GRAS Newsletter 30

January 2011

Risk Review for ORM

Summary
Many banks have a clearly defined Credit Risk Inspection function that examines the actual implementation of procedures, reviews credit files, and performs spot checks on the administrative process. A similar role for Operational Risk is oddly lacking. This newsletter examines why that may be the case and examines whether such a role is desirable for OpRisk and if so what such a role might look like.

Dear reader,
Risk policies and procedures resemble “Please Keep off the Gras”-signs. In ideal circumstances the sign does not need to be augmented by gates, fences, surveillance cameras or people in uniform. Merely putting up the sign is enough to ensure that the grass is kept pristine. In practice, however, it is only in exceptional circumstances that this is all it takes to keep the public to the footpaths. In the real world, there are fences, borders and gates to ‘guide’ behaviour, there are implied sanctions and there are park rangers to perform surveillance cum spot checks to ensure that the laws and regulations are followed in practice.

Likewise, Risk Management does more than just create policies and procedures. It ‘guides’ the business behaviour in the form of various prescribed models and systems, e.g. for pricing, limit setting, assessment techniques, ratings, or maintaining an appropriate portfolio mix. The externalised sanctions are in the hands of Audit and Compliance who have an independent assessment role. On the (internal) control side, Risk Inspection or Review[1] (often in combination with Internal Audit) acts like the park ranger, checking practical compliance to policy, day-to-day adherence to internal and external regulation by physically getting out there to check the state of operations. What is remarkable is that this park ranger role exists only for Credit Risk.

Why is there no OpRisk Review?
OpRisk has traditionally provided the “Please Keep off the Grass”-signs as well as the models, templates and reporting formats to guide the business in implementing them. Audit and Compliance have taken it all up in their assessment programmes but a role that is comparable to Credit Risk Review has not emerged for OpRisk. Indeed, OpRisk usually takes the stance that “operational risk is owned by the business, which is both accountable and responsible’. Although this is quite true, it does not mean it should be left at that. Maintaining credit files is a business responsibility yet it is the responsibility of Credit Risk Review to perform spot checks to see how that is done in practice.

Perhaps the main reason why we do not see OpRisk Review units is a misunderstanding about OpRisk data. Credit Risk information is associated with concrete credit files, records of collateral management, credit administration files etcetera, whereas OpRisk data is typically associated with “soft” information which would then not allow thorough analysis. This concept is quite wrong.

[1] The terms Risk Inspection and Risk Review will be used interchangeably here. While Risk Inspection is the more traditional term, it is also almost exclusively used in the context of Credit Risk.

Risk Review for ORM

OpRisk Review data

Operational Risk is determined by the specific processes and circumstances that the various business units face. And since no two business units operate in the exact same environment, or execute the exact same processes, there is a great variability in the range of operational risks within a bank. To some degree, all credits are similar whereas all business processes are inherently different across bank units. But that does not mean there are no concrete objects to study in OpRisk. Although the underlying processes and hence the underlying risks are dissimilar, there is in fact a wide range of topics that lend themselves for a sound OpRisk Review programme

Take the following list as an example. The business is expected to:

- maintain a risk register;
- maintain proper data regarding their process flows and the associated dependencies;
- regularly re-assess the key risks and controls of their processes;
- record all OpRisk events (above a certain threshold);
- follow up on the causes of OpRisk events (above a certain threshold);
- collect KRI data
- prepare KRI overviews;
- follow up on KRI breaches.

In all these cases, Audit will normally check whether these activities are carried out. Adding a dedicated OpRisk Review team will allow an assessment of whether the *content* of such activities and records is complete and correct and whether it follows the spirit as well as the letter of the underlying risk policies and procedures.

The added value of OpRisk Review

The purpose of establishing a OpRisk Review team is to provide the stakeholders with an independent assessment of the quality of execution of the operational risk policies and procedures and the remaining risk in the business processes. To ensure that the bank's operational risk is adequately assessed, the scope of the reviews should not be limited to isolated business units. Rather, OpRisk Reviews are to be conducted across selected business units, processes, client segments, geographies, IT systems, products and possibly other dimensions. That way, the false sense of security that comes with examining individual parts without looking at the whole machine can be avoided. As an example, it can be very insightful to do an OpRisk Review of the credit risk process *across* the bank in its various guises, or the OpRisk in the retail segment.

Conclusion

Many banks have OpRisk policies and procedures but fail to make the step from administration to active monitoring and advising on OpRisk. The establishment of an OpRisk Review team which, in conjunction with Internal Audit, takes an active role in assessing the efficiency and effectiveness of OpRisk programmes will do wonders for the actual management of operational risk in the bank and will at the same time remove the inertia that is slowly creeping into many ORM programmes.