Areas of Challenge for Embedding Operational Risk

Most banks face a significant number of challenges in bringing Operational Risk (OR) to life.

- Muddled and unclear **accountability** for operational risk
- Inadequate **resources**
- Failure to demonstrate the **value added** to the business
- A focus on completing the process rather than **truly managing** the risk
- Failure to appropriately understand OR **risk appetite**
- Failure to manage **forward-looking** view of risk
- Operational Risk Management Framework (ORMF) not considered by the business or during **business decision making**
- Inability to leverage the ORMF for effective management of **conduct related risks**
- Difficulty in supporting risk management with strategic and centralised **technology solutions**
Embedding Operational Risk

Firms should use OR to run the business. Examples of embedding OR include informing decisions on business plans and change initiatives, forward-looking risk monitoring, and defining an appropriate risk culture.
Embedding Operational Risk

1. Strategy & Business Planning

Key areas of focus

- Identify and assess key operational risks to business plan

- Articulate inherent risk exposure against appetite to inform strategic and operational decisions e.g. new business or products, acquisitions, technology investment

- Undertake scenario analysis & reverse stress testing against top inherent risks for unexpected losses
Articulating Operational Risk Management Objectives

Examples of articulation of ORM objectives and desired outcomes.

- Risk are maintained within appetite on a risk-reward basis. When appetite is breached, risks are economically brought within appetite.
- The type of OR and the amount the Bank is willing to accept is clearly defined and understood.
- OR within and/or due to products, services and operations are recognised and identified.
- Nature & extent of OR faced by firm is understood. The more material the risk, the deeper the understanding.
- The firm surveys its products, services and operations for changes in risk profile, and risk exposure is monitored vigilantly.
- Operational risks are ‘owned’ by 1st line of defence. There is clarity on responsibility and accountability for management of operational risks.
Operational Risk Appetite & Firm Strategy

Explicitly consider OR appetite throughout the business life cycle particularly during strategic planning, new product approval and performance evaluation.

The Front Office explicitly considers their respective BU’s appetite for operational risk during the development of the operating business plan by addressing the following questions:

1. How does the proposed budget address the operational implications of the business strategy considering:
   - Projected growth or contraction
   - Changes in the operational, business and/or regulatory environment

2. How does the proposed budget include consideration of potential operational constraints:
   - Major internal and external losses
   - Staff changes
   - Remediation plans committed to
   - Other projects linked to enhancing/maintaining the operating and control environment
**Embedding Operational Risk**

*2. Risk Appetite and Forward-looking Monitoring*

**Key areas of focus**

- Monitor forward-looking risk appetite e.g. set budgeted loss
- Thresholds in financial forecasting, and metrics to track performance
- Escalate breaches of these thresholds, showing consequences for future business performance and remedial actions
Operational Risk Appetite Framework

A mature framework links qualitative and quantitative measures of appetite to specific risk indicators and includes robust governance, monitoring and reporting processes.

- **Business Objectives**
  - Strategic objectives set by the Board

- **Top Risks**
  - Based on RCSA results and Divisional priorities
  - Mitigation informed by risk appetite

- **OR Appetite**
  - The level of risk the Bank is willing to tolerate/accept in the course of doing business in order to achieve its strategic goals

- **Indicators**
  - Objective measures to evaluate risk position with respect to risk appetite

- **Qualitative Statements**
  - Qualitative tolerance statements articulate the level at which certain types of risks (including reputational and conduct considerations) will be tolerated or accepted with linkage to some form of indicators to enable monitoring of these levels within predetermined boundaries or limits.

- **Quantitative Measures**
  - Quantitative measures are used to evaluate risk position on a historical basis per division/ function. These loss thresholds can be calibrated against historical data (e.g. past losses by Basel II loss categories over a period of years) as well as forward looking factors (e.g. capital model and scenario analysis).

- **Indicators**
  - Indicators can evaluate the risk position on a forward looking basis per division/ function and act as early warning indicators to enable appropriate management action to prevent a loss.

- **Breaches of loss thresholds and indicators**
  - Breaches of loss thresholds and indicators will be reported and linked to a Response Framework.
## Operational Risk Appetite Example

*OR appetite is expressed using a combination of qualitative statements and quantitative measures and linked to existing risk indicators to enable forward-looking monitoring.*

<table>
<thead>
<tr>
<th>Qualitative Statement</th>
<th>Cumulative Loss Tolerance Level</th>
<th>Individual Material Loss Threshold</th>
<th>Example Indicators</th>
</tr>
</thead>
</table>
| **The Bank endeavours to avoid OR events arising from the following:** Violations of market integrity through improper market making, manipulative book building and the application of price fraud | £5m | £30m | • Number of Front to Back office FX, IR and Price breaks  
• % of total desks fees generated per trader  
• % of trades booked remotely  
• Product profitability |

- Set as approximately the 95th percentile of the 5 year internal loss distribution
- Limits are defined for each metric, and these limits are used to calculate the metric's 'limit utilisation' which is a percentage of the metric value vs. its limit
Embedding Operational Risk Appetite

Operational Risk Appetite is embedded across the Group: vertically through the organisational structure with all businesses required to implement and operate as per OR policy.

1. The Board will decide the type and amount of OR the Bank is willing to take for the pursuit of its business goals. It is good practice for the Board to document its appetite in the Firm’s appetite statements.

2. The firm’s appetite statement is then cascaded to business entities usually in the form of “do’s” and “don’ts” found in the Bank-wide operational policy suite.

3. Legal entities implement the policies by cascading the “do’s” and “don’ts” to the business lines whose responsibility is to ensure the procedures in place comply with the policies.

4. Finally, at operational level, procedure and processes are assessed as part of the self-control assessment to ensure that they contain effective controls for managing the operational risks and its sources.
**Embedding Operational Risk**

*3. Major Change & Cost-cutting Initiatives*

**Key areas of focus**

- Assess impact of change on OR profile of the business, e.g. whether cost cutting initiatives increase or reduce OR exposure

- Monitor change implementation against impact on OR profile, using defined programme stage gates

- Include senior OR management in programme approval & decision forums
## Principles for an Effective Change Management Process

<table>
<thead>
<tr>
<th>Principle</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>1st Line Ownership &amp; Alignment to Top of House Decision Making Process</strong></td>
<td>• Change initiatives driven centrally across the firm, by a COO function for example, can help to ensure consistency in approach, minimum risk &amp; control standards and alignment to firm-wide strategy and objectives.</td>
</tr>
<tr>
<td><strong>Clear Governance Paths &amp; Authorities</strong></td>
<td>• Functions supporting the change management process should be given appropriate authority to effectively drive the change programme and provide oversight and challenge.</td>
</tr>
<tr>
<td><strong>Clear Objectives</strong></td>
<td>• Risk &amp; Control assessments and Post Implementation reviews should be linked back to the original objectives.</td>
</tr>
<tr>
<td><strong>Firm-wide Understanding of Risk and Control Processes</strong></td>
<td>• Training should be driven centrally to ensure consistent understanding of fundamentals across the 3 lines of defence.</td>
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<tr>
<td><strong>Use of Available Frameworks &amp; Metrics</strong></td>
<td>• Use of existing metrics, tools and common taxonomies (e.g. for articulating risks and controls) across the firm for all risk assessment processes can support risk profile aggregation, decision making and reporting.</td>
</tr>
<tr>
<td><strong>Classification of Change</strong></td>
<td>• Change initiatives classified by a risk or impact matrix can help to define the correct level of stakeholder engagement and oversight for the change programme.</td>
</tr>
</tbody>
</table>
New Major Change Management Process Map

1. New Major Change Initiative
   - Change Initiative Approval by Senior Management Committees

2. Risk and Control Assessment
   - Co-ordinate Risk & Control Assessment Phase
   - Report on Progress
   - Define Target State
   - Perform Risk & Control Assessment of Planned Change
   - Make Risk Appetite and Acceptance Decisions

3. Design & Plan
   - Business Process and Technical Design and Plan
   - Formal Approval of Plan and Acceptance vs. Risk Appetite
   - Functional Input into Design & Plan and Sign-Off

4. Implementation
   - Co-ordinate Implementation Phase
   - Report on Progress
   - Project Close-out
   - Co-ordinate Process Implementation and Sign-Off

5. Post Implementation Review
   - Final Sign-Off
   - Understand Lessons Learnt which have Firm-Wide / Strategic Impact
   - Changes Accepted into BAU
   - Post-Implementation Review (PIR)
   - Understand Process-level Lessons Learnt

- Co-Ordinate Process Design & Plans Across 1LOD and 2LOD
- Report on Progress
- Co-Ordinate Process Implementation and Sign-Off
- 2nd Line Oversight and Challenge of Process / In-flight Assessment Against Plan
- 2nd Line Oversight and Challenge of Process
- Internal Audit Review of Accepted/BAU Processes and Controls
- Final Sign-Off
- Understand Lessons Learnt which have Firm-Wide / Strategic Impact
- Changes Accepted into BAU
- Post-Implementation Review (PIR)
- Understand Process-level Lessons Learnt
- Final Sign-Off
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4. Capital Allocation

**Key areas of focus**

- Distribute regulatory capital adequately and appropriately based on size and potential OR exposure
- Promote good business behaviours by incentivising the businesses through the use of a forward-looking OR profile
- Utilise operational risk loss data in a way which gives insights into the riskiness of businesses
Implications of OR Capital Modelling Changes

One mechanism to incentivise businesses to proactively manage risk is through capital allocation.

The objectives of the allocation approach include:
- Promote good business behaviours by incentivising the businesses through the use of a forward-looking operational risk profile.
- Distribute regulatory capital adequately and appropriately based on size and potential operational risk exposure.
- Continue to utilise operational risk loss data in a way which gives insights into the riskiness of businesses.

The operational capital could be allocated to the businesses via three criteria based on pre-determined weightings. An example is shown below:

Typically this information is available on a monthly basis but it may be more appropriate to discuss capital allocation on a quarterly/bi-annual basis at senior management committees.
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5. Cultural Measurement & Behavioural Reinforcers

**Key areas of focus**

- Define a statement showing what the risk culture should be
- Include good risk management behaviour in the purpose, vision and values of the bank
- Use behavioural reinforcers to embed desired OR behaviours e.g. business leaders as OR champions, OR culture communicated throughout the firm
The programme is governed by 5 key principles:

1. **Don’t reinvent the wheel** - align with global initiatives and leverage work already underway

2. **Lead from the line** - each workstream should have a business sponsor and SME workstream lead

3. **Build from established foundation** - leverage and build on elements of the strong positive culture that may already exist

4. **Prioritise, don’t do everything at once** - start with the levers that engage and make the biggest impact fast

5. **Play the long game** - first focus on moving fast and completing quick wins before moving to the longer term formal elements of structure, policies, processes and other infrastructure

**Measuring Proactive Culture Change**

A proactive, client centric approach to conduct and culture helps rebuild trust in the industry rather than simply react to regulatory requirements.
Key Benefits of Measuring Proactive Culture Change

The benefits of this approach are:

- Business leaders are engaged from the beginning and feel more ownership of the changes, helping to bring the rest of the business on the journey with them.
- There is an initial focus on quick wins so that an impact is made quickly.
- Measuring the changes on a bi-annual basis allows frequent tracking of the same measures so clear progress or issue areas can be identified.

Thereby the programme enhances the chances of success by gaining clear leadership buy-in, engaging the business, working with and not duplicating other initiatives and tracking the progress of both the programme and culture journeys.
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6. Personal Scorecard, Compensation and Incentives

**Key areas of focus**

- Embed OR objectives into every employee’s performance scorecard e.g. timely completion of OR training, demonstrating target behaviours

- Include performance against OR objectives as a key measure when setting remuneration and incentives
## A Shortlist of Critical Things to Get Right

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>1</td>
<td>Having people with the right skills across the first and second line of defence</td>
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<tr>
<td>2</td>
<td>The right risk culture; defined, embedded into enablers and measured</td>
</tr>
<tr>
<td>3</td>
<td>Demonstrably linking operational risk management &amp; measurement to decision making, allowing management of risk rather than issues</td>
</tr>
<tr>
<td>4</td>
<td>Speaking the language of the business and avoiding operational risk jargon where possible (KRI, BEICF, KC, RCSA, ...)</td>
</tr>
<tr>
<td>5</td>
<td>Driving consistent use of operational risk tools by the first line in running the business</td>
</tr>
<tr>
<td>6</td>
<td>Supported by a high quality enterprise-wide risk management framework; underpinned by a common language and component linkage</td>
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