

Implementing an Operational Risk Framework

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Agenda – what I’m going to cover

As advertised, three dimensions:

1. Practical problems with implementing an operational risk framework
2. How to embed the framework in an organisation
3. How to address the cultural challenges

Signposting

1. Scope - what I’m going to include - and what I’m not
2. Setting the scene – some thoughts on:
 - 2.1 Operational risk
 - 2.2 Framework
 - 2.3 Embedding
 - 2.4 Culture
3. Problems and some suggested solutions

1. Scope

I'm NOT going to cover:

- Framework design and development
- Problems relating to:
 - Consistent categorisation
 - Data and MI
 - Independent review

I AM going to cover:

- Framework implementation
- Problems relating to:
 - Senior management buy-in
 - Business line responsibilities
 - Communication

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2.1 Setting the scene – operational risk

Definition:

"The risk of loss resulting from inadequate or failed internal processes people and systems or from external events" *Basel II Accord and FSA Handbook*

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Causes of loss

- Event: "Inadequate or failed processes" (and/or controls)
 - Causes: Design and/or execution
 - Root cause: People
- Event: "People" e.g. employment practices and workplace safety
 - Causes: Design and/or execution
 - Root cause: People
- Event: "Systems"
 - Causes: Design, development, maintenance, support, data input etc
 - Root cause: People
- Event: "External events"
 - Causes: Preparation and/or response
 - Root cause: People

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An alternative definition?

Operational risk is the risk of loss caused by people:

- Internally or externally
- Accidentally or deliberately

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2.2 Setting the scene - “framework”

STRATEGY: objectives and approach; risk appetite; categorisation; culture and language
GOVERNANCE/ORGANISATION: departments/committees; reporting lines; roles/responsibilities; skills/resources

RISK ASSESSMENT
Risks & controls
Identification
Analysis
Evaluation

RISK MONITORING
KPIs
KRIs
Control indicators
Thresholds

LOSS TRACKING
Incidents
Near misses

Measurement, reporting and management/mitigation

INFRASTRUCTURE: tools; systems; training & development; communication & awareness

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2.3 Setting the scene - “embedding”

- Why should a business embed its operational risk framework?
- What does embedding involve?
- What does successful embedding look like?

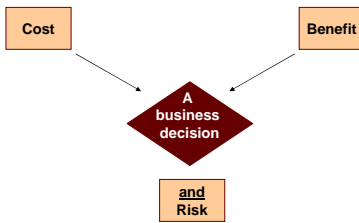
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Why embed operational risk?

- The definition and scope of operational risk is premised on loss.
- Losses reduce profitability.
- Reduced profitability is undesirable / unacceptable.
- Oh, and by the way, the industry's regulators demand that operational risk is embedded....

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What does it involve?



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What does success look like?

When embedded, the management of operational risk is:

- Integrated
- Informed
- Intuitive

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2.4 Setting the scene - culture

Definition:

“A firm’s risk culture encompasses the general awareness, attitude and behaviour of its employees and appointed representatives to risk and the management of risk within the organisation.” *FSA Handbook SYSC 3A.5.1*

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Culture: “risk appetite”



Risk aversion

Risk tolerance

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Culture: response to change

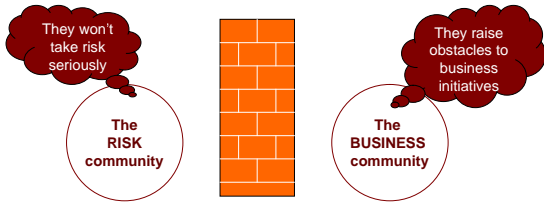
Benign distraction	Silent protest	Revenge
Thinking about future	Going slow	Poor service to customers
'Dropping the ball'	Taking longer lunches	Corruption of information
Seeking other jobs	Not co-operating	Fraud
Surfing the Internet	'Jumping ship'	Theft
LOSS OF FOCUS ON BAU	MINOR DISRUPTION TO BAU	MAJOR DISRUPTION TO BAU

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3. Problems and solutions - overview

- 3.1 Organisation
- 3.2 Leadership
- 3.3 Communication
- 3.4 Incentives

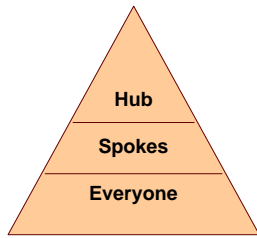
3.1 Organisation: a problem



3.1 Organisation: a suggestion



3.1 Organisation: how it might look



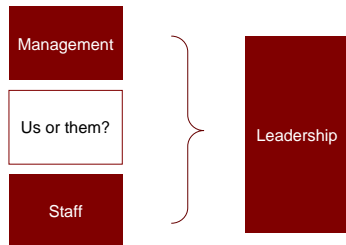
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3.1 Organisation: FSA feedback

“At a few firms, the OR policy stated that responsibility for managing operational risk lay with business line management. However, there was no further clarification on how actual individual responsibilities...differed between different areas.” *FSA Feedback from a thematic review*

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3.2 Leadership: a definition



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3.2 Leadership: some problems

1. "Do as I say"
2. Blame culture
3. Someone else is responsible
4. The tick box approach

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3.2 Leadership: some suggestions

- Be clear about ownership, roles and responsibilities
- Seek senior management buy-in
- Demonstrate the value added

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3.2 Leadership: FSA feedback

"We noted that one of the challenges faced by firms implementing an OR framework was gaining senior management buy-in." *FSA Feedback from a thematic review*

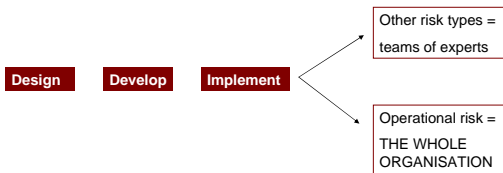
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3.3 Communication: a problem

Q. What makes operational risk different?

3.3 Communication: a problem

Q. What makes operational risk different?
A. The target audience



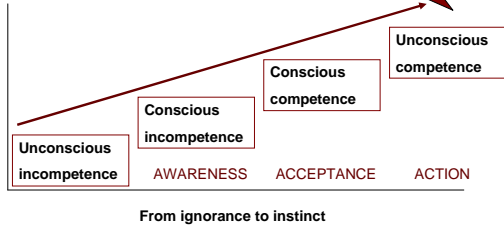
3.3 Communication: what the regulator says...

"A firm should ensure that all its employees are capable of performing and aware of their operational risk management responsibilities." *FSA SYSC 3A.6.3*

"A firm's ...risk management systems should be effectively communicated so that all employees and contractors understand and adhere to the procedures related to their own responsibilities." *FSA PRU 1.4.23*

3.3 Communication

"The most effective countermeasure to operational risk"



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3.3 Communication: some suggestions

- Have a communication strategy
- Focus on getting it right
- Provide good information

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3.3 Communication: FSA feedback

"A significant omission at most firms was a lack of guidance to line management..." *FSA Feedback from a thematic review*

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3.4 Incentives: what the regulator says...

"A firm should control its operational risks, as appropriate, through activities for the avoidance, transfer, prevention or reduction of the likelihood of occurrence or potential impact of an operational exposure. This might include, but is not limited to, consideration of ... adjusting a firm's culture and creating appropriate incentives to facilitate the implementation of its risk control strategy." *FSA Handbook PRU 6.1.23*

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3.4 Incentives: some problems

- Lack of awareness / understanding
- Conflict of interests:
 - Increasing sales
 - Reducing costs

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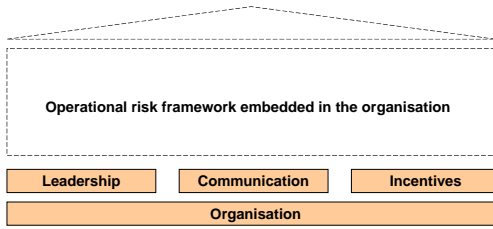
3.4 Incentives: some suggestions

Encourage good risk behaviour and discourage poor risk behaviour through:

- Recognition
- Transfer charging
- Performance development

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Summary – the foundation and building blocks



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Conclusion

- The practical problems in implementing an operational risk framework are largely associated with people
- Addressing organisational and cultural challenges can help to mitigate the problems

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And finally...

- When you think of a great question later...
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