GRAS Newsletter 54

January 2013

2013: A Busy Year for ORM

Summary: With banks under scrutiny, what should they be doing next? First of all, they should recognise that Risk Management (RM) is the core business of banking, not an add-on. And secondly, they should realise that RM is a question of *culture* and *behaviour,* not a matter of formulas. Culture and behaviour determine how banks cope with emerging risks, especially those that are not actively sought but that are thrust upon banks. It turns out that ORM programmes, which are not bound by formulas or restricted to given portfolios, perform better than conventional risk measures in tackling these risks. That implies a busy ORM year for all banks that still want to be around in 2014 and beyond.

Dear reader,

A survey on 2012 banking risks[1] gives pause for thought regarding the place of risk management in banks. Overall, the report is gloomy in its outlook. Risks levels are at a 13-year high, anxiety levels are unprecedented while capital requirements put the ROE under pressure. From another report[2], we learn that global banking ROE fell by 0.8%, well below the 10–12 % average cost of equity. Combined with capital scarcity, loss of earnings and the need for cost efficiency the question is how risk management can be employed to survive or even prosper in this setting. A starting point would be to realise that the nature of the risks has changed which requires a rethinking of the nature of risk management. Let's look at the top six risks from the survey to illustrate this.

The top six risks

The list of the 30 highest risks has been compiled since 1994, and since that time many trends have been reflected (if not exactly predicted) by interviewing bankers (69%), regulators (3%) and assorted observers (28%) on the most relevant problems they believe the industry faces. Although the survey canvasses opinions and does not pretend to give facts, the 710 interviewees from 58 countries provide unrivalled insight in risk trends from many perspectives[3].

The latest survey has some features never seen before. The most notable thing is that the report labels five out of the six top ranking risks as exogenous, credit risk[4] being the exception. Classifying the other five risks as exogenous suggests that they are somehow not really within the banks' control.

Annual Risk Ranking				**Risk description**
2006	**2008**	**2010**	**2012**	
14	5	4	**1**	Macro-economic risk
2	2	2	**2**	Credit Risk
-	1	5	**3**	Liquidity risk
-	-	6	**4**	Risk of unavailability of capital
15	22	1	**5**	Risk of Political interference
1	8	3	**6**	Regulation risk

Source: PwC/CSFI Banking Banana Skins 2006, 2008, 2010, 2012

[1] Centre for the Study of Financial Innovation, *Banking Banana Skins 2012: The System in Peril*, New York, February 2012. Available at: http://download.pwc.com/ie/pubs/2012_banking_banana_skins.pdf.
[2] *The Triple Transformation*, 2nd Annual McKinsey Annual Review on the Banking Industry, Oct 2012, p 6.
[3] Dominated, however, by the UK with 31% of the respondents.
[4] Credit Risk has consistently held the second place since the 2003 survey.

Stated another way, banks do not elect to engage in these kinds of risks. Rather, these risks are part of the 'state of the world' and banks need to contend with them, like it or not. One implication of this is that these risks cannot be fully captured in statistical models or mathematical formulas the bank uses for its measurement and management. This is where ORM comes to the rescue.

An OpRisk view of exogenous risks

From an OpRisk perspective, these so-called exogenous risks are no different from any other threat to the bank's objectives. What matters in OpRisk is not whether the bank has elected to engage in a risk but how the bank's internal processes, systems and people are limiting (or contributing) to the likelihood/impact of losses from that risk. This focus on the *drivers* of the risk has several consequences. Firstly, it looks predominantly at the downside of risk and OpRisk Managers are used to considering risks that have (almost) no upside. For OpRisk managers to be heard by the board and the executive, they must step away from that, amend their vocabulary and show how ORM leads to better pricing, greater cost reduction and enhanced company revenue.

Secondly, ORM deals with the translation of risk drivers into *actions* aimed at managing them within the risk appetite. These actions are found in all manner of processes, systems organisation structures, staffing issues and reporting matters throughout the bank. A notable aspect of ORM is that there is no limit to the scope of these actions. This extremely broad scope makes ORM unsuitable for mathematical modelling, but at the same times allows it to steer clear of model bias and unrealistic formulas.[5] ORM programmes (particularly assessments, risk indicators and scenario analysis) have the capacity to look beyond the current practice and create a more versatile and innovative solutions to emerging issues.

For that to work, however, the ORM programmes for 2013 must start by re-examining the bank's processes, perform in-depth qualitative assessments and then act upon them. The 2011 Basel guideline, *Principles for the Sound Management of Operational Risk*, is still the best reference for banks, be they AMA banks or novices in ORM. Following the OpRisk principles, banks will discover that it makes them fit to deal with endogenous and exogenous risks alike.

Conclusion

The state of the world economy, and the place of banks with the economy, suggests a bumper year for risk management ahead. We can expect more regulation, enhanced scrutiny of the behaviour of banks, and a much reduced appetite for risk – at least from the point of view of the public and the regulators. For risk management, this will mean a more visible role in the day-to-day running of banks, tighter (control over) risk limits and most of all, a significant increase in reporting requirements. ORM should be one of the busiest departments in 2013.

[5] This continues to be one of the least understood differences between OpRisk and other risk types. Other risk types thrive on capturing the risk characteristics in models that translate directly into investment or portfolio decisions. OpRisk boasts no such models and no such direct translations. Rather, the OpRisk repertoire consists of process adjustments and control measures based on assessments regarding risk drivers and controls, which lack the rigour of the formulas, but that allow out-of-the-box thinking and new solutions to pop up.