GRAS Newsletter 18

January 2010

A regulatory take on ORM in 2010

Summary
A recent regulatory consultative paper provides a welcome boost for Operational Risk Management. Although it focuses attention on issues that are known, it does provide additional guidance on how to deal with those issues. Some of this additional guidance could have far reaching consequences for banks and shows how regulatory thinking is changing. It therefore needs to be studied by all banks.

Dear reader,
On 21 December 2009, the Committee of European Banking Supervisors issued a consultative paper regarding the management of OpRisk in trading activities[1]. The paper is largely a reaction to the 2008 fraud at Société Générale, and is meant to provide more detailed guidance on the OpRisk. As stated in the preamble: "The objective of the paper is to complement the framework of high-level guidelines with more specific principles and implementation measures for the identification, assessment, control and monitoring of operational risks in market-related activities". The paper discusses 17 principles in detail. In this newsletter, we will focus on four of the most striking aspects that we expect will impact the OpRisk practice in most banks[2].

1. The composition of governance bodies
The composition of OpRisk committees is one of those areas where the OpRisk philosophy meets reality. Although the top level management is responsible for OpRisk, in reality this will be delegated to committees. It is commonly assumed to be a line management responsibility, sometimes with the main focus on the front office, The paper takes a clear standpoint when it states that in all bodies that deal with identifying, assessing, controlling and monitoring operational risk, *"members of the 'control functions' should be pivotal"*. The term 'control functions' is further specified as *"functions in charge of supporting, verifying and monitoring transactions (e.g. back office, middle office, finance, risk management, compliance and internal audit.)"*

This is an important point, since it spells out that these control functions, either through the sheer number of their representatives or due to the kind of their roles within the committee should be able to effectively challenge the activities undertaken by the front office. Not all institutions have reached that level yet.

2. The risk culture in front offices
It is encouraging to see regulators addressing culture explicitly, as CEBS does in principle 2: *"The management body should promote a front office culture designed to mitigate operational risks [...]"* What is less encouraging, even disappointing, is that the further detailing is restricted to a code of

[1] CEBS Consultation Paper 35 *"Consultation paper on the management of operational risks in market-related activities"* can be found at:
http://www.c-ebs.org/documents/Publications/Consultation-papers/2009/CP35/CP35.aspx
[2] The remaining principles are mostly captured under sound business practices.

conduct, a policy for leave-taking and the strict monitoring of staff movements between front-, middle- and back-office.

The problem here is that Enron had the most elaborate ethical standards, on paper. Unfortunately, that does not even begin to address the actual culture at the firm.
I have recently come across a case where, although leave taking was in the policy, a staff member had been coming in daily, even during his time off. Such dedication, was the general attitude. Again, the policy does not affect the culture which is in situ.

What is needed is time and effort spent on instilling an appropriate culture, starting with a policy for sure, but not stopping there.

3. Know your business
Managing a business with insufficient knowledge is a non starter, and it should go without saying that the same is true for the control functions in those activities. This last point has, however, sometimes been lost on the risk profession. Not only do the people in risk management need to be well versed in risk management, they must also know the business they are involved with inside out. For OpRisk especially, this requirement is essential. Unfortunately, OpRisk often needs to oversee vast areas with very limited resources.

The requirement as stated in the paper, for the *" […] control functions to have appropriate understanding, skill, authority and incentive to provide effective challenge to traders' activities"* is therefore to be welcomed. In the further detail, one may question the proposed approach to consider *"[…] the possibility of introducing incentive mechanisms at the level of the control functions to ensure that the oversight of traders' activities is promoted and rewarded."* The debate about incentive mechanisms is far from over but we can surmise that it has proven to be counterproductive in some cases and cumbersome in all cases. Caution is needed here.

4. The level of OpRisk as a component in objectives setting
Introducing OpRisk in performance measurement will breathe some life into the quantification of risk exposure. It is a necessary step for OpRisk to take, although the tolerance levels, the risk culture and maximum levels of acceptable risk exposure are all concepts that still await rigorous treatment. But since that is a necessary step for ORM to take, we should welcome this endorsement and make use of it in communications to senior management.

Concluding remarks
The consultative paper is an important document that should be discussed at all financial institutions. Not least since the implementation date is set at 31 December 2010. It is a welcome development in the regulatory approach to OpRisk to see continued refinement in approaches and techniques. The high level principles in OpRisk were, so far, too loosely defined to wield much power. This CEBS paper provides another chance for OpRisk to assert itself. The next step is for the risk discipline to further operationalise and implement these requirements in their own institutions.