The Point

An *Outlook* Financial Services Publication

Mastering Bank Mechanics

Making operational risk management a value driver

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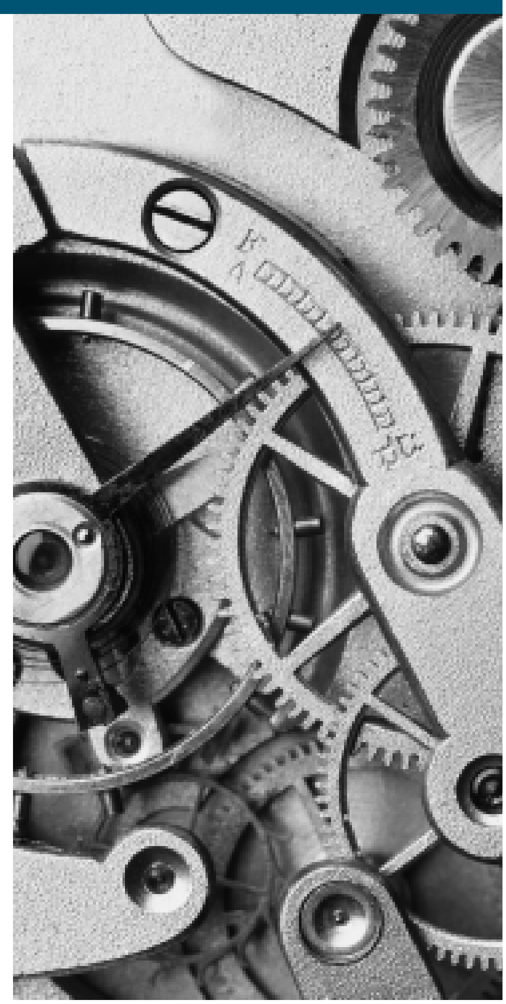

For the majority of banks around the world, the New Basel Capital Accord (Basel II) represents the need to implement more stringent credit-risk standards. That is what is drawing most of their attention and investment. But lurking in the long shadows cast by the Accord's updated capital requirements is the largely unwanted mandate for banks to address institution-wide operational risk.

Unfortunately, because Basel II has made operational risk management a compliance issue, too many senior executives are approaching it that way, taking the basic bare-minimum approach to meeting the tighter Basel II criteria. Instead, what they should be doing is treating the mandate to upgrade their operational risk capabilities as the strategic opportunity it is.

The question of whether shareholder value can be derived from operational risk management is certainly one that resonates in the minds of bankers everywhere, yet banks first developed operational risk management programs specifically to build that value. The inclusion of operational risk in Basel II came later. So, while the fact that so many banks are taking a rather near-sighted route to Basel II compliance is understandable to an extent, the banks that identify and invest in operational risk as a business opportunity can reap rewards those purely compliance-driven institutions will never realize.

The cost of compliance

Although the cost of a sophisticated Basel II program will vary, it's reasonable to assume that a large European bank adopting the advanced Basel II approaches for credit and operational risk compliance should plan to spend €100 million to €150 million over a three-year period. Approximately 15% - 25% of the expenditure relates to operational risk. The biggest global banks will likely need to spend even more.

In addition to the implementation costs, there will be a significant increase in the ongoing costs of operational risk management within banks that decide to approach it as a business opportunity.

What makes Basel II so expensive? In the first place, scale. Basel II cuts across businesses and functions, much as the Y2K initiatives did in the late 1990s. Second, compliance will require banks to implement applications with new functionality, such as credit rating models and operational risk assessment tools. Third, data must be sourced from multiple systems, which necessitates processing, cleansing and storage. Finally, embedding risk management into a bank often demands that the bank change its business processes.

Gaining value beyond Basel II

The good news is that advanced operational risk management can deliver value above and apart from Basel II mandates. The banking industry developed operational risk management during the 1990s for two very practical reasons: to provide early warning of operational risk issues to avoid unexpected losses; and to create a more level "risk-based" playing field for assessing performance across disparate businesses.

Intuitively, it seems apparent that these advantages would have clear economic value, but demonstrating and quantifying that value is difficult for several reasons.

- **No "before" picture** Loss-data reporting is usually inconsistent and patchy prior to implementing an operational risk management framework. There is no clear "before" picture to allow a neat "before and after" comparison. Banks know how well they have done after implementing a system, but can't gauge their improvement because they don't have data from the starting point.

- **Cultural resistance** Operational risk management requires employees to identify risk issues and report "near misses". For many organizations, this approach is counter-cultural because line managers prefer to resolve problems quietly, rather than bring them to the attention of higher-ups.

- **History** The losses suffered by banks today often result from risks taken years or even decades ago. For example, U.K. banks/bancassurers are now paying compensation to retail customers for endowment polices and pensions that were mis-sold during the 1980s and 1990s.

- **Low-frequency, high-impact losses** Banks that developed loss-distribution risk models during the 1990s quickly identified that the primary drivers of operational risk capital for a business were the "tail events", i.e., large, unexpected loss events suffered by third-party banks. Consequently, improvements in the general control environment by line managers had limited impact on their businesses' operational risk capital.

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- **Organizational structure** Operational risk management functions are not responsible for managing the functions that contribute to a bank's risk profile, such as legal or human resources, or for making the tactical and strategic decisions that might alter that profile. Therefore, it is difficult for the operational risk function to claim credit for, or demonstrate its contribution to, improvements in the risk profile.

Keys to making risk pay

The role of the operational risk function is to determine management's risk tolerance, establish the processes for tracking the actual risk profile against those tolerances, report any breaches and monitor resolution. Banks can derive value from these activities in three ways: 1) cost reduction—cutting losses from operational failures and improving process efficiencies; 2) capital efficiency—reducing the operational risk capital requirement; and 3) revenue enhancement—using the advanced operational risk capabilities as a competitive advantage.

In order to understand how banks can do this, it is important to recognize the highly diverse nature of operational risk. The Basel Committee Quantitative Impact Study 3 data (QIS 3) underscored what the leading banks had already discovered: a fraction of events generates the majority of losses and drives the value of operational risk capital. However, the significance of the high-frequency, low-impact losses is typically underestimated because of the difficulty in determining the indirect costs of the staff and management time required to resolve these issues. And, of course, the QIS 3 data omitted losses under €10,000.

The implications, then, are quite straight-forward. In order to reduce costs, banks need to focus on the high-frequency, low-impact losses. In order to improve capital efficiency, banks need to focus on the low-frequency, high-impact losses.

Failure to manage operational risk almost inevitably drives costs up. Simply put, it takes more time to fix a faulty transaction or deal with a customer complaint than it does to do the job right the first time. The relationship between operational risk management and sound business practice is subtle but unmistakable. Banks that have implemented efficiency programs such as Six Sigma are discovering a significant overlap between the data required by those programs and the data required to comply with Basel II.

Prior to the publication of Basel II, the leading banks in operational risk management were collecting data on

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Basel II Implementation in Perspective

Component	%	Description
Strategic Direction	2	Impact of Basel II on the individual portfolios in relation to the capital requirement changes and likely market reactions
Credit Risk Measurement	10	Development of compliant credit risk-taking models, including PD, LGD and EAD and segmented retail portfolios
Policies and Procedures	3	Development of documented compliant policies and procedures for all levels of risk management
Organization Design	2	Establishing organizational responsibilities to appropriate independence, review and validation functions
Systems Integration	55	Integrating changes to existing systems and interfaces and developing new data storage, calculation and reporting functionality
Operational Risk	10	Establishing an operational risk framework, including loss-event metrics, causal analysis and capital calculation
Pillar II: Economic Capital	5	Integrating regulatory risk models with other quantified risk metrics and balance sheet management
Pillar III: Reporting	3	Integrating capital and risk reporting with financial and regulatory reporting
Program Management	10	Management and coordination of the program across diverse business lines and geographies

Note: % represents the estimated man-day implementation effort for a typical bank across various areas of capability
Source: Accenture

the specific causes of errors. This data allowed them to develop business cases for expenditures to provide early warning of problems, improve applications and re-engineer existing processes. In fact, while many banks were still struggling to calculate transaction costs, some banks had already measured the relative cost of normal transactions and "failed" transactions. Clearly, there is a significant opportunity for banks to improve processing efficiency and drive out tangible costs by harnessing the operational risk data required by the Accord.

Moves to reduce exposure

Regrettably, low-frequency, high-impact events are not as rare as they should be. Recent sources for such major losses run the gamut from unchecked rogue traders and gross sales misrepresentation to accounting fraud and terrorist attacks.

Recurrent low-frequency, high-impact losses include:

- Rogue trader losses, such as Nick Leeson, Barings (1995), Yasuo Hamanaka, Sumitomo Corp. (1996), John Rusnak, Allfirst, a subsidiary of Allied Irish Bank (2002), and most recently the foreign exchange trading scandal that rocked National Australia Bank (2004).

- Mis-selling of financial products; such as the examples in the U.K. of banks that have suffered from mis-selling of personal pensions, endowment policies, and, more recently, split-capital investment trusts.

- Terrorist attacks on financial centers, including the Baltic Exchange (1992), NatWest Tower (1993), Canary Wharf (1996) and the World Trade Center (2001).

Although operational risk management can't completely prevent such occurrences, it can reduce their likelihood and the losses they trigger. Banks can use a range of safeguards to reduce their exposure, including:

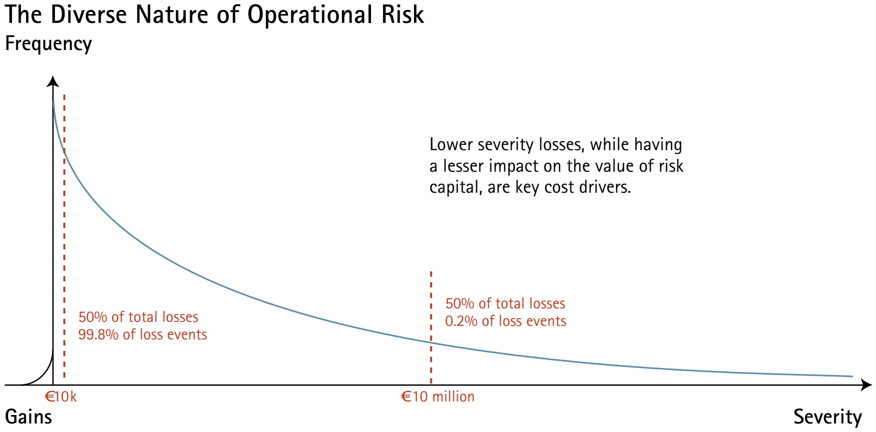
- **Insurance** Some banks have undertaken risk assessment exercises and scenario analysis as part of their operational risk programs. The analysis may suggest revisiting the insurance portfolio, with an eye toward coverage levels, retained exposure and policy cost.

- **Offshoring** In addition to cost benefits, offshoring offers advantages for managing operational risk. Among other things, it can diversify a bank's portfolio of locations, thereby reducing vulnerability to business interruption.

- **Outsourcing** The Basel Committee is clear that outsourcing can lower an institution's risk profile by providing enhanced capabilities and scale, transferring processes to others with greater expertise and pricing expected losses into the contract (thereby excluding them from a bank's capital calculation).

Operational risk management can also help drive revenue growth, especially in the brokerage, asset management and custodial services areas. Banks can

The Diverse Nature of Operational Risk



Source: Basel Committee, Quantitative Impact Study 3

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leverage their superior operational risk capabilities in customer acquisition and retention efforts, and their advanced understanding of, and framework for, risk can enhance pricing.

Model objectives and execution

Operational risk management was developed by the banking industry because it was perceived to add value. But given its inclusion in Basel II and the compliance mentality that has engendered among many banks, realizing the potential value of operational risk management must begin with a solid business case, top-level executive commitment, and sufficient, appropriately skilled resources.

From the beginning, management must address the operating model, not only to allocate projects, systems and data responsibility, but also to avoid political issues. It may be necessary to manage the relationship between operational risk and various other initiatives, such as Prudential Source Book, IAS and Sarbanes-Oxley. The technology plan should depend on the business case, and offer a clear five-year plan of what systems model the organization will have. Sound words of advice on this front include "buy, don't build" and that data modelling is key so "start early; stay late."

Experience suggests that employee awareness of operational risk is often too low to support an effective implementation of an appropriate and effective risk framework. In turn, implementations suffer when staffers reduce the time that they commit to the risk program. At times, this scaling back results from an inability to perceive the relevance and value of the operational risk management activity. It may seem to be little more than "filling out forms".

In some cases, as an unintended consequence of other bank practices, staff may falsify operational risk management information. This is a particular problem when employees who report control weaknesses in their processes or near-misses are unfairly treated, and when internal auditors use the contents of operational risk reports to justify adverse audit ratings.

Banks can encourage compliance in four ways:

- By disseminating emerging best practices and common issues so that employees understand the benefits
- By providing specific operational risk management training
- By linking appraisals and bonuses to specific operational risk management objectives
- By excluding operational risk issues already identified by staff from internal audit reports

Other less obvious measures can also help. For example, banks can tailor operational risk management processes to individual businesses so that the tools are relevant to the staff. They can also automate the operational risk management processes and remove overlaps with other functions in order to reduce the administrative burden. Finally, they can incorporate the results of self-assessments in the monthly management reports.

Operational risk management is a regulatory requirement, but it can be much more. Its inclusion in Basel II is a significant opportunity for banks to transcend mere regulatory compliance and reach for a higher level of performance. By pursuing the most advanced governance and system structure to optimize operational risk management in lieu of the most basic approach, forward-thinking chief executives can position their organizations for high performance well beyond the proposed regulatory imperatives. Those banks that decide to make the investment to establish a fully integrated operational risk management framework are the most likely to wear the competitive glass slipper, gaining a marketable leg up on their peers by unlocking unrealized value, lowering overall costs and heightening competitive differentiation for their institutions. Those that choose to forgo it may well turn into pumpkins.