pp.1-5.

⁷ Ibid.

The Basel Committee on Banking Supervision, as a very important financial institution in the world, defines the legal risk as follows, and says that: *"the legal risk includes but is not limited to exposure to fines, penalties or damages, subject to penalties arising of supervisory activities as well as private settlement, but excludes strategic risk and reputational risk"*.⁸

The operational risk includes *the legal risk* that in the legal system of the Republic of Macedonia is defined as "the current or the future risk to profits and own funds of the commercial bank, which is caused by the violations or disregard of legal regulations, agreements, prescribed practices, ethical standards or as a result of misinterpretation of the regulations, rules, contracts and other legal documents"⁹.

This type of risk occurs particularly in developing countries due to their mismatched regulation, and the fact that they often change other laws and bylaws in these countries because the legal system is not sufficiently stable and primarily is dependent on a ruling set, which is a real handicap for the normal functioning of the institutions.

*The legal risk may appear in several sub-variants, including*¹⁰:

1. as a result of actions taken by the commercial bank and its employees that are not fully in line with the legal framework;
2. due to the uncertainty of the effects of the implementation of the legislation; and
3. inefficiency of the legal system in the country as a whole.

The first mode of appearance refers to the risk due to errors in contracts, improperly documented and illegal transactions, clauses in contracts that are not clearly formulated and hence are incomprehensible, errors that occur due to failure of the

⁸ Basel Committee on Banking Supervision, "Sound Practices for the Management and Supervision of Operational risk"; BIS, June 2011, p.5.

⁹ Народна Банка на Република Македонија, "Одлука за управување со ризиците", („Службен весник на РМ“ бр. 42/2011), глава II, точка 3.

¹⁰ Mantysaari P., "The Law of Corporate Finance: General Principles and EU Law - Volume I: Cash Flow, Risk, Agency, Information", Springer, 2010, pp.29-94.

employees, or for errors of the legal counsel of the commercial bank, as in the case of securities in payment of the commercial bank performed with improperly selected instruments. All this causes the commercial bank to face the risk that would prevent the realization of her legal rights and followed in pursuit of her daily activities.

Although it can be noticed that in all the cases mentioned the human factor, i.e. the staff and the management of the commercial bank are the main causes of the risk, so we must emphasize that for these errors of the insiders at the commercial bank, she took the responsibility, but this should not be equated with the loss as a result of the commercial bank fraud.

So, whether the commercial bank is damaged, or its management or employees deceive customers or other participants, the loss due to fraud, according to some authors¹¹, it is not part of the legal risk. The only point is the responsibility of management of the commercial bank to prevent this fraud and to monitor whether participants comply with the rules and codes of practice of the commercial bank.

The second mode of appearance of the legal risk is the uncertainty of the effects of implementing the legislation as a result of unclear and inaccurate, i.e. incomprehensible interpretation of laws and regulations that have further repercussions on the future operations of the commercial bank. So it is an external factor in this case that is the cause of the legal risk, and the commercial bank is trying to protect the same by engaging the legal counsel and experts, but cannot fully eliminate his presence. Also the problems in the implementation of the laws and lack of harmonized regulations, can cause this uncertainty of applied legal framework.

And the last mode of appearance of the legal risk arises in the form of inefficiency of the legal system in the country as a whole, which means the absence of effective legislation and case law, the lack of legal certainty, i.e. poor legal system in the country,

¹¹ Chorafas D., *"Wealth Management - Private Banking, Investment Decisions and Structured Financial Products"*, Elsevier, 2006, pp.167-180.

which causes the risk of the commercial bank operations. The countries with a high degree of corruption and judicial inefficiency, like our country – the Republic of Macedonia, especially feel the effects of this subspecies of the operational risk.

4. The management of legal risk

The key activity in the conduct of prudential policy in the banking operations is the risk management. As in the life of every person, also in the banking operations, the risk simply cannot be avoided, and therefore the only thing that can be done is to professionally manage it. Therefore we say that the risk management is perhaps the most important function of the commercial banks, to insure against the risks they face in their daily operations. This commercial bank risk management consists of¹²: *the identification of the risk, its measurement, control, insurance and the elimination of the risk.*

In the first stage, i.e. *in the identification of the legal risk* we need to answer the question: where the legal risk is likely to occur and when, why and how the events (that are a threat or weakness) can prevent the achievement of the goals or can diminish the value of the property of the institution.

The identification of legal risk should be done in a way that meets the goals it wants to achieve in the institution with the implementation of the program for the management of legal risk.

The measurement or assessment of the legal risk is associated with mathematical formulas to determine the likelihood and the impact of the risk.¹³ In assessing the legal risk these factors are relevant:¹⁴

¹² Comptroller's Handbook, "*Bank Supervision Process*", Comptroller of the Currency Administrator of National Banks, 2007, pp.1-25.

¹³ McCormick. R., "*The management of Legal risk by financial institutions*"- Draft discussion paper, 2004, p.3.

- *The legal infrastructure* in the state in which the institution does business, as well as the independence of the judiciary, the complexity of contracts and corporate legal concept, the execution of court decisions and arbitration decisions and the risks associated with the transaction and contractual security;
- *Whether the relevant source of law* (typically, the case law or legislation) *together with the market practices are responsible and firmly against the legal problems* that are most likely to affect the institution in a given jurisdiction;
- The vast extent of having any *legal uncertainty*, i.e. "*the worst case scenario*", in the case the uncertainty is resolved in a manner that is unfavorable to the institution;
- Chronological display data from institutions in the same business in the same jurisdiction (publicly available) against rival lawsuits or defective transactions;
- The risk of "*collateral damage*" in the event of the materialization of the risk;
- Are the legal documentation and the regulatory environment relatively easy or extremely difficult to understand, run by individuals who will be involved in marketing and selling products; and
- The probability of appearance of a *conflict of interest*.

The question that arise is: who should take the responsibility for the assessment of the legal risk in the institution, and the answer of this question would be: *the legal department*. However the assessment phase should be seen as a separate issue, unlike that of making business decisions based on the assessment that was already made.

The phase of monitoring or *tracking the performance*, includes a procedure for reporting and monitoring process of managing the legal risk. Once that the identified risks are described, assessed and evaluated by the team, it is necessary to adopt a series of business decisions by senior management within the institution, and *in controlling and mitigating these risks*.

¹⁴ Ibid.

In this context, the institution should adopt a *strategy for dealing with risks identified and evaluated*, for all more or less predictable risk scenarios. Another important segment, in terms of control of legal risk is *the loss caused by the legal risks*, which requires an analysis of the financial impact that the documentation that has and also the resources for legal proceedings, etc. The establishment of the effective strategies for dealing with the legal risks, requires the involvement of experiences and knowledge of the market experts and institutions in the process of their creation.

Finally, in practice often we discuss the removal and insurance of the legal risk through *the distribution and the allocation of the legal risk in contracts*, but these two techniques should not be considered as tools for the risk transfer, but as an approach for treating the legal risk. The distribution of the legal risk guides the deployment risk through standard rules and principles of the contract law, and the allocation of risk relates to the ex ante risk of displacing one or both parties through contractual rules.¹⁵

In our regulation framework, namely in chapter I, paragraph 2 of the Decision on risk management that is prescribed by the National Bank of the Republic of Macedonia, the identification, measurement and evaluation, the control and monitoring or reducing risks, are the integral components of the management process of banking risks.

But despite the fact that today is the increased interest in managing the legal risk worldwide, however there is a lack of specific methods that would facilitate prompt management of legal risk.¹⁶

When it comes to the question of *who and how we should manage the legal risk*, there is a need for management at the highest level in the institution to establish, approve and periodically review the framework for the process of managing the legal risk.

¹⁵ Keskitalo, P., "*From assumptions to risk management: an analyses of risk management for changing circumstances in commercial contracts, especially in the Nordic countries: the theory of contractual risk management and the default norms of risk allocation*" Helsinki: Kauppakaari, 2000, p.20.

¹⁶ Burnett, R., "*Legal risk management for the IT industry*"; Computer Law & Security Report, 2005, p.21.

The Managing Authority, should oversee senior management to ensure that policies, processes and systems are effectively implemented at all levels.¹⁷ In many institutions, the responsible for managing the legal risks are: the director of the legal department or chief legal counsel, or "*the service for compliance with the regulations.*"

When it comes to legal risk all employees in the company are involved in it. You should therefore make appropriate *information system for legal risk*, and for the risks that are affecting the company's operations in general. Also within the institution we should implement and foster a *culture of risk* (and also for the legal risk), whereby this to build the awareness of the employees of the existence of risks in performing working tasks, their knowledge, recognition and learning a proactive approach to work.

In the commercial banks in the Republic of Macedonia the person that is responsible for the operational risk on a monthly basis following all operational risk events, including those that are separated by the regulations, reports the board's risk management and, through his report and the Supervisory Board of the commercial bank. Once in a year he is preparing a special report on the registered risk events and measures taken to overcome them. It daily monitors the compliance of the commercial banks with legal and supervisory framework, and as a result, the banking business is constantly aligned with the legal requirements.

Finally, it remains to conclude that there is much room for improvement in this segment of banking operations, and it is a task that is primarily of the members of the highest governing bodies in the commercial bank, and the claim remains that the overall system and its functionality will depend of the Supervisory Board and Chief Executive Officer, as the Chairman of the Board in the commercial bank.

¹⁷ Basel Committee on Banking Supervision., "*Sound Practices for the Management and Supervision of Operational risk*", BIS June 2011, p.5.

5. Conclusion

The legal risk in the banking operations as an integral part of the operational risk, namely his main subspecies, occurs particularly in developing countries due to their mismatched regulation, and the fact that they often change other laws and bylaws because in these countries the legal system is not sufficiently stable and primarily is dependent on a ruling set, which is a real handicap for the normal functioning of the institutions.

The legal risk may appear in several sub-variants, that are: as a result of actions taken on the commercial bank and its employees that are not fully compliant with the legal framework; because of the uncertainty of the effects of implementing the legislation; and inefficiency of the legal system in the country as a whole.

However the process of the risk management is perhaps the most important function of the commercial banks' insurance risks they face in their daily operations. This commercial bank risk management consists of: *identification of the risk, its measurement, control, the security and the removal of the risk.*

The managing with the legal risk in the future should include the implementation of policies, structures, processes and culture that are directly aimed at building effective management of potential opportunities and adverse events which has the source of the legal risk and risks that can be treated with remedies.

As for our country, the Republic of Macedonia, *in the future, the compliance of the commercial bank with the applicable legislation* should provide protection and elimination of all consequences that may arise as a result of non-compliance and improper implementation of the regulation. This objective will be accomplished by monitoring the new regulations, amendments, and assessment of its impact on the commercial bank's operations and recommending the corrective measures for the full compliance of the commercial bank.

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