GOODBYE TO RISKY BUSINESS

CRAIG SPIELMANN OF JPMORGAN ADDRESSES THE CRITICAL ISSUE OF MANAGING OPERATIONAL RISK VIA BETTER CORPORATE GOVERNANCE AND TIGHTER REGULATORY CONTROL.

Operational risk has become a defining issue of our times. As regulators have been voicing increased concern, so too has operating risk exposure been a key element in recent headlines concerning corporate governance and the increased threat of business disruption from terrorism. In response, a host of new regulatory initiatives are unfolding to mandate heightened vigilance in operational risk management. For example, The Combined Code on Corporate Governance and the Sarbanes-Oxley Act of 2002 provide rigorous requirements for listed corporations in the UK and the US, respectively. The UK's Financial Services Authority's (FSA) new requirements, the European Commission's Capital Adequacy Directive (CAD3) and the proposed Basel Capital Accord (Basel II) tighten regulatory requirements for financial institutions.

While national, regional and global regulatory bodies may be moving at different speeds, at least they are all moving in the same direction. They are united in the common goal of achieving a safer operating environment. The multiple initiatives align in mandating that rigorous internal controls be put in place and senior executives attest to the effectiveness of these controls.

Whether the price of non-compliance is heavier fines or even imprisonment for senior executives (as stipulated by Sarbanes-Oxley and the like) or higher capital reserves (in the case of CAD3 and Basel II), the new regulations create strong incentives for accountability. But beyond the regulatory implications, as the potential looms for severe impact to businesses – and even economies – of operational risk failure, there is a new sense of urgency to create transparency at the highest levels of corporate governance.

UNDERSTANDING OPERATIONAL RISK. Operational risk, unlike risk taken for economic reward, is an inherent part of any business. Understanding it is a prerequisite for transparency and effective business management. It is a fundamental element that necessitates regular assessment, measurement and reporting. How can a company move forward with confidence if it does not have an effective and transparent operational risk programme that is tied into its business strategy? It would be like trying to win Le Mans or a Grand Prix with your pit crew only coming out after your car has broken down. CEOs/CFOs and Boards need to have a good understanding of their capabilities. They need to have both hands firmly on the wheel, while their team performs regular preventative maintenance. An effective operational risk programme will help them manage and determine which corrective investments are required to help them compete in the markets.

The Basel Committee on Banking Supervision (the Committee) has developed a list of the types of operational risk events that can lead to significant losses. These categories include: internal fraud; external fraud; employment practices and workplace safety; clients, products and business practices; damage to physical assets; business disruption and system failures; and execution, delivery and process management.[1]

THE CHANGING REGULATORY LANDSCAPE. The Sarbanes-Oxley Act of 2002 is indicative of good practice concerning the handling of financial reporting, conflicts of interest, corporate ethics, internal processes and accounting oversight. A key section deals with executive certification of financial statements and establishes more severe consequences for non-compliance. Sarbanes-Oxley also addresses management's assessment of internal controls and real-time issuer disclosures.

Each annual report must now contain an internal control report that accomplishes two things. It must state management's responsibility for creating and maintaining an adequate control structure and procedures for financial reporting. Second, it must assess the structure and procedures currently in place. To further protect investors and safeguard public interest, there must be timely public disclosure of material changes in financial condition or operation for specified firms.

The UK's Combined Code on Corporate Governance, developed by the Turnbull Committee, is similar in its call for robust internal controls and executive verification. The Code specifies three requirements:

- that directors must attest annually that they have reviewed the effectiveness of their groups' internal controls;

- they must attest that the system of controls has been operating the entire year; and
- firms must perform continuous monitoring.

According to the Institute of Chartered Accountants in England and Wales, in its *Guidance for Directors on the Combined Code*: "Effective monitoring on a continuous basis is an essential component of a sound system of internal control." This last point – stressing "continuous" monitoring – imparts fear in the hearts of most directors. In the past, monitoring was likely delegated to an internal control or audit group. But the Combined Code and similar initiatives squarely put senior management in the driver's seat, with the recognition that the car is in continuous motion.

The FSA's new requirements, which complement the Combined Code, extend control requirements to financial institutions. The European Commission, through CAD3, is calling for additional controls to ensure financial institutions have adequate capital to protect against the shock of an event that is operational-, market- or credit-related in nature. CAD3 requirements are on par with Basel II, which more broadly covers banks in more than 100 countries. Basel II reflects the recognition that operational risk management, while always a central focus of banks, is increasingly viewed as a comprehensive discipline equal in stature to the management of either credit or market risk.

Beyond the more frequent, high-profile operational-loss events, the Committee points to a number of trends within the banking industry that are driving the changing view towards operating risk. E-commerce, industry consolidation, the emergence of high-volume service providers and a high degree of automation, to name a few, all increase the complexity of risk profiles.[2]

Under Basel II, banks must more actively manage operational risk to potentially reduce capital reserves. The Accord provides three methods of calculating reserve requirements. First, firms can take what regulators enforce, which means holding up to 12% of gross revenues in reserves – a burden on working capital efficiency. Second, firms can allocate a different percentage of reserves by segregating their lines of business based on the type of activity.

The final method, the Advanced Measurement Approach (AMA), incentivises firms to manage operational risk in return for potentially reduced reserves. Firms must analyse their historical losses and other key risk indicators on a regular basis, justify their level of controls, and develop a model for assessing the correct amount of reserves. Although compliance must occur by the end of 2006, the real deadline looms closer. Approval under AMA requires up to three years (this may differ by country) of historical loss data and up to two years of running a parallel capital reserve model to prove to regulators that effective risk management is firmly in place.

THE CHALLENGE. The most challenging part of implementing a successful risk management process is changing the corporate culture to be open and mature. Some employees worry about their image and want to hide the fact that the business is in danger from an activity in their area. They are able to do this because their corporate culture does not have a robust assessment and risk management process. Also, they may not have a vehicle to truly understand how to communicate their concerns to senior management. The culture must promote self-assessment as the proper way to conduct business.

Defining risk implies you have an idea of where you want to take your company or your department from a strategic point of view. This challenges people to face the reality of the risk in doing business and to set criteria for expected performance, which is not easy. In addition, having good criteria to judge your risk management effectiveness requires some critical and tough thinking about your business. The criteria you define should focus senior executives on the major risk heading their way, or the 'tractor trailers' versus the 'tricycles'. This means an organisation needs to have a cohesive process to focus management on critical risk and only invest in the gaps that can have a substantial impact to their business. Often, this necessitates a cultural change from reaction and blame to a level of true proactive risk management and transparency.

'CREATING RISK TRANSPARENCY IN THE ORGANISATION IS A CRITICAL GOAL. A COMPANY MUST CREATE A COMMON UNDERSTANDING OF STRATEGY AND ACTION AT ALL LEVELS'

Creating risk transparency in the organisation is a critical goal. A company must create a common understanding of strategy and action at all levels. Employees must understand where management is placing emphasis, so they can focus their priorities. By the same token, management must understand where the weak links are in the chain of operational risk, so that appropriate actions can occur at the right level to address gaps.

Last, as a company comes to terms with the need to create better risk managers and have a defined risk framework, it needs to deal with corporate-wide execution. How does the firm manage data across the whole group? It can be a daunting task. The goal is to enable management to act on factual information, rather than anecdotal evidence, in the most efficient way possible.

TAKING A TRIANGULAR APPROACH. A triangular approach to risk management provides an effective strategy. The first side of the triangle involves self-assessment, which enables individual departments to test their control procedures against an established template, rate their own level of compliance, develop action plans to address gaps and monitor progress. The second side involves testing, where auditors validate the self-assessment to ensure its accuracy. Finally, the third side employs key performance indicators and actual losses, which act as a management control by quantifying and tracking the organisation's risk-management and loss performance.

Such an approach may seem simple in concept, but executing such a strategy in a multinational firm is complex. The consolidation of information across multiple lines of business and geographic locations can be daunting. The value of employing a web-based system is to enable universal access to and sharing of information. It is critical that all appropriate staff gains access to the same fact-based information and that management can view information concerning remote locations. This promotes decision-making based on fact. It also facilitates the sharing of risk expertise and best practices across an organisation.

A web-based solution creates transparency by enabling senior management to get an organisation-wide view of operational risk. It also delivers the flexibility to view information from different perspectives, including regionally, globally and functionally.

Management also must be able to drill down to the level of a specific individual. This ensures accountability by helping managers understand the status of operational risk management for each key activity globally and to monitor progress against action plans. It can facilitate a clear understanding of priorities and strategy, which helps an organisation to align strategy with execution.

NEW TOOLS TO AID WITH COMPLIANCE. Companies and financial institutions are turning to a handful of banks and third-party providers for web-based solutions which support risk assessment and compliance monitoring efforts. A select few banks offer such tools to help transform a corporation's culture and create transparency to improve corporate governance and risk management. Clients appreciate the value that a bank brings to developing a solution based on a unique understanding of operational risk and reporting issues.

The cornerstone of any solution must be business self-assessments and audit reviews, which help management and staff better understand their gaps and the joint commitment required to achieve excellence. The solution must help perform self-assessments that identify gaps, set action plans with assigned responsibility to address those gaps and monitor progress. Such solutions are also a practical tool for allaying the concerns of regulators and addressing their requirements. For example, JPMorgan plans to use its own web-based solution to satisfy requirements under Basel II, following the AMA for allocating capital.

CULTIVATING CULTURAL CHANGE. The key to success is implementing a streamlined approach to understanding corporate governance and managing operational risk. The process must be easy to adopt, exceptionally user-friendly and efficient. The solution must enable staff to achieve a balance between meeting commitments to address risk issues and to report to management with current information, and, at the same time, maintaining their focus on revenue-generating activities.

By facilitating the efficient integration of operational risk management into daily business activities, new web-based tools promote a consistency and discipline that enables cultural change. To add value, such tools must provide both cost-effective and sustainable processes that help ingrain proactive risk management at all levels of an organisation. Further, they must support an institution in focusing appropriate resources on strategic, risk-related priorities such as business continuity readiness and disaster recovery planning.

Managing operational risk is no longer an option. Regulatory agencies are mandating requirements, which will continue to evolve. But the best reason for investing in a robust operational risk solution is to lead your company to excellence and become more competitive. If you constantly know your company's strengths and weaknesses, you can lead it to success. Conducting business in the context of today's realities demands nothing less.

Craig Spielmann is Vice President and Horizon Business Executive for JPMorgan Treasury Services.
craig.r.spielmann@jpmorgan.com
www.jpmorgan.com/ts

Notes

[1] *Sound Practices for the Management and Supervision of Operational Risk*, published by the Bank for International Settlement, February 2003.

[2] Ibid.