Operational Risk Management

Sorry, There's No 'Easy Button'

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••Operational risk management has its challenges. Tail events, regulatory hurdles, and management expectations were just a few of the issues discussed during a recent New York Chapter event.

BY KATHLEEN M. BEANS

OPERATIONAL RISK MANAGEMENT plays a key role in the strategic success of organizations, but it presents unique challenges compared to managing market and credit risks. During a recent panel on operational risk sponsored by RMA's New York Chapter, Joe Iraci, managing director, Operational Risk, TD Ameritrade, noted that it is still difficult to quantify operational risk, which makes it difficult to present a number to senior management.

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Natural disasters, geopolitical events, and regulatory challenges must be managed so that their impacts on organizations are minimized. No less important are managing management's expectations and defining what successful operational risk management should look like. As noted by panel moderator Steven Vivola, controller, Fidelity Investments Institutional Businesses, "Operational risk management is not an 'easy' button from Staples."

Vivola lamented that many people view operational risk management only as a back-office function that evaluates processes and systems. In today's global market environment, however, managers of operational risk must prepare for a variety of business vulnerabilities facing organizations and their counterparties. "Impacts can be lessened by properly leveraging operational risk management within an organization," Vivola said.

Doug Hoffman, president, Operational Risk Advisors, noted that some types of occurrences, although catastrophic, have a history of erupting from time to time, and risk managers have an established way to respond to them. He pointed to recent events in Japan and political instability in the Middle East, as well as to recurring disasters such as oil spills, chemical contamination, and hurricanes. For newer types of events, however—such as the loss of a database containing sensitive client information—the industry needs to determine what its response should be.

"We need to think about the impacts from an organizational standpoint," Hoffman said. "We don't necessarily have to pinpoint the actual events."

Hoffman, who serves as facilitator of RMA's Advanced Measurement Approaches Group, said his company advocates a "business vulnerability analysis" that helps organizations understand the four "Rs" of impact that an operational risk event may produce:

1. Impact on *revenue*.
2. Associated *risk* of loss or expense.
3. Impact on *reputation*.
4. *Regulatory* and legal implications.

Strategic Views of Operational Risk

Strategic and tactical (execution) risk management functions are necessary if a firm wants to ensure that its risk principles are embedded throughout the organization. Iraci explained that the strategic element is best placed within the corporate center function, which establishes the tools and framework to align with the firm's strategic direction. The tactical element is best performed by the business risk managers who work within the business lines to implement practices set by the corporate center.

Jack Faer, senior vice president, Operational Risk Management, State Street Global Advisors, disagreed with Iraci. "I don't think the strategy always comes from the center. If you have either very strong business lines or a decentralized organization, strategy is set as much by the business-unit risk managers as by the corporate center. The corporate center focuses on common language and common tools, but the business-unit risk managers often drive the business."

Iraci explained further that the business model itself influences the organizational model. "If you have a strong holding company structure, there's one corporate center," he said. "But if you have a weak holding company structure, that may not be the case. The difference between strategic and tactical depends on the business model."

He also noted that all of the risk management disciplines—credit, market, and operational risk—align with the firm's strategic direction, but operational risk, in particular, is very much intertwined with the corporate governance process.

"It's very common to find operational risk managers more present at management committees than their credit or market counterparts," said Iraci. "That's because market and credit are built around discrete decisions on taking positions, but nobody dials the operational risk manager and says, 'I want to assume segregation-of-duties risks.'"

Driving Efficiencies

Matt Marsh, partner, Deloitte & Touche, helps clients develop an operational risk management infrastructure by breaking down the silos of risk management within organizations and pulling together data from the various silos. Decision makers can then pull the data they need to make decisions based on meaningful risk-based information.

"We think in terms of the opportunities to drive potential efficiencies through the operations," said Marsh. "It doesn't matter whether the efficiencies come from the top or from the business unit. Everybody is interested in how they can do things faster and better."

For example, Marsh said that when they deploy a new infrastructure model, whether it is technology or the process that goes with it, they consider the parts of the business that are suffering from compliance fatigue or that are getting audited frequently on operational risk issues. "As we look for ways to simplify those processes, the business units come to appreciate that the model works. It allows them to generate the desired feedback to the corporate center, while also improving the efficiency of their day-to-day activities," he explained.

Marsh noted that Deloitte, in its most recent survey of global financial services risk, found that many institutions continue to view infrastructure and technology as deficiencies. "If we can get that data governance right, we'll have an opportunity to make operational risk a more strategically aligned piece of the risk management equation," he said.

Communicating the upside of operational risk to management can be difficult because so many of the benefits are qualitative. Hoffman recommends that practitioners "find a toehold that works. If the organization is very data- and capital-driven, use a risk-based capital model to illustrate the benefits. Business continuity planning may be a very visible and respected function in some organizations, so where that is the case, you want to communicate the benefits of operational risk management through that prism. In addition, you might find the kinds of metrics that managers respond to and are measured on and compensated for."

Navigating Global Regulatory Issues

Regulators in a number of countries, including Japan and the United Kingdom, now require corporations to be self-contained, fully operating businesses if they want to do business within their borders, said Faer. Noting the cost of such operations, Faer said those rules are causing organizations to ask, "How many countries exactly do we want to be in?"

It's often hard to reconcile the positions of country regulators when determining what needs to be done in order to comply with their regulations, he said.

Managing Managers' Expectations

Managers want results from their investment in operational risk, but they frequently can't define their expectations. "They usually expect you to answer that question for them," said Marsh. "But what they don't want is to create a bureaucracy on top of every other risk management function they already have. Organizations need to think in terms of how the tools and methods they deploy can be used to break down silos and harmonize data across the organization so that it can produce meaningful information."

If all else fails, operational risk managers can point to the cost savings equation, said Marsh. "Many organizations could get direct dollar savings by having a more streamlined, simplified assurance model if they did a better job of integrating across the silos of risk management."

What Does Success Look Like?

"Defining success is something we all struggle with," said Faer. Credit for reducing losses can go to many departments in an organization, not just a small operational risk group. But at the end of the year, if operational risk managers ask themselves if they made a difference, Faer said they could point to specific processes or projects that had an impact on the organization.

Success of the operational risk framework can sometimes be gauged by market reaction. "When an organization responds to a disaster effectively, the market generally rewards the firm," said Hoffman. "We've seen that time and time again with natural disasters and one-off events. Events caused by control failures are more difficult, but even those failures can be mitigated substantially if the firm responds well and the market sees that the firm has a means of managing the risk and the losses." ❖

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