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OPERATIONAL RISK MANAGEMENT IN BANKS: A THEORETICAL PERSPECTIVE

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ABSTRACT

The rising financial scandals, increased reliance on technology, growing competition, rising severity of operational risk losses and introduction of an exclusive capital charge has brought the focus of the global banking industry towards Operational Risk Management. Moreover, a number of previous studies on the subject have indicated an adverse impact of operational risk loss events on the market valuation of affected banking institutions. Thus, effective management of operational risk is essential for any banking institution. Operational Risk Management in banks is considered close to quality management and efficiency management and, hence, adds value for the shareholders and other stakeholders (Credit Suisse, 2003). In view of this, the present paper attempts to investigate the operational risk definition, the role of operational risk management framework and the regulatory architecture of operational risk. Moreover, it is essential for any banking institution to carefully understand and implement these aspects of Operational Risk Management in order to effectively manage their operational risk.

KEY WORDS- operational risk management, banks, definition, framework, regulatory architecture.

1. INTRODUCTION

Banks face a number of risks in the course of its operations. These risks can adversely impact the business as well as the reputation of the bank. The major risks in banks may be classified as Credit risk; Market risk; Operational Risk; Liquidity risk; Interest rate risk and Other risks (including strategic and reputational risk). Thus, banks need to employ effective risk management systems in order to successfully identify; assess; monitor and control/mitigate the various risks and, further, allocate capital to cover the losses from these risks.

Moreover, the banks, world over are operating in an environment marked by growing restructuring, rising expectations, increasing regulatory requirements, proliferating financial engineering, rapid changes in technology and increased competition. This has significantly increased the risk of failures in the banking operations. Losses caused by operational failures have the potential to corporate failures. It is more so in the case of banks as the operations are voluminous and geographically well distributed. In view of this, financial regulators require the banks to effectively manage their operational risk by putting in place a strong ORM (Operational Risk Management) Framework.

Operational risk as defined by BCBS (Basel Committee on Banking Supervision) is "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk¹." Moreover, Basel Committee has also proposed a framework consisting of three approaches for allocating operational risk capital charge. In the order

of increasing sophistication and risk sensitivity, these are the Basic Indicator Approach (BIA); the Standardised Approach (TSA) and the Advanced Measurement Approach (AMA). The simplest approach is the Basic Indicator Approach and the most advanced and risk sensitive approach is the AMA that relates the capital amount to the loss experience of each institution.

Operational risk in the global banking industry is becoming increasingly significant with the financial irregularities appearing regularly resulting in losses to the banks. Hence, ORM in banks is imperative and it is necessary that every bank manages its operational risk in the most effective manner. In view of this, it becomes essential to understand the definition, the Operational Risk Management Framework and the regulatory architecture of operational risk in banks.

2. OPERATIONAL RISK DEFINITION

A number of authors have pointed out 'diversity of operational risk' as its most distinguishing feature. Smallman (2000) describes the breadth of operational risk as mind boggling and suggests that for practical purposes this spectrum wide family of risks should be broken into subcategories. Thus, to narrow down the diverse operational risk it is essential to define operational risk along with its sources.

Very few definitions on operational risk are available in the literature, the oldest being to negatively define operational risk as any risk that is not market risk or credit risk. An early definition of operational risk provided by Crouchy et al (1998) defines operational risk as "the risk that external events, or deficiencies in internal controls or information systems, will result in a loss whether the loss is anticipated to some extent or entirely unexpected".

As indicated above BCBS (2004) defined operational risk "as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk". This definition is based on a definition originally given by Robert Morris Associates et al (1999) which defined operational risk as "the direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events". However, Basel Committee drops the word 'indirect loss' from this definition and, further, excludes strategic and reputational risk in order to allow ease in the quantification of operational risk. However, in reality banks do face the strategic and the reputational risks.

BCBS faced a lot of criticism regarding its definition on operational risk. In the opinion of critics, Basel Committee's attempt to define operational risk is deeply flawed. Turing (2003) regards BCBS definition to be totally unhelpful as it is so broad. Hadjiemmanuil (2003) considers the definition to be opaque and open ended. It is argued that the scope of operational risk is not clearly defined by Basel Committee in its definition of operational risk. Moreover, the review of literature on the subject also indicated that most of the authors have described operational risk, without attempting to define operational risk. Thus, there is a need for an alternative definition which clearly articulates and covers the various sources of operational risk along with its relation to other risk types.

As pointed out, Basel Committee's definition on operational risk fails to clearly articulate the various sources of operational risk. Therefore, a definition of operational risk is proposed which is based on the definition and operational risk events identified by Basel Committee (2004). According to this, Operational Risk may be defined as a risk of loss that may arise from any of the events such as Fraud; Damage to Physical assets; Business Disruption and System Failures; violations of Employment Practices and Workplace Safety; failure to meet obligations of Clients, products and business practices and failure of Execution, Delivery and Process Management.

Thus, as indicated above, Basel Committee has classified operational risk into 7 Operational Risk Loss Event Types which include Internal Fraud; External Fraud; Employment practices and workplace safety; Clients, products and business practices; Damage to physical assets; Business disruption and system failures and lastly Execution, delivery and process management. Moreover, the underlying causes or sources of operational risk emanating from Basel Committee's definition are People risk; Process Risk; Technology Risk and External Risk. Further, the distinctive features of operational risk as described by Moosa (2007) include the diversity; one-

sidedness and idiosyncratic nature of operational risk. Since, the sources of operational risk are diverse; it is most difficult to define of all the risk types. Moreover, Operational risk is considered to be one sided as it is said to be associated with only the cost side of business not the revenue side. Whereas, both credit risk and market risk are said to be associated with both cost and revenue side of business (as by undertaking these risks banks earn revenue as well). Further, operational risk is believed to be idiosyncratic in nature as it affects only one institution and does not spread to others. Moreover, while measuring operational risk it is difficult to define a suitable unit of risk. Perhaps, this is the reason why operational risk is the most difficult to identify out of all the risk types affecting banks.

3. OPERATIONAL RISK MANAGEMENT FRAMEWORK

It is difficult to fully eliminate operational risk. However, it can be effectively managed. To be able to effectively manage operational risks banks need to develop and implement an Operational Risk Management Framework comprising of all the essential aspects of operational risk. Developing an ORM Framework is the very basic and the first step in the process of ORM. ORM Framework comprises of all the policies, processes and procedures which are associated with ORM in a banking institution.

Basel Committee recommends that “banks should develop, implement and maintain an Operational Risk Management Framework that is fully integrated into the bank’s overall risk management processes” (BCBS Principles for the Sound Management of Operational Risk, 2011: Principle 2). Moreover, the task of framing and implementing an ORM Framework is primarily the responsibility of the top management, but does require effective involvement of personnel at all levels.

An ORM Framework should comprise of clearly defined scope of operational risk adopted by the banking institution along with the identified ORM Objectives. The other important aspects of an ORM Framework include Operational Risk Management Policy Statement; Operational Risk Tolerance statement; Governance structure of ORM Function, detailed description of ORM process of operational risk identification; assessment; reporting; monitoring and mitigation. Further, it should also clearly specify the roles and responsibilities of the ORM team and the contribution required from personnel at all levels of the bank.

An effective ORM Framework is essential for any banking institution for a number of reasons. As suggested by RBI, “ORM Framework provides the strategic direction and ensures that an effective operational risk management and measurement process is adopted throughout the institution” (Reserve Bank of India Guidance Note on Management of Operational Risk, 2005). KPMG (2012) points out that implementing an ORM Framework leads to sound evaluation of the risk profile of the entire institution and effective analysis as a result of combining past, present and future looking tools. It further, adds that since ORM Framework integrates various processes of the banking institution, it provides a global view of the entire institution. Credit Suisse (2003) regards ORM Framework as essential for an institution asserting that operational risk management is close to quality management, efficiency management and, hence, adds value for the shareholders and other stakeholders. Moreover, an effective ORM Framework is expected to develop a sound system to identify, assess, report, monitor and control operational risk faced by the institutions.

4. OPERATIONAL RISK REGULATORY ARCHITECTURE

The Structure of ORM Framework would normally be influenced by a number of factors including the regulatory architecture and the identified benchmark practices. The international benchmark practices for ORM have been to a great extent defined in BCBS International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2004) and BCBS Principles for the Sound Management of Operational Risk (June 2011). The broad aspects of ORM as described by Basel Committee are discussed in the following paragraphs.

4.1 Basel Committee norms on ORM

Basel Committee’s definition of operational risk has already been discussed in the previous paragraphs. Basel Committee also presented three methods for calculating operational risk capital charges in the order of

increasing sophistication and risk sensitivity. These are (i) the Basic Indicator Approach; (ii) the Standardised Approach; and (iii) Advanced Measurement Approach. The Committee also indicated the disclosure requirements for operational risk (BCBS, June 2004).

Further, in June 2011, Basel Committee came out with eleven principles of sound operational risk management covering three most important areas of ORM i.e. governance, risk management environment and the role of disclosure². These principles set the standard for the sound practices to be followed by banks related to operational risk. These eleven principles are briefly described below:

I. Board of Directors and Senior Management should take the responsibility of ensuring that a strong ORM culture exists in the organization. A culture emphasizing the importance the ORM throughout the organization is essential for getting the maximum contribution of personnel in managing operational risk.

II. To develop, implement and maintain an ORM Framework that is fully integrated into the bank's overall risk management processes. Hence, banks must develop an ORMF and the associated policies and practices integrated with the day to day risk management practices of the bank.

III. The board of directors should establish, approve and periodically review the ORM Framework. The board of directors should provide approvals for the policies set by senior management and ensure the effectiveness of implemented policies, processes and systems.

IV. The board of directors should approve and review an operational risk appetite and tolerance statement for the bank. This statement should encompass the nature, types and levels of operational risk that the bank is willing to take. Also the appropriateness of the limits set in the statement should be regularly reviewed.

V. Senior management should develop a clear, effective and robust Governance Structure with well defined, transparent and consistent roles and responsibilities. Senior management is, thus, responsible for implementing and maintaining the policies, processes and systems essential for effective ORM.

VI. Senior management is responsible to ensure the identification and assessment of the operational risk inherent in all material products, activities, processes and systems of the bank. Some of tools that can be used for operational risk identification and assessment are Audit findings, internal and external loss data collection and analysis, Risk Assessments, Key Risk Indicators, and Scenario Analysis, etc.

VII. Senior management should ensure that there is an approval process to fully assess inherent operational risk in all new products, activities, processes and systems. The approval process should also consider changes to the bank's operational risk profile, risk appetite statement and bank's existing products or activities.

VIII. Senior management should employ processes to regularly monitor the operational risk profiles of the institution and the exposure to material losses. Moreover, proper reporting mechanisms should be in place at the board, senior management, and business line levels to achieve effective management of operational risk. Banks should produce regular and in time reports on important aspects of operational risk.

IX. Banks should have an effective control environment that utilises policies, processes and systems; appropriate internal controls; and appropriate risk mitigation and/or transfer strategies. Having clearly established roles, responsibilities and accountabilities; compliance to the policies; monitoring of adherence to assigned risk limits; use of sound technology (rather than manual processes), etc support a strong operational risk control environment.

X. Banks should have in place business resiliency and continuity plans to ensure an uninterrupted operation of business and limit the losses due to business disruption. Hence, the banks should develop business continuity and disaster recovery plans to appropriate to their nature, size and complexity of operations.

XI. Public disclosures made by banks should allow stakeholders to assess its approach to operational risk management. A bank should disclose its operational risk management framework such that it allows the stakeholders to determine whether the bank identifies, assesses, monitors and controls its operational risk effectively.

Thus, the various sound practices related to ORM as reflected by these principles include Strong ORM Culture; ORM Framework and the associated policies and practices; Operational Risk Appetite / Tolerance statement; Governance Structure for ORM function; Operational Risk Identification and Assessment; New Product Approval Process wherein operational risk inherent in new products, processes is identified;

Operational Risk Monitoring and Reporting; Effective Control Environment; Business Resiliency and Continuity and Operational Risk related Disclosures.

5. CONCLUSIONS

The paper provides an overview of operational risk management in the banking institutions. It focuses on different aspects related to Operational Risk Management. Based on the review of regulatory architecture on operational risk, the sound ORM practices are identified. These include ORM Culture; ORM Framework and the associated policies and practices; Operational Risk Tolerance statement; ORM Governance Structure; Operational Risk Identification and Assessment; New Product Approval Process; Operational Risk Monitoring and Reporting; Operational Risk Control Environment; Business Resiliency and Continuity and Operational Risk related Disclosures. It is essential for any banking institution to carefully understand and implement these aspects of Operational Risk Management in order to effectively manage their operational risk and migrate towards more sophisticated approaches of operational risk capital adequacy calculation. Thus, every bank should establish policies and practices that focus on these aspects of operational risk. Moreover, the strength of the ORM Framework would depend upon the extent to which these aspects have been extensively incorporated in the Operational Risk Management policies and practices followed by the banks.

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