IRM Operational Risk SIG MINUTES

Date:	26th March, 2009
Time:	17.30 – 19.00
Meeting location:	RBS offices Waterhouse Square, 138-142 Holborn, London

Attendees	
Mark Russell (RBS) Chair	Anna Nichioll (BNY Mellon)
Fagan Shah (Prudential)	Susan Young (Antares)
James Macrae (Metrorail)	James Cole (Cognitics 360)
Ian Fraser (IRM)	Sarah Job (BDO Stoy Hayward)
Anthony Epstein (BNY Mellon)	Julian Philips (JP Risk)
Filipe Araujo (Skandia)	Peter Cleavely (RBC)

No.	Notes
1	**Welcome and introduction** In welcoming members, the Chairman noted that the Operational Risk community continues to be rocked by the waves of cost cutting sweeping through industry, although it seemed that the SIG membership had not suffered casualties during the past month. The theme for the evening was '*Inherent risk assessment is more important than residual risk assessment',* arguments for and against being put by members.
2	**Agree minutes of previous meeting** The minutes from the meeting of 26 February 2009 were agreed with no change, but the Chairman left the window open for comments for a further week.
3	**Presentations for and against '*Inherent risk assessment is more important than residual risk assessment*"** Two SIG members each gave a five minute presentation, the first in favour of the motion, and the second against it. These talks set out theoretical positions to prompt debate and did not represent either personal or corporate opinions. The main points presented were as follows: <u>In favour of Inherent Risk assessment</u> • What does Inherent Risk Assessment actually mean? • You can see Inherent assessment as top-down and Residual assessment as bottom-up. Inherent assessment is about what could go wrong in the big picture. • Residual assessment is an incomplete view; the stuff we already know about, risk that has already been actioned and done with. • What is the benefit of Inherent Risk assessment? • I care about what could go wrong; the extreme blue-sky scenarios. • Senior management also needs to know that the risk process is working effectively and that the view of the risk profile is accurate in terns of inherent exposure. • Inherent Risk assessment is what lifts management above their recent experience and enables them to take pragmatic action to prevent 'road accidents' of types they haven't seen before. • Inherent Risk assessment is also the only way of recognising the value of our control environment. Inherent risk being the exposure the business would face if it had no controls in place, the difference between inherent and residual exposure is the value added by our controls. We can then see which controls add such significant value that we should monitor them closely, testing their effectiveness, and which controls are of

	marginal value and possibly cost more to operate than the potential loss they mitigate. • Management needs to understand the costs of wrapping controls around inherent risks to be able to decide where to make savings.
	<u>In favour of Residual Risk assessment</u> • You can't start with a view of Inherent Risk because your estimates of potential impact will be too high to have any practical relevance. • Most business people find Inherent Risk impossible to quantify because in the extreme case, any risk could bring a business to its knees, so the potential impact is inevitably close to infinite. • In crossing the road, the inherent risk is that you are knocked down and killed, but if you focussed on this, you would never go near a road. By applying controls (mainly looking and listening) you reduce the likelihood of having a problem to the point where you choose to ignore the inherent risk because your controls make it so unlikely that you implicitly consider it impossible. The fact that we have a zero appetite for being knocked down and killed doesn't mean that we will never go near to a road. • In setting appetite it is helpful to establish the potential range of impact and set appetite (or tolerance) against this range. The range will often, though, run from 0 at the low end to ∞ (infinity) at the top end of the inherent range. To set appetite you need to know what ∞ actually means for the risk you are considering. There was then a wide ranging discussion, the main points made were as follows: • It makes sense to see risk in terms of the amount of capital we could lose, and the amount we are prepared to lose is our appetite. We can then choose to spend more on controls to mitigate the exposure down further until it comes within our appetite. • You can't avoid starting from a view of potential and future risks, which is an inherent view. You will say to yourself: we're exposing ourselves to this set of risks, are we happy with this? We all think like this and this is an Inherent assessment. We must start with a blank sheet and identify the universe of risks. • The test of an inherent assessment is to remind yourself that any firm engaged in exactly the same type and scale of business activity, in the same location, would have the same inherent exposure. • Some firms start by assessing Residual risk and then suppose that all the controls are not working to set the Inherent exposure on this basis. Inherent risk is, after all, the level of exposure in the absence of controls. • One reason why it is difficult to come up with inherent exposure numbers that are robust is that your experience of possible losses is based on historical data, which may not be a good indicator of future levels of impact. • In some ways the regulatory capital number is irrelevant. What matters is the capital level that others who you want to borrow from will accept. In this environment you are likely to need something nearer to your inherent exposure, in capital, than in the past. • An organisation needs to stress the high impact, low frequency events to find the risks at the tail, developing scenarios to test these and come up with a realistic capital number. This may mean that you either need more capital, or that you need to discontinue specific business activities. • Rating inherent risk impact is difficult because of the subjectivity. I can be best to put each person 'in a darkened room' to come up with an individual view and then combine these individual views to reach a consensus opinion. In the recently publicised HBOS case it sounds as though there was no consensus. In summing up, the Chairman asked each person for something that they would take away from the discussion; these are a sample of the responses: • I look at inherent and at 'post-mitigation' exposure. If losses are at the Inherent level it shows that we are not even doing our day jobs. • The inherent exposure assessment can be vital as a sense-check on resource allocation.

	• Initial reactions to inherent assessment were not good but now business people see that it gives good results and they now find the process very interesting. • Senior management behaviour is key; if this is unhelpful; then everything falls on deaf ears.
4	**Topics and Speakers** The Chairman again asked for any fresh topics and speakers for 2009, and suggested, to general agreement, that the subject of the next few meetings could be ‘risk assessment’, divided into manageable chunks. April’s topic will be ‘Tolerance and Appetite are the same’. Two members have volunteered to put arguments for and against.
5	**Next meeting** 30 April 2009, 17.30 – 19.00, RBS offices Waterhouse Square, 138-142 Holborn, London.