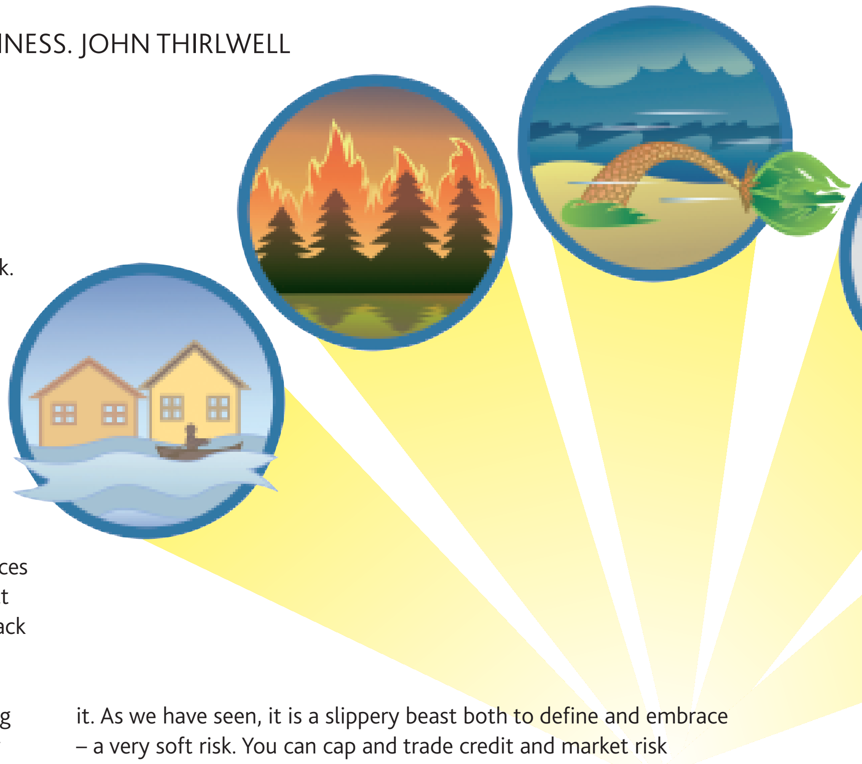
Many headed hydra

OPERATIONAL RISK IS IN EVERY PART OF YOUR BUSINESS. JOHN THIRLWELL ON WHY IT MATTERS AND HOW TO MANAGE IT.



First we should understand what we mean by operational risk. Operational risks are incurred as soon as a business opens its doors – risks such as fire, flood, terrorism or theft. It is a broad church, which began as a discipline some years ago in the 'safety critical' industries, such as energy, space, nuclear, defence and aviation, where mistakes can have catastrophic consequences in terms of human life.

In the financial services it emerged as a discipline during the mid-1990's and became part of the new bank capital rules, Basel II, which were finally implemented from 2008. Banks and their regulators had noticed that for some years threats to financial services activity had come not from poor credit decisions, but from conduct such as unauthorised trading (Sumitomo and Barings), a reckless lack of controls (LTCM), incompetent strategy (Metallgesellschaft) or technological threats such as the Millennium Bug.

In Basel II, operational risk was defined as 'The risk of loss arising from inadequate or failed internal processes, people or systems, or from external events'. This statement makes the important point that operational risk is not just confined to internal operations or processes, but includes all those problems which arise from employees' frailties and failures, as well as exposure to external events, whether natural disasters such as Hurricane Katrina or Icelandic volcanic ash, or man-made ones, such as 9/11 or deepwater oil rigs or a combination of the two such as the SARS near-pandemic.

It includes strategic risk and the management of reputational risk, almost invariably the result of failures of operational risk management, as well as supply chain management, project management and the management of outsourcing and other procurement contracts. It is present in all risk 'silos' – which makes it difficult to identify in its own right. Operational risk pervades everything firms do and, unlike other risk types, is the daily responsibility of all employees.

AT THE HEART As such, it embraces the risk culture of an organisation and so can be said to have been at the heart of the financial crisis. Not so much a failure of operational risk management in itself, as a failure to apply it intelligently – or at all.

The Basel definition was a definition for capital assessment purposes. And capital is measured in currency. That had the unfortunate effect of persuading many banks to spend their time trying to measure operational risk to extraordinary levels of confidence – up to one in 1000 chances or beyond – rather than to concentrate on managing it. As we have seen, it is a slippery beast both to define and embrace – a very soft risk. You can cap and trade credit and market risk exposures, but you can't cap or trade exposure to operational risk.

Banks (and their regulators) believed that gathering their operational risk event data, would enable them to quantitatively to assess their future capital requirements. They forgot two things: first, that in the chain of cause-event-effect the key for operational risk assessment and management is not events but their causes; and secondly, 'stuff happens'. Operational risk management is hugely about unknowns, including both external events and those caused by people. Money, in the form of capital, is a poor proxy for both bombs and people.

Any major event will inevitably lead to a change in a firm's internal risk environment. When Alfred von Hayek accepted his Nobel Prize in 1974, he made the memorable observation that economics was not a physical or mathematical science, but a social science. Similarly, if operational risk is a science at all, it is a social science, and those managing it should humbly accept their limitations in quantifying it.

A FRAMEWORK FOR MANAGEMENT But just because it is difficult to measure, does not mean it is so difficult to manage. First, of course, there needs to be proper governance. The Walker Review of the financial crisis emphasised the importance of good risk governance. In operational risk management terms, that means elevating risk management to a core competence and responsibility of the board, so that risk is fully considered in all major decisions. It also means the company has clear strategy and objectives, because these provide the context for its risk appetites and help set the tone for its risk culture.

While the tone will be set from the top, the important thing with operational risk, which involves every employee, is that there is a satisfactory 'tune in the middle'. That will come from everybody being clear about their risk roles and responsibilities and through open communication and reporting up and down the firm.

With proper governance in place, the tools within the operational risk management framework can then be deployed: gathering and analysing operational risk losses, 'near misses' and gains (because there should, in a trading room for instance, be as many operational risk gains as losses), applying risk and control assessments to the likelihood and impact of risks identified by the firm, monitoring risk and control indicators, analysing scenarios and modelling operational risk data.

BENEFITS OF GETTING THE FRAMEWORK RIGHT It can be difficult for operational risk managers to demonstrate their value so operational risk is not seen, in common with other risk management activities, as yet another obstacle to doing business. It is not a discrete risk in its own right and its management is rooted in common sense – 'what we do every day' as we make sure that controls are working and that we cope with unforeseen problems.

The key benefit of operational risk management is informed decision-making. Better informed decisions are likely to be better altogether. Good operational risk management can also help instill a culture of continuous improvement and business optimisation, including Six Sigma and Lean. But most importantly, the techniques of operational risk improve the bottom line – the focus of management's attention. All firms probably perform risk and control assessments on the risks identified in the risk register, first on the basis that the related controls fail (the gross risk) or work (the net risk). The process enables them to identify risk hotspots and control bottlenecks quickly. Too often controls and costs remain in place which are not cost-efficient. Used well, risk and control assessments can ensure resource is moved to where it is needed.

MOST IMPORTANTLY, THE TECHNIQUES OF OPERATIONAL RISK IMPROVE THE BOTTOM LINE.

Learning from previous problems is a fundamental part of operational risk event analysis. It is tempting to see loss event data primarily as a basis for modelling. How far the past is a good guide to the future is especially arguable in operational risk. The real value of event data, including major events outside the firm, is to point to the causes of an event. This analysis enables a firm to protect itself from future losses.

LOOKING FOR TRENDS Future losses will more likely be flagged through risk and control indicators which enable a firm to identify trends in its risk and control environment quickly. Indicators also enable firms to monitor their risks against agreed risk appetites. Again that means scarce resource can be targeted where the business will benefit most.

Another important element of the management framework is the use of scenarios to consider and model extreme, but plausible, outcomes for the firm. Scenario analysis enables firms to assess the costs of events, or more properly a multiplicity of events. It also sheds light on the causal relationship and sensitivities between risks and controls and provides a way to see how a firm may look in the future.

Beyond the framework, operational risk management includes business continuity planning, insurance buying and managing third party procurement arrangements. Good business continuity pays for itself many times over. The 9/11 tragedy would have been far more financially catastrophic if it had not struck relatively soon after firms had established and tested robust plans to counter the Millennium Bug. Insurance is a fundamental mitigant of operational risks, so understanding operational risk exposure should lead to far smarter insurance buying. Similarly, good operational risk management practice will greatly reduce waste and the unforeseen costs which almost inevitably seem to go along with large procurement projects.

Overall, management of operational risk affects the bottom line through reduced losses, higher productivity and improved quality and customer satisfaction. And since most reputational damage is the consequence of one or a number of operational risk failures, good operational risk management will reduce reputational damage.

PEOPLE – ASSETS OR LIABILITIES? But there is one aspect of operational risk management which is rarely managed as a risk management issue and that is people risk. People lie at the root of the vast majority of operational risk failures. That may be because they are incompetent or even prone to criminality or immorality. But people problems are often risk management failures – poor management, incompetent recruitment, inadequate training, inappropriate remuneration. Good people risk management lies at the heart of good operational risk management, yet it's rarely treated as such. The human resources department is rarely seen, or indeed regards itself, as a key risk management department. It should.

The financial crisis was an excellent example of failures of people risk management. There were undoubtedly failures of credit, market and liquidity risk management. But they were driven by boards and therefore cultures which failed to place risk management at the top table, where it should sit, and allowed herd instinct – and greed – to drive decisions.

Placing risk management at the top table is not a plea to fill it with policemen, but to ensure that risk and reward are properly assessed and opportunities grasped on the basis of knowledge. Intelligent risk management, and especially intelligent use of the broad discipline of operational risk management, is a force for successfully growing the business and delivering true long-term benefit.

John Thirlwell advises boards in financial services on risk management and regulation and is co-author of Mastering operational risk
info@johnthirlwell.co.uk
www.johnthirlwell.co.uk