

## IRM Operational Risk SIG MINUTES

<b>Date:</b>	25 <sup>th</sup> September, 2008
<b>Time:</b>	17.30 – 19.00
<b>Meeting location:</b>	RBS offices Waterhouse Square, 138-142 Holborn, London

<b>Attendees</b>	
Mark Russell (RBS) Chair and Minutes	Julian Philips (JP Risk)
Anne Stenning (Environment Agency)	Susan Young (Zurich)
Ian Fraser (IRM)	Tom Bodkin (Job Centre Plus)
Jeremy Philpott (LloydsTSB)	

<b>No.</b>	<b>Notes</b>
<b>1</b>	<p><b>Welcome and introduction</b></p> <p>In welcoming members to the fourth meeting of the SIG, the Chairman noted that continued pressure in the financial services industry was taking its toll on the ability of members to leave work in time for SIG meetings; 50% of this meeting's confirmed attendees had been unable to come.</p> <p>The theme of the meeting was 'risk appetite and tolerance' for and against.</p> <p>With this topic, it seemed that good arguments could be put forward on both sides.</p>
<b>2</b>	<p><b>Agree minutes of previous meeting</b></p> <p>The minutes from the meeting of 28<sup>th</sup> August were agreed without changes.</p>
<b>3</b>	<p><b>Presentations for and against risk appetite and tolerance</b></p> <p>Two SIG members each gave a ten minute presentation one in favour of articulating and using defined levels of risk appetite and tolerance, the other against. 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 using risk appetite and tolerance</u></p> <ul style="list-style-type: none"> <li>• It is achievable, despite the challenges, to get a management team (from the top executive downwards) to sign up to and act within a defined appetite and tolerance.</li> <li>• The alternative is that people throughout the firm have to work in a vacuum, without defined boundaries. If you don't say what level of risk is OK, the naturally risk-averse will avoid risk and the naturally risk-taking will take risk; there will be no coherence, no consistency. If risk-taking is rewarded, as is often the case, then exposure will spiral until the consequential losses are seen as unacceptable.</li> <li>• But Operational Risk (OR) isn't a single type of exposure, and there is great advantage in setting different appetite levels for different types of OR.</li> <li>• Appetite is the target level of risk the firm wants, tolerance is the maximum level of risk it will accept. By defining both, people know when to escalate (over appetite) and when</li> </ul>

they must not take on further risk (tolerance).

- This clarity encourages the risk-averse to take more risk, making them more likely to seize opportunities.
- The key to success is that the appetite and tolerance levels have executive authority behind them, and that this does not crumble when losses within appetite crystallise. It is humorous folk wisdom that the appetite for un-crystallised loss is much higher than the appetite for crystallised loss.

#### Against using risk appetite and tolerance

- On p28 of the September copy of Strategic Risk Magazine, the results of a survey into the new landscape of risk management show that companies are struggling with the articulation of meaningful risk appetite and integrating this into their culture.
- Most organisations have an innate idea of how much risk they will accept, but this is not to say that this is documented.
- Trying to formalise appetite can be a waste of good risk management time:
  - Appetites constantly change in the face of changes in the commercial environment
  - Your own firm's loss experience changes its appetite (once bitten, twice shy).
  - Each executive's risk appetite is different
  - Each dimension of impact (financial, regulatory, reputational) has a different appetite against it, and this makes appetite setting overly complex. Unlike Credit Risk, OR appetite cannot be reduced to a single dimension.
- A more productive use of risk management time is to consider the most severe potential events and build defence against them.
- Setting appetite distracts from opportunity. People can be distracted by focusing on appetite, like a driver in a 30 mile per hour speed trap sticking at 29 miles per hour but hitting a pedestrian.
- In some cultures groups of staff concentrate energies on trying to break the appetite set.
- Appetite is the 'Emperor's new clothes' of risk management.
- The internal audit mentality can drive towards setting an appetite target against each main risk; the level of risk you want to carry. But it doesn't make sense to treat this as a set of fixed levels because appetite is dynamic.
- Even setting boundaries to tolerance is problematic because you come to very different views going top-down or bottom-up. Accepting that people have a need to refer to a level of appetite, it is very difficult to find an approach that is effective at different levels of granularity.
- Although it may be possible to set out a view of appetite, it is very difficult to get senior management to commit to this.
- In many organisations, the centre of gravity has been moving towards Head Office, and local management looks there for the setting of appetite.
- We could sensibly limit appetite to key exposures:
  - How many copies of your data do you want?
  - How many data security breaches do you want each year?
- Setting appetite requires that you have a good understanding of objectives; appetite must be closely aligned to objectives.
- Unrealistic appetite statements are as unproductive as unrealistic business targets.

	<p>There was then a wide-ranging debate on the pros and cons of the arguments offered. Some points raised were:</p> <ul style="list-style-type: none"> <li>• Appetite can be presented as a zone between areas of extreme upside and downside that we are equally uncomfortable with. Attention is then focussed on areas of performance that show clear blue water from the pack; this is where the exposure often is.</li> <li>• When the resource for mitigating risk is limited then the articulation of appetite is an effective start to directing resource to areas where it is most needed, being the furthest outside appetite.</li> <li>• It can be best to set appetite at the macro level without breaking it down to the micro level; this is enough to drive the thought process and the culture.</li> <li>• Appetite is vital in enabling the business to consider whether its residual risks are acceptable. The challenge is to recognise both the financial and reputational dimensions; you can't reduce everything to a financial impact. Some firms use three impact dimensions: Customer reputation, Regulatory and other Reputational, and Financial.</li> <li>• Sometimes it isn't politically correct to express an appetite e.g. an appetite for breaches of customer data security. But to manage any risk to zero tolerance you have to get out of whatever the business is that exposes you; so in reality there is an implicit level of tolerance even if the business is unwilling to articulate it.</li> <li>• Without a top-down articulation of appetite and tolerance there can be no effective governance of risk. The failure to articulate appetite is a failure of management. Credit and Market risk could not be managed without the setting of top-down limits, Operational risk is no different.</li> <li>• The joke "<i>The appetite for uncrystallised risk is much higher than the appetite for crystallised risk</i>" draws out the hypocrisy of a manager who says that his/her appetite is for £1m of loss in a year and then finds it unacceptable when there is a first loss of £500k nine months into the year.</li> <li>• In reality, management has two sets of appetite: <ul style="list-style-type: none"> <li>○ The appetite for cumulative annual loss, and</li> <li>○ The appetite for a maximum size of individual events.</li> </ul> </li> </ul>
4	<p><b>Topic for October</b></p> <p>Two SIG members agreed to present the arguments for 'top-down' as against 'bottom-up'.</p> <p>It was agreed that the SIG would start to consider the question of its definition of OR in the October meeting. This is expected to prove a challenge because much of the financial services industry has a definition imposed by regulation, while other sectors have a free hand.</p> <p>FSA Handbook definition:</p> <p><i>Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.</i></p>
6	<p><b>AOB</b></p> <p>Post-Xmas SIG meal 27<sup>th</sup> January: please contact Jeremy Philpott to reserve a place.</p>
7	<p><b>Next meeting</b></p> <p>30<sup>th</sup> October 2008, 17.30 – 19.00, RBS offices Waterhouse Square, 138-142 Holborn, London.</p>