



Examples Please

Summary

OpRisk comprises a fairly fixed set of instruments that suggest a universal applicability. Because of the wide scope of OpRisk, these instruments often come across as rather theoretical. Some examples of actual OpRisk situations may help to give a better picture of what does and does not work in practice. Two cases are outlined in this newsletter, one concerning a fundamental transformation project and one concerning a rapidly deteriorating loan book.

Dear reader,

If there is one thing OpRisk suffers from as a discipline, it is that it is fairly long on theory and often painfully short on practical help. One way of making OpRisk more palatable to management and staff is by adding practical examples of how OpRisk techniques can help address practical issues, can assist in meeting even short term performance targets and at the same time further the longer term soundness of the bank. Below you can find two such examples¹.

Two OpRisk Cases

The two cases outlined below contained a considerable operational risk component. Both situations contain useful lessons for other banks, especially about which OpRisk tools made a difference.

§ *Case 1: All change, this train is cancelled*

Situation: In a mid-sized bank, the core banking system has been in use for over 15 years and needs to be upgraded to allow more products, better reporting and greater data access. Not least, the support for the version in use is running out, the bank has an aggressive growth target and is looking to upgrade not only the core banking system but many of its satellites, feeds, the infrastructure, the associated data warehouse and the supporting network. At the same time, the management teams are reconfigured, the products are redefined and the marketing strategy of the bank is overhauled. In short, the bank is changing everything that is in sight and out of sight.

OpRisk perspective: A major restructuring creates fertile ground for OpRisk. Prevention being better than cure, this is the moment OpRisk can shine in the review of functional specifications, in any business process redesign and in identifying risks before they become incorporated in business-as-usual. This is in part what happened in this case.

Challenges: There are even more vested interests to combat during major transformations than when we evaluate an existing business. Most of the staff and management in the bank are unsure of what the end result will look like and OpRisk is not the first thing they are concerned with. Senior management's role is paramount and in this case they never tired of reiterating the importance of meeting sound risk principles. In practice, however, pressure to meet inflated expectations, lack of commitment from certain managers who did not believe in the need for

¹ GRAS was involved in both of these cases. They are taken from banks in the Asia-Pacific and Central European region from 2009-2011.



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changes and certainly not in the value of OpRisk, as well as deeply ingrained working methods by support units (especially IT) all combined to frustrate many risk initiatives.

Actual result: OpRisk managed to keep the senior management's interest throughout the transformation. One of the reasons for this success was the pivotal role of OpRisk in keeping the information flow going during the process redesign, the risk assessments, the implementation efforts and the aftermath of system changes. OpRisk was, however, only marginally involved in actual decision making and could often do no more than report issues.

The most useful tools turned out to be old fashioned project management tools and the development of a risk register alongside the new process flows to allow frequent reporting. With a bank in a state of flux, the most important task was to ensure that process changes did not become isolated and thus detached from what else was changing at the same time. Challenging assumptions as a standard part of project management evaluation turned out to be the most useful activity that OpRisk could contribute. With a multitude of initiatives taking place at the same time, however, OpRisk was spread very thin indeed and would have benefitted from a stronger Audit / Internal Control function.

§ **Case 2: Operation successful—patient dead**

Situation: A domestic bank has seen a remarkable rise in both the number and the value of its consumer loans (10% and 38% from the baseline respectively), in line with its much published ambition. However, the NPL-% also rose by 184% over five quarters from 3.1% in Q4 2009 to 8.8% per ultimo Q1 2011.

Period	Number of Loans	Σ Loan Amount [†]	NPL
Q4 2009	240,765	773,096	3.1%
Q1 2010	245,580	796,444	3.3%
Q2 2010	257,859	878,079	3.6%
Q3 2010	270,752	1,014,182	3.8%
Q4 2010	273,460	1,075,540	5.0%
Q1 2011	267,991	1,064,569	8.8%
† Total outstanding in 1,000 USD Equivalents			

There were no noticeable changes to the product's characteristics or to the bank's handling of the products. The general market conditions declined somewhat over the given period, with a small rise in the rate of unemployment but only limited adverse exchange rates (all loans were EUR or USD denominated) while income was generated in local currency. Also, loans to existing customers were not under the same level of scrutiny as loans to new customers.

OpRisk perspective: Once a loan has been granted, the NPL rate depends on the ability and willingness to pay which correlates strongly with macro-economic factors. But the process of granting the loan is also a business decision that depends on growth targets, market share and sign-on fees. In Q2 and Q3, the number of loans grew by an average of 5% per quarter, which was exactly the target put out by the bank. At the same time, the average amount borrowed grew by 5 and 10% respectively and again by 5% in Q4, also conform the bank's target of raising the average loan amount from 3,000 to 4,000 USD. The idea was that the cost of servicing smaller loans would erode profitability. Also, since existing customers did not have



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to pass the same tests as new customers, agents were keen to increase the loan size rather than expand the customer base.

The NPL rate trailed the origination process by about 4 to 6 months. Upon investigation, the root cause that accounted for the rise in NPL was found to be relaxed acceptance criteria for existing clients by agents who were working on a commission basis. A total of more than 85% of the troubled loans were found to be sub-standard and would not have been accepted if the acceptance criteria for new clients had been applied to existing customers.

Actual result: As a first measure, the same criteria are now applied for both new and existing clients. This measure had a direct positive effect. Next, the OpRisk department collaborated with credit risk inspection to review loan applications and the supporting evidence. Nearly 00 new applications drawn from Q2 and Q3 of 2010, as well as 200 applications taken from Q4 2010 and Q1 2011 were examined. These applications were checked against the NPL files and based on that analysis, a risk profile was created (a KRI if you will) that is now used to identify potentially problematic loans long *before* they default. Also, an additional charge is applied to loans below 2,500 USD to cover operating expenses.

The most useful tools here were policy review and developing KRIs based on file research.

Conclusion

These are two cases where the application of OpRisk principles was, in the end, rather successful. Risks were measured and monitored at the operational level, that information was presented succinctly to the (executive) management level, senior/board level management was capable of making appropriate decisions within their overall risk tolerance without ever worrying about theoretical risk appetite issues. The two real success factors were senior management's genuine interest and OpRisks down to earth approach.