Operational Risk: The Management Perspective

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Abstract: ‘Operational Risk’ (OpRisk), interpreted in the context of Basel II as ‘the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events’, introduces a challenge to financial services providers and institutions who have to date predominantly controlled their organization’s exposure to market and credit risk. It is no surprise that approaches chosen and methods employed are often dominated by the needs of corporate controlling, accounting and regulatory reporting functions. This observation raises no immediate concerns, however; a lack of proactive cooperation from risk management counterparts can render controlling-driven OpRisk initiatives inefficient and ineffective over time. Moreover, to portray a worst-case evolution, attempting to address Basel II’s OpRisk by means of introducing another set of independent software tools into an already complex IT infrastructure; generating yet another pool of practically irreconcilable data originating from a mix of objective measurements and individual subjective assessments of uncertain quality; and employing practically incompatible analysis methods may actually raise an organization’s exposure to OpRisk, hence defeating the objective.

Beyond reactively addressing stakeholders’ and managers’ requirements appropriately implemented OpRisk management infrastructure, process and people investments can be business enablers – turning risk management into an opportunity and addressing the requirements of Advanced Measurement Approaches (AMA) as a desirable side-effect. Early-mover financial services providers and a larger number of industrial organizations have in these efforts demonstrably generated net value. This article attempts to outline a generic roadmap for organizations who have in the past placed little or no emphasis on the management aspects of OpRisk – allowing the early introduction of those evolutionary steps known to generate considerable value quickly; highlighting some appropriate choices at policy level; and building on practical lessons learnt in managing typical hurdles throughout the implementation of suitable OpRisk management systems and processes.

Keywords: Operational Risk, Risk Management Strategy, Cost Effectiveness, Value Generation, Advanced Measurement Approach
1. Introduction

‘Operational Risk’ (OpRisk), interpreted in the context of the Bank for International Settlements’ various documents on Basel II as ‘the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events’, introduces a challenge to financial services providers (FSPs) and institutions who have to date predominantly controlled their organization’s exposure to market- & credit risk. While a fully automated implementation of minimum capital requirement calculations by business line, certain computer models and some newly designed regulatory reports may be a challenge, the overall topic ‘OpRisk’ is not exactly new. A variety of internal and regulatory policy driven approaches to managing OpRisk aspects can be found in all organizations affected by Basel II.

What really is new for FSPs will be the level of transparency and integration required to address so-called ‘Advanced Measurement Approaches’ (AMA), and the intensity and the process oriented focus to be expected in future reviews and audits performed by regulating authorities.

Of course, considering how most FSPs have structured their business operations, many affected parties will attempt to develop and implement IT solutions allowing them to run their OpRisk controlling and reporting as a more or less fully automated additional reporting feature. Attempting to solve the overall problem by means of designing yet another ‘one-size-fits-all’ IT solution may not yield the desired results, though. Introducing another set of independent software tools into an already complex IT infrastructure; generating yet another pool of practically irreconcilable data originating from a mix of objective measurements and individual subjective assessments of uncertain quality; and employing practically incompatible analysis methods from a portfolio vs. a system and process oriented focus; may actually raise an organization’s exposure to OpRisk, hence in some regards defeating the objective and raising costs. Furthermore, a variety of operational and cultural hurdles must be taken in order to create an environment compatible with the new levels of transparency – which in turn imply hazards to the overall success of the exercise and again raise the organization’s exposure to OpRisk.

This article attempts to demonstrate that these typical approaches are not the best choice an organization can make, even over the short term. Instead, this article outlines a generic roadmap for organizations who have in the past placed little or no emphasis on the management aspects of OpRisk – allowing the early introduction of those evolutionary steps known to generate considerable value quickly; highlighting some appropriate choices at policy level; and building on practical lessons learnt in managing typical hurdles throughout the implementation of suitable OpRisk management systems and processes. To set the stage this article initially highlights common approaches and likely pitfalls in what organizations will likely need to address to become ‘AMA compliant’, followed by a discussion of desirable side-effects in OpRisk management, and then followed by a framework to analyze value generation potentials and set strategic or tactical priorities.