



cutting through complexity™

A Regulators view on Operational Risk

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3 questions.



How many?



418 UK registered airliners



Approximately 400 uk banks and building societies

Which has more operational risk?



Which has more failures?



No fatal accidents in last 10 years



At least 8 UK banks or building societies have required rescue in last 4 years

A banker's view?



“A British Bank is run with precision”

Disney's Mary Poppins, 1964

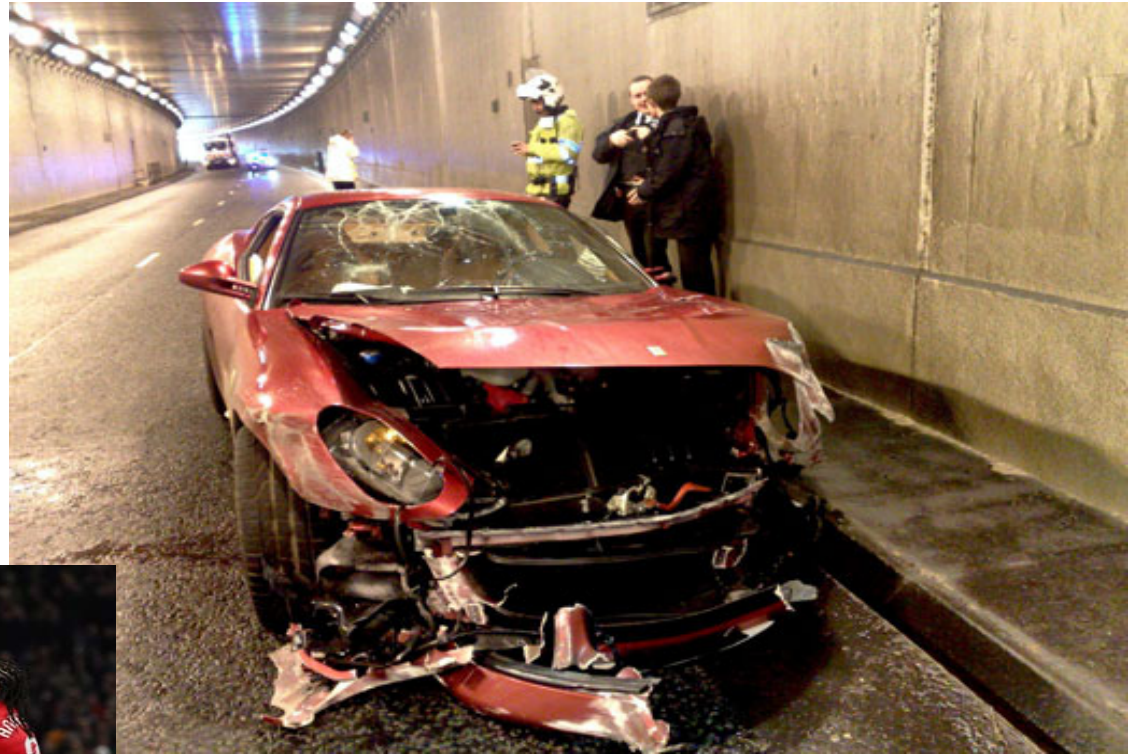
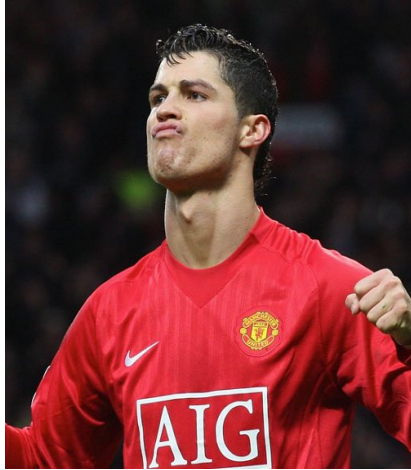
A parked Ferrari? – a regulator’s thought



Capable of 250 mph – and in the right hands/team...



But get it wrong.....



Setting the scene

2007/8 – years of reckoning



LEHMAN BROTHERS



Setting the scene – operational risk

Three case studies

Large European banc-assurer:

- Maximum possible single loss < Euros 100m
- We knew of two events with a liability of up to 5 times this maximum
- Risk management assumed such data to be irrelevant when controls taken into consideration

Medium-sized European bank

- Maximum foreseeable loss:
 - ✓ Clients, Products & Business Practices ~ €200 million
 - ✓ Internal/External Fraud ~ €10 million
- The board would not accept a higher exposure

Madoff

- In March 2009, Madoff pleaded guilty to 11 federal crimes
- His Ponzi scheme defrauded thousands of investors of billions
- The amount missing from client accounts, including fabricated gains, is estimated at almost \$ 65 billion

A fundamental shift in regulatory expectations

- o Regulators -increasingly acting unilaterally and prescriptively, more intrusive style and more demanding for information
- o Improvements required in the effectiveness of internal risk management and firm governance



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“While some of the problems could not be identified at firm specific level ...there were also many cases where internal risk management was ineffective and where boards failed adequately to identify and constrain excessive risk taking.”

The Turner Review – March 2009

“Board level engagement in risk oversight should be materially increased, with particular attention to monitoring risks and discussion ... on appetite/tolerance”

Walker Review – July 2009

“...there was a severe underestimation of default risks, concentration risks, market risks and liquidity risks ...a number of banks had weak controls over balance sheet and off-balance sheet growth...”

Financial Stability Forum – April 2008

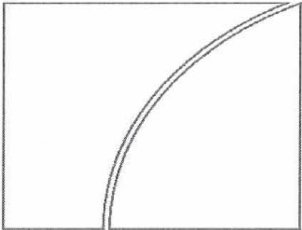
Basel Committee
on Banking Supervision

Consultative Document

**Sound Practices for the
Management and
Supervision of Operational
Risk**

Issued for comment by 25 February 2011

December 2010



BANK FOR INTERNATIONAL SETTLEMENTS

Too big to fail?

The interconnection of a bank's operational functions has made it hard to separate out failing parts.

Eg:

- Payments
- Treasury
- IT
- Operations

Regulator's definition of operational risk management

“Sound operational risk management is a reflection of the effectiveness of the board and bank’s management in administering its portfolio of products, services and activities.”

But there is more work to do:

*“The Committee is seeing sound operational risk governance practices adopted in an **increasing number** of banks.”*

Basel committee on banking supervision

Regulatory expectations for operational risk?

Sound practices for the management & supervision of operational risk

- **Basel Committee issued a consultation paper in December 2010**
- **Consultation covers three key elements:**
 - Governance
 - Risk management environment
 - Role of disclosure
- **Builds on guidance published in 2003 together with experience and knowledge gained through data collection, prudential supervision**

3 lines of defence

“Common industry practice for sound operational risk governance often relies on three lines of defence –

(i) business line management,

(ii) an independent corporate operational risk management function and

(iii) an independent review and challenge. “

Regulatory expectations for operational risk?

Sound practices for the management & supervision of operational risk

- Governance
- Boards and senior management should establish:
 - ✓ A culture guided by strong risk management with compensation aligned to balance risk and reward
 - ✓ A framework, which it approves and periodically reviews
 - ✓ A risk appetite statement articulating nature, type and levels of risks the firm is willing to assume
 - ✓ A clear, effective and robust governance structure, with consistent lines of responsibility
- Firms should develop and implement an operational risk framework fully integrated into its overall risk management processes
- The framework should be comprehensive and appropriately documented in board approved policies

Regulatory expectations for operational risk?

Sound practices for the management & supervision of operational risk

- **Risk management environment**
- Senior management should:
 - ✓ Ensure the identification and assessment of operational risks inherent in all material products, activities, processes and systems
 - ✓ Ensure there is an approval process that assesses exposure to operational risk
 - ✓ Implement a process to regularly monitor the risk profile and exposures with appropriate reporting mechanisms to all level of the business, including the board
- Firms should:
 - ✓ Have a strong control environment using policies, processes and systems with appropriate internal controls and risk mitigation strategies
 - ✓ Determine the maximum loss they are will to take and financially able to absorb
 - ✓ Have business resilience and continuity plans in place, which should be reviewed periodically
- The board and senior management are responsible for understanding and effectively managing risks associated with outsourcing and should annually review of the firm's insurance programme

Regulatory expectations for operational risk?

Sound practices for the management & supervision of operational risk

- **Role of disclosure**
 - Firms should make sufficient disclosure to allow stakeholders to determine the effectiveness of operational risk management

Regulatory expectations for operational risk?

We are seeing from the regulator

- **More intrusive regulation**
- **A focus on ensuring firms get the basics right for sound operational risk management:**
 - Framework design, operational effectiveness and use to identify, manage, monitor and report on the risks it is potentially exposed to
 - The role of the governing body and senior management in providing oversight
 - Role of the risk control function
 - Demonstration of 'use test' – using risk to manage business

Regulatory expectations for operational risk?

We are seeing from the regulator

- **Proof that appropriate resources are being used, and in many instances external parties, to review and validate risk frameworks and processes**
- **Expectation that Pillar 2 capital will be greater than Pillar 1**
- **Where insurance mitigation is incorporated into Pillar 2**
 - A clear demonstration of the mitigation provided in line guidance given by the Basel Committee in its consultation document issued in October 2010

Principles for the management of operational risk

- Principle 1: The board of directors should take the lead in establishing the “tone at the top” which promotes a strong risk management culture.
- Principle 2: Banks should develop, implement and maintain a Framework that is fully integrated into the bank’s overall risk management processes.
- Principle 3: The board of directors should establish, approve and periodically review the Framework.
- Principle 4: The board of directors should approve and review a risk appetite and tolerance statement¹⁰ for operational risk that articulates the nature, types, and levels of operational risk that the bank is willing to assume.
- Principle 5: Senior management should develop for approval by the board of directors a clear, effective and robust governance structure with well defined, transparent and consistent lines of responsibility

Principles for the management of operational risk (contd)

- Principle 6: Senior management should ensure the identification and assessment of the operational risk inherent in all material products, activities, processes and systems to ensure the inherent risks and incentives are well understood.
- Principle 7: Senior management should ensure that there is an approval process for all new products, activities, processes and systems that fully assesses operational risk.
- Principle 8: Senior management should implement a process to regularly monitor operational risk profiles and material exposures to losses.
- Principle 9: Banks should have a strong control environment that utilises: policies, processes and systems; appropriate internal controls; and appropriate risk mitigation and/or transfer strategies.
- Principle 10: Banks should have business resiliency and continuity plans in place to ensure an ability to operate on an ongoing basis and limit losses in the event of severe business disruption.
- Principle 11: A bank's public disclosures should allow market participants to assess its approach to operational risk management.

Capital cost of operational risk

Basel II recognises the impact of operational risk via pillar 2 add on.

For complex and diversified groups this can be a material amount.

Good risk management can bring this add on down.

There is a lot to be said for progressive conservatism

A look at some of the winners of the crisis suggests there is much to be said for progressive conservatism.

- HSBC
- Coventry
- Yorkshire
- Leeds
- CFS

For most of us a Mercedes is a better bet than a Ferrari



