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Not just another list of top X risks

Summary
Banks would do well to focus on what they need to do rather than to dwell endlessly on yet another list of 'top X' risks for the institution. There is undoubtedly value in understanding risks and even in ranking them into 'top X' lists, but the only real value will come when that is translated into actions. This note therefore does not enumerate a top ten but rather lists what ORM now needs to focus on. There are four such actions, namely: De-fragment ORM; Incentivise Middle Management; Have a Long Term View; and Rekindle your AMA.

Dear reader,
Recently, AON Risk solutions published the 2015 Global Risk Management Survey which highlights the trends in OpRisk from a range of industries.[1] It is a thorough and very well researched paper (108 pages) which clearly spells out that brand protection, external developments, technology dependency, HR issues and cyber developments are the key topics regarding OpRisk. The report provides ample evidence for these themes and covers risk management from many angles. From a practitioner's perspective, however, I would like to add one more angle by presenting the most effective answers I have come across for these risks.

A. De-fragment ORM

The risks types identified in the survey are by no means mutually exclusive. If anything, they reinforce each other and some risks are even direct consequences of others. As an example, the top risk of reputational damage can clearly be the result regulatory issues, non-compliance, internal fraud or misspelling, all of which are also in the top 12.

Now OpRisk is an elusive concept. Ever since the first attempts by the Basel Committee to categorize operational risk events into six classes[2], it has been pointed out that these classes are neither Mutually Exclusive nor Comprehensively Exhaustive ("MECE"). But rather than attempt to come up with a MECE taxonomy, it has proved to be best to accept the loose definitions and overlapping concepts. Unfortunately, this has also played havoc with the domain of OpRisk management itself. In quite a few banks OpRisk management is hopelessly fragmented with completely separate departments looking after closely related areas such as Information Security, Business Continuity, Fraud Management, Reputational Risk, New Product Assessments, and Loss management. Unfortunately, this in turn has lead to a fragmentation in assessments, analysis and reporting.

At minimum, the starting point for de-fragmentation is better information sharing. A shared approach with respect to gathering, analysing and reporting OpRisk related issues using a common

[1] For a copy of the document, visit http://www.aon.com/forms/2015/2015-global-risk-management-survey.jsp
[2] The well known first level hierarchy comprises of: Internal Fraud / External Fraud / Damage to Physical Assets / Employment Practices and Workplace Safety / Clients, Products and Business Practices / Execution, Delivery and Process Management. There has been much criticism of this list, but it is still the only commonly shared categorization in OpRisk land used in (regulatory) reporting and much internal modelling.

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risk and control repository will further facilitate integrated reporting to the board and senior management.

B. Incentivise Middle Management

It is well known that the culture of risk management in a firm relies on the "tone from the top". This leading by example is a necessary condition, but if that is where it stops then it is only good for some catch phrases and feel good slogans. What really matters is how this message is taken up in the middle management and disseminated throughout the organization. Middle management typically has KPI's that are centred around profit levels, cost to income ratio's, market share and product innovation. At the very least, OpRisk targets should be part of their KPIs and thus part of their actual day to day thinking about running their department.

C. Have a Long Term View

The perception of risk across the bank is not static. Risk management is no stranger to fads, and a sudden spike in computer crime, or a flurry of news on compliance related issues, or indeed a new list of top X risks, can re-focus risk OpRisk before it has had time to prove itself. A de-fragmented OpRisk management programme that is carried by middle management will prove itself over time. There is enormous value in consistent assessments, analysis and reporting not just across departments but also over time. This will allow trends to be established and is a prerequisite for testing your risk exposure against risk appetite, which is what the board will eventually expect of OpRisk.

D. Rekindle your AMA

In order to calibrate the Revised Standardised Approach, which is intended to replace the simpler capital approaches[3], the Basel Committee has developed a generic AMA model to calculate a bank's OpRisk capital requirement (OpCar[4]). There are many flaws in OpCar, as in any AMA, but once this model becomes available it is inevitable that this will become the benchmark for in-house developed AMAs.

Many banks have opted for TSA (or even BIA) because they had insufficient OpRisk data or because they lacked the ability to develop, calibrate and validate their own AMA model. But failing to develop your own AMA severely limits a bank's ability to reward good OpRisk behaviour. Although OpCar can hardly be called risk sensitive, it provides an excellent starting point for banks to add this risk sensitivity, e.g. by product type or by department. Rekindle your AMA ambitions, and it will help de-fragment OpRisk, it will engage the middle management and it will go a long way towards better trend analysis of your OpRisk exposure versus appetite.

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[3] The well known methods known as Basic Indicator Approach, and The Standardised Approach which are notoriously insensitive to changes in the actual management of OpRisk. The Revised Standardised Approach (RSA) suffers from the same default.

[4] The consultative paper is available at http://www.bis.org/publ/bcbs291.pdf

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