



## Unintended consequences

### Summary

In setting up ORM, a number of practices have evolved with unintended consequences. We discuss three examples. The adoption of the (credit) risk jargon is a Procrustean bed for ORM; making ORM a generic responsibility fails to address actual risk ownership; and the practice of equating risk categories with loss categories obscures the true risk classes. In all of these examples, the damage can be repaired, but not without acknowledging the problem and a thorough realisation of what ORM can and cannot deliver.

### Dear reader,

Two recent BIS publications<sup>1</sup> concerning ORM have refined the principles of ORM and the AMA framework. The advice itself makes sense. Establish an integrated risk framework. Create a broadly disseminated risk culture; Identify your risk appetite. Set up an appropriate governance structure with roles and responsibilities. Identify and assess all material risks in existing and proposed products/ processes. Monitor exposures. Ensure continuity and Publicise how this is being done. So far so good.

Upon implementation of these principles, however, banks have experienced quite a few problems. Some of these problems can be ascribed to the law of unintended consequences<sup>2</sup>. In brief, it works as follows. Although there is nothing wrong with the principles themselves, there are certain implicit assumptions that are fundamentally flawed and that render them counterproductive. Here are some examples of ORM principles which have unintended consequences:

- Adopting the standard (credit) risk jargon;
- Putting the business in the driver's seat
- Using the Loss classification as the basis for the capture of risk

### Adopting the (credit) risk jargon

Like any discipline, the risk management function has developed a set of tools with its own jargon. Although this risk jargon which works reasonably well for areas such as credit and market risk, unfortunately it fails totally in the operational risk space. Exposure, VaR, and Appetite<sup>3</sup> are examples of quantitative measures that have been foisted on OpRisk.

The unintended consequence of this is that while has been ORM struggling to come up with defensible numbers for these measures, they have taken their eye off the ball. These measures assume that risk is actively sought in order to reap some reward and can be contained within

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<sup>1</sup>The BIS published these two important a (and highly readable) documents on OpRisk in June 2011: 'Principles for the Sound Management of Operational Risk' <http://www.bis.org/publ/bcbs195.pdf> and 'Supervisory Guidelines for the Advanced Measurement Approaches' <http://www.bis.org/publ/bcbs196.pdf>

<sup>2</sup> The idea of unintended consequences is usually connected to the American sociologist Robert K. Merton. See 'The Unanticipated Consequences of Purposive Social Action', in *American Sociological Review*, 1 (6) Dec. 1936, pp 894-904. Available upon request.

<sup>3</sup> It is common practice in ORM to get around this by shifting gears from risk appetite to risk tolerance. This does address some issues, but not all.



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reasonably given bounds by active risk management. ORM, however, deals with *unsolicited* and *unbounded* risks, and thus is ill-suited for these measures. But superficial reading has already led to a host of meaningless risk measures, that appear to follow the (credit) risk practice, but in fact obfuscate the real OpRisk.

Take VaR as an example. In market risk, where there are almost real time data feeds on prices and volumes, the VaR at 99.9% confidence is calculated on a 10 day horizon. Not to be outdone, ORM is expected under AMA to come up with a 99.9% confidence level and a one year time horizon. And that is for a risk area where data is intermittent, fluctuates wildly and is open to dispute. Critical reviews have already suggested that a VaR of 95% is probably the best we can hope for as far as ORM is concerned. That, and a scaling factor to get us to a 99.9% equivalent, makes more sense than trying to force the data to do what it cannot support.

### **Putting the business in the driver's seat**

Since OpRisk is embedded in the bank's products, processes, systems, and their vulnerability to external events, it stands to reason that the responsibility for fixing any issues must lie with the product owner, process owner and systems owner: in short the business. Hence the oft repeated statement that management at all levels is accountable and responsible for OpRisk. That is a truism since they are the first line of defence. The third line is also obvious, internal Audit providing an independent opinion.

What ORM should provide is an OpRisk methodology and active involvement in the implementation thereof. That implies that an ORM department must step on the business' turf, if only regarding the analysis and reporting on the identified risk. The extent of this legitimate 'trespassing' is often not formalised, which can be seen as an unintended consequence of making the business responsible.

### **Using the Loss classification as the basis for the capture of risk**

The Basel committee has not been very prescriptive in how to do active ORM. One notable exception is the classification of OpRisk Loss events. The seven main Loss categories have been universally adopted. The unintended consequence of this universal adoption of the loss categories is that many banks also use them for the classification of Risks. This is unfortunate because it can lead to a blinkered view regarding risks. Risks, comprising an infinite and unobservable universe, have a far more complex nature than losses, which comprise only a very limited and observable universe. Using only the Loss event classification thus limits the scope ORM unnecessarily.



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### **Conclusion**

ORM is a funny discipline. It can be regarded as trivial since it is simply the business of banking itself. In that view, ORM should manage the risks that are the result of the bank's own processes, systems and human behaviour. But it can also be regarded as exceedingly complex. In that view, it should manage the risks that are the result of *failures* in the bank's own processes, systems and human behaviour. The distinction matters. As anybody knows, managing your own failures is the hardest task around.

The ORM discipline has been relying on a number of principles which do not always lend themselves for straightforward implementation. The practice has shown that misinterpretation of the principles has led to unintended consequences which severely cripple the effectiveness of ORM. It is up to the OpRisk managers to prevent this from happening and to repair it where it has already occurred.