

# Compliant, now what?

## Editorial

In all industries, particularly banking, operational risk has been of great concern for several decades. As included in the Basel II capital requirement, operational controls and compliance is a must.

Control, Risk Management, and assessment are musts for an organization, but at what price?

At which point should control and performance be put together? It is easy to say, yet less easy to do.

In this month's newsletter, we review this very topic with two articles:

> **Operational risk approach based from Risk Management and Quality**

> **Calculating capital to improving operational performance**

Have a good read!

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## >> Operational Risk Management and Quality

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Operational Risk Management originated in the industrial sector and became vital to the financial sector following losses caused by failures of internal controls (Barings, Sumitomo, etc.). Since 2004, the Basel Committee has included operational risk in its calculation of capital requirements. In addition, under the pressure of banking regulations, financial institutions have implemented "active management" mechanisms for operational risk.

### Operational risk

The Basel Committee defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people, systems or external events."

### Regulatory requirement

The regulatory issue affects all sectors of businesses. At a time of growing risk aversion, regulators are increasingly prompted to protect third parties from "collateral damage" due to a disaster. As a result, new regulations emerged due to major catastrophes (the Enron bankruptcy, the Seveso disaster, etc.) and translated into more stringent regulations (CRBF, adaptation of Basel II accords, etc.) with active "Risk-Management" systems.

### Comparing Risk Management and Business Process Management

Risk Management is defined as a set of management processes whose goal is to control risks preventing a firm from attaining its objectives. Originating in the 1960s, insurance contracts in US Risk Management have become more sophisticated and resulted in risk cartographies of the 1990s and ISO 31000 standards. Parallel to Risk Management approaches, businesses have implemented approaches (since the 1970s) aimed at improving quality and performance (ISO 9000, TQM, Lean, Six Sigma, BPR, etc.) to reduce costs, processing errors and delays. The link between these approaches to Risk Management is not easy to identify, but it does exist: reducing errors and malfunctions contributes to reducing operational risk. Nonetheless, there is a slight difference between these approaches and that of Risk Management. In a Risk Management approach, the risk is identified in advance and an acceptable solution to reduce it is created. However, Risk Management approaches tell us very little about how to find the most suitable control and we must therefore trust industry expertise. In a "Lean"-type process approach, we tackle the problem from a different perspective. The idea is to start from a process whose malfunctions need to be fixed, particularly through streamlining. As an example, to reduce the number of checks lost during check processing, the two approaches would address this differently:

> In a Risk Management approach, the risk of "check processing errors" is identified within the context of "check processing" activities. This risk is considered frequent but not serious. It can be reduced by adding controls at the end of chain. The cost of implementing this measure is acceptable, and it should reduce the frequency of occurrence to a "low" level. In this case we accept the "residual" risk.

> In a Business process improvement approach, we review the check processing chain to reduce costs, delays, and errors. Certain tools (value analysis, flow charts) allow us to detect the weak points and find solutions. Reducing the risk of "check processing error" is therefore one of the by-products of this approach. Quite often the reduction is made without identifying or measuring this risk.

### Two complementary approaches

The possible drawback of a poorly-handled Risk Management approach may be an accumulation of controls that certainly reduce losses but at the same time weigh down the processes and can lead to a loss in the firm's competitiveness.

As for approaches to improving performance, the firm risks missing "potential" risks which have not taken place in the past but would prove catastrophic should they happen (extreme risks). The visibility of these extreme risks helps ensure the survival of the business.

Considering the above, OTC Conseil and Kairos Management ([www.kairosmanagement.com](http://www.kairosmanagement.com)) have worked together to find the best way to harmoniously combine the advantages of the two approaches. Our thinking falls within the scope of Basel II, but can easily be extrapolated to any type of service or industry ■

# >> From calculating capital to improving operational performance

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Within the framework of "active management" mechanisms, identifying the real causes of risk, the appropriateness of controls, and improving operational performance all come into play. Indeed the important thing is not to weigh down processes in implementing these controls, but instead to benefit from their implementation. The steps taken to follow through on regulatory programs can in this way serve as a starting point to a genuine approach to improving performance (reducing costs, delays, errors).

## Basel II and operational risk

Regulators' major concern has always been to avoid bank failures resulting from overexposure to risk. A direct way of limiting that risk entails forcing each bank to reduce the total amount of loans made according to its financial soundness, the latter measured by its capital holdings. It was with this in mind that the Basel Committee established the Cooke ratio in 1988, which only covered credit risk. The market risk was integrated into the Cooke ratio in 1998. Finally in 2004, operational risk became part of the Basel II Committee's new solvency ratio, the McDonough ratio. In addition, Basel II requires banks to implement "active" management of operational risks.

Basel II measures allow banks to choose between three different approaches in calculating operational risk (in order of growing complexity): "Basic Indicator," "Standard," and "Advanced Measurements." The chosen approach must be approved by the regulator. This approval is conditional on the implementation of an "active" Risk Management system that is all the more restrictive given the complexity of the method. In these conditions, why would a bank be interested in adopting an advanced approach (AMA)? In fact, there are at least three reasons:

- > Better management through risks: AMA enables more detailed knowledge of known and potential risk.
- > Capital savings: provided that the risk level ("known" and "potential") is actually reduced by active measures, the need for requirements will decrease relative to the basic approach which in turn allows for an increase in lending.
- > The independence of auditing agencies.

## The current situation of banks

Currently, nearly two-thirds of banks employ the standard method or higher. That means that in these banks, an active Risk Management framework has been established, including at least an operational risk manager, a loss event database, and risk mapping. The 2007 French Banking Commission report on the progress of banks in operational Risk Management raises several interesting questions about the current approaches.

## Risk Mapping

The report reminds us that risk maps are most often derived from processes maps. The principal problem encountered is the difficulty in maintaining an exhaustive map approved by the professional experts. Furthermore, the criteria allowing a choice of so-called "significant" risks has not been formalized, which leaves a great deal of room for subjectivity.

## Rating (evaluation) risks

As for risk rating in terms of seriousness and probability, progress remains to be made in terms of consistency of rating practices, reproducibility, and reliability.

## Loss event database

The French Banking Commission report focused in particular on the data collection process. Indeed, there are doubts about the exhaustiveness of recorded incidents.

Loss events are not systematically declared (the degree of exhaustiveness varies according to the event type, the institutional culture, etc.). Finally, the data collection rules differ from one institution to another and may have a non-negligible impact on risk analyses inferred from the loss event database. A classic example of this is the loss threshold: certain institutions report events downward to a single euro, others prefer higher thresholds. Even though it was published in 2007, the report provides a good picture of one of the difficulties of the current approaches.

## Improving the Risk Management framework

Operational Risk Management mechanisms have several objectives:

- > Ensure a capital measurement accepted by the regulator and advantageous to the bank (at an equal risk level),
- > Provide an accurate and precise picture of risk levels,
- > Genuinely reduce known losses,
- > Actually lower potential losses,
- > And all this at a reasonable cost.

It is therefore advisable to optimize the components of the approach to that end. In this regard, it may be desirable to employ well-tried methods (Six Sigma, Lean – see insets on our website) in order to make certain components more reliable.

## Improving operational performance

Reducing risk is not an end in itself and by shooting for zero risk, a firm simply increases the likelihood hindering business growth. Furthermore, isn't the best way to eliminate risk simply to close up the business? Keep in mind that reducing risks is only one of the components that go into improving performance, which also aims at reducing delays, costs, and errors. However, any approach to improving processes depends on knowledge of the business. Mapping business activities and processes is in fact one of the by-products of the Basel II plans. Moreover, the event database offers precious information about known malfunctions.

The Operational Risk Management techniques implemented by banks can thus be reused and serve as the basis for a genuine approach to improving performance, which should aim not only at reducing risks but also at reducing operating costs, errors, and increasing customer satisfaction.

We are currently seeing a fundamental movement tied to the growing industrialization of banking processes. Most big banks have thus begun to launch programs inspired by the Lean and Six Sigma methodologies.

Only the future will show if the approaches will end up becoming the norm in banks as has been the case within industry or if the banking "industry" will remain an exception ●