



Is this OpRisk within your Appetite?

Summary

The appetite for defining operational risk appetite appears to be making a comeback. That is good news, since it puts operational risk management on the board's agenda. The way to express risk appetite for OpRisk is still work in progress for many banks. The usual approach, which is to define risk appetite as a monetary sum, does not work well in ORM. It is better to express the risk appetite in terms of the board's *expectations* regarding OpRisk, i.e. the expectations regarding the need for actions in a particular area, if any. This newsletter explains one such approach.

Dear reader,

The notion of defining the appetite for OpRisk rests on a lofty idea. The idea is that if the Board of Directors (BoD) defines something like 'limits' for OpRisk, the bank will somehow pay more attention to weaknesses in systems, processes, staffing or vulnerabilities to external events and the bank can better manage operational risk. That is an illusion. Stating that "this bank will not tolerate internal fraud" is fine for a PR campaign, but that does not do it for a risk appetite statement. Other approaches have tried to focus on the cost versus the effectiveness of controls. One bank has developed the risk appetite statement by examining the status of actions. That approach is illustrated here.

Step 1: Get rid of the notion of a numerical value.

A risk appetite statement by the BoD should help management and staff to focus on the risks that it believes require further mitigation. It goes without saying that virtually no operational risks are actively sought by the bank. Since there is no upside to, e.g. systems disruptions, there is, fundamentally, no appetite for it. To come up with a number of fraud cases that would be tolerated or an amount of credit card fraud that would be tolerated is not practical. To make the risk appetite statement for OpRisk practical, it has to be formulated in terms of Actions. The question then becomes, given the current knowledge of risk, which areas does the BoD require further action, and from whom?

The rationale behind this approach is that if there is a need for *additional* actions, then by implication the risk is outside the risk appetite. Conversely, if there is no need for additional actions, then the risk level must be within the limits of acceptability.

Note then, that there is no need for a value regarding risk appetite. All we need is a statement about the acceptability of the current level of risk. This can be based on loss reports, audit findings, rumours, private knowledge or any other form of knowledge about the bank and its operating environment. Such a statement should tell us whether this risk is within the limits of acceptability or not in terms of action. One advantage of this approach is that it allows the management to monitor what is being done about the risk level by monitoring the ensuing actions.

Step 2: Get the Board of Directors' real opinion regarding the level OpRisk

Following the usual Basel event categories, Table 1 below captures the essence of a risk appetite statement. Risk appetite of OpRisk must be in terms of the acceptability of the level of operational

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risk. The more specific the BoD is in formulating the appetite in terms of what needs to be done that, and the more specific it is in explaining the rationale why certain risk fall outside the appetite, the better the bank management can act. Table 1 shows an example of a yearly appetite statement by the BoD that is both practical and can be put to direct use by management. It uses the seven event types that will be familiar to the management from their loss recording and hence is easily supported by evidence.

This way of formulating the risk appetite statement (in fact, seven statements about the need or non-need for further actions) can be directly communicated across the bank. The risk appetite statement must be discussed and further operationalised by the Risk Management Committee in its evaluation of the ORM programme.

Table 1. The Board of Directors’ Risk Appetite statement for Operational Risk

The current state with respect to Risk (type)	Risk Appetite	Department	Remarks
Internal Fraud	<input checked="" type="checkbox"/> Not accepted <input type="checkbox"/> Accepted	All	Several Internal Frauds occurred in 2011. It must be put on the agenda of the monthly management meetings of the Branch level and the HQ level.
External Fraud	<input checked="" type="checkbox"/> Not accepted <input type="checkbox"/> Accepted	Payments, reconciliations	External payment fraud is a special topic for the regulator now. See Circular 2012.232
Workplace safety and Employee relations	<input type="checkbox"/> Not accepted <input checked="" type="checkbox"/> Accepted	All	No additional actions anticipated since this has not occurred yet.
Damage to physical assets	<input type="checkbox"/> Not accepted <input checked="" type="checkbox"/> Accepted	Branches	Almost all branches are now leased rather than owned, transferring the risk of physical damage to buildings, which was the largest component.
Clients, products and business practices	<input checked="" type="checkbox"/> Not accepted <input type="checkbox"/> Accepted	Treasury and SME lending	There is a growing concern over possible mis-selling of products in these areas. Extra care must be taken and actions are expected to be reported.
Business Disruption and Systems failure	<input checked="" type="checkbox"/> Not accepted <input type="checkbox"/> Accepted	IT	The bank depends on system availability which needs to improve.
Execution, delivery and process management	<input checked="" type="checkbox"/> Not accepted <input type="checkbox"/> Accepted	All	Process optimisation is still needed to reduce cost. Incidents in this area are too high.

Step 3: Translate the BoD’s Risk Appetite statements for ORM into actions at BU level.

The nice thing about this way of expressing risk appetite is that it can be directly taken up by the first line management to put it in the forms of actions. Not only that, it can also be used by the Risk Management Committee to ascertain whether the BoD’s directives are being followed through the monitoring of actions, and what, if any, effect is has though the corresponding change in incidents, losses or altered audit ratings over time).

Conclusion

Setting a Board level Risk Appetite statement for OpRisk is possible, but only if we abandon the fetish for numbers and make the statement on what ORM is about: managing processes, people and systems. It will help both the BoD and line management to focus on what needs to be done.