

IRM Operational Risk SIG MINUTES

Date:	21 st May, 2009
Time:	17.30 – 19.00
Meeting location:	RBS offices Waterhouse Square, 138-142 Holborn, London

Attendees	
Mark Russell (RBS) Chair	Susan Young (Antares)
Ian Fraser (IRM)	Lisa White (Nationwide BS)
Lorraine Love (RB Canada)	Peter Phillpot (National Counties BS)
Jonathan Allen (TFL)	Sally.Suleman-Fereday (NHS Litigation)
Nick Spittle	Paul Grey (Co-op)
Ian Davitt	Ola Omoyele (TFL)

No.	Notes
1	<p>Welcome and introduction</p> <p>In welcoming members, the Chairman noted that the SIG now has a core attendance of 40 – 50 members who attend roughly every 3 months, and expressed the view that this is now a critical mass – allowing the SIG to move forward.</p> <p>In the current economic crisis, the Chairman noted that Operational Risk appears to be an easy target for cost challenges, with the Operational Risk toolset still evolving, lacking the formal authority of the other risk disciplines, and still working towards a common lexicon. The deliberate intent of operational risk managers embed their practices within the operational functions of the business, as an integral aspect of everyday business management may contribute to a lack of recognition / respect of operational risk as a specialism in its own right.</p> <p>The Chairman also reemphasised that the SIG runs under Chatham House rules, with open and frank discussion to be respected and not to be disclosed outside of this forum.</p> <p>The theme for the evening was ‘<i>Operational Risk Appetite and Operational Risk Tolerance – the same or different ?</i>’, arguments for and against being put by members.</p>
2	<p>Agree minutes of previous meeting</p> <p>The minutes of the previous meeting were agreed with the amendment that Jonathan Allen (TFL) should be shown as being in attendance.</p>
3	<p>Presentations for and against ‘<i>Operational Risk Appetite & Operational Risk Tolerance – the same or different?</i>’</p> <p>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.</p> <p>The main points presented were as follows:</p> <p><u>In favour of Operational Risk Appetite and Tolerance being different from each other</u></p> <ul style="list-style-type: none"> • Businesses exist for shareholder returns • Board of directors determine the level of risk for investment / capital returns • Appetite considered in light of risk and return, with risk not just being downside but representing opportunities • Risk appetite representing how much risk an organisation accepts for those risks that a firm deliberately takes (e.g. Insurance, Strategic, Market)

	<ul style="list-style-type: none"> • An example of this was represented by insurance risk, and in particular catastrophe risk exposures balanced with return in loss free years. • Risk tolerance representing deviations from risk appetite (e.g. Operational, Credit, Group, Legal & Regulatory). • An example of this was represented by driving a car, and the requirement to wear seatbelts – seatbelts are legally required, however, it has not been proved that they always save lives – people feel safer when wearing seat belts and may drive faster and hence cause more risk.
	<p><u>In favour of Operational Risk Appetite and Tolerance being the same</u></p> <ul style="list-style-type: none"> • Use of Appetite or Tolerance depends on the nature of the individual, and their propensity to take risk. • Examples of this were given as – Financial Director having no Operational Risk appetite but having a tolerance for a certain level of failures. In contract a Marketing manager may use the term appetite. The difference being in the individuals DNA. • The speaker proposed consequences (potentially unwanted) of using the two terms. Risk Appetite implying that it was OK to take risk up to and including the risk appetite, however, the use of the phrase tolerance implying that this is a maximum limit not to be reached / exceeded. • This suggested a trap for staff, operational risk managers, and business managers where the level of appetite for uncrystallised losses is significantly higher than the level of appetite for crystallised losses. e.g. when $\frac{3}{4}$ of risk tolerance is reached this could result in adverse consequences / action / termination – therefore appetite implies a false level of comfort that in reality senior management will not tolerate. • In specifying appetite / tolerance for Board, and then cascading this from the top table to roots – there should be no surprises in the level of risks taken within the firm. • Risk appetite needs to be carved up and aligned with delegated authority to be able to be managed to a certain level within individual business areas, and the aggregate risk profile must not exceed risk appetite. • The argument is that this is already difficult to achieve, with the use of one threshold, and that it is too difficult for the Board to comprehend, articulate, monitor and manage two parallel sets of threshold in relation to levels of risk. Therefore, whether the threshold refers to appetite or tolerance, there is only room for one. <p>There was then a wide ranging discussion, the main points made were as follows:</p> <ul style="list-style-type: none"> • It was agreed that there is a real challenge for senior management to align bottom up, and top down risk appetite / tolerance and risk profiles. • An example, provided by a member of the group, related to the difference between Ford and Toyota where both automated production, however Ford tolerated a 5% failure rate and Toyota tolerated a far lower failure rate, with corresponding objectives linked to personal measures, and success for the firm. • It was suggested that risk appetite may remain relatively constant, whereas tolerance may change on an ongoing basis, e.g. the PIA / FSA appetite for failure of financial services firms, versus government tolerance for failure of Northern Rock where the regulator allowed the business model that ultimately resulted in failure, however government didn't ultimately allow failure. • The UK model of regulation (lighter touch than in USA) to encourage business to the UK may have encouraged a higher risk tolerance. • The FSA, having deskilled many of their teams are in the process of upskilling and strengthening their teams to respond to the reduced tolerance for failure. • It was suggested that Internal Audit and Operational Risk work together to look at controls in relation project delivery, where controls are manual and not automated to educe project delivery costs. It was stated that controls could be better embedded and used to drive out efficiencies and control improvements. • It was also stated that in some instances controls exist, however, there is little understanding of the raison d'être for the controls and what risks the controls exist to

	<p>mitigate.</p> <ul style="list-style-type: none"> • Whether risk appetite should start from a zero appetite and then increase based on known weaknesses in controls as opposed to top down statements of appetite.
4	<p>Topics and Speakers</p> <p>The Chairman again asked for any fresh topics and speakers, with general agreement that the subject of the next few meetings will be around 'risk assessment', divided into manageable chunks. Options for future meetings are Time based v business change based (e.g. should risk assessments be 3 monthly, 6 monthly etc, or be triggered when business objectives, processes or systems change); or 1st and 2nd line of defence – should risk assessments be performed within business lines or by risk professionals in the risk function.</p> <p>Potential suggestion for July is around the deskilling of processes within firms and resultant outcomes that staff don't understand underlying controls, risks and rationales.</p> <p>Members are asked to e-mail thoughts to the Chairman, and any volunteers to speak on either side of the argument are asked to discuss and agree alternative speaker from the attendees.</p>
5	<p>Next meeting</p> <p>25 June 2009, 17.30 – 19.00, RBS offices Waterhouse Square, 138-142 Holborn, London.</p>