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CONSTITUENTS OF AN EFFECTIVE OPERATIONAL RISK MANAGEMENT FRAMEWORK IN BANKS

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Abstract:

Growing exposure of the global banking industry to operational risk has emphasized the need for an Effective Operational Risk Management Framework. Banks need to put in place an Integrated Operational Risk Management Framework to identify, assess, monitor and mitigate their exposures to operational risk. The present study aims to examine the constituents of an effective operational risk management framework in banks. The study concludes that seven components form an Effective Operational Risk Management Framework which include Risk Management Strategy; Governance and Organisation Structure; Operational Risk Policy Statement; Operational Risk Management Process; Operational Risk Mitigation Process; Operational Risk Culture and Awareness and lastly the Framework Enablers including Infrastructure, Operational Risk Taxonomy and Technology.

KEY WORDS:

Banks, Constituents, Enablers, Operational Risk Management Framework.

INTRODUCTION

1. OPERATIONAL RISK: AN INTRODUCTION

Basel Committee on Banking Supervision has 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.

Basel Committee on Banking Supervision has further classified the operational risk into seven loss event type categories. These are 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. Any loss arising on account of these categories is termed as an operational risk loss. Operational risks are therefore complex and diverse. Although both credit and market risks are narrow in nature as these are limited to specific areas of an organisation. However operational risk is broader as it is pervasive throughout the banking institution. The growing financial irregularities in the banking industry have underlined the importance of managing operational risk. High profile operational loss events taking place in the global banking industry have made operational risk management being viewed as an inclusive discipline at parity with credit and market risk management.

Banks are required to maintain regulatory capital exclusively for their operational risk exposure. Basel Committee on Banking Supervision has therefore put forward a framework of three approaches to calculate operational risk capital charge in order of their increasing sophistication and lower operational risk

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capital charge. These are the Basic Indicator Approach; the Standardized Approach and the Advanced Measurement Approach (AMA). Further the Committee has issued several guidelines and principles for a sound supervision and management of operational risk.

To manage operational risks banks need to put in place a Framework to identify, assess, monitor and mitigate exposures to operational risk. An Integrated Operational Risk Management Framework is required by the banking institutions to effectively manage operational risk and move towards more sophisticated approaches of calculating operational risk capital charge, as adopting advanced approaches result in a lower operational risk capital charge.

Hence the present study attempts to identify the constituents of an effective operational risk management framework after examining the frameworks presented by previous studies and working papers from leading global consultancy agencies.

2.NEED FOR AN EFFECTIVE OPERATIONAL RISK MANAGEMENT FRAMEWORK (ORMF):

To effectively assess and manage operational risk exposure, banks need to have in place an ORMF integrating all the operational risk elements. Reserve Bank of India (RBI) in its 'Guidance Note on Management of Operational Risk' (2005) asserts that operational risk management framework provides the strategic direction and ensures that an effective operational risk management and measurement process is adopted throughout the institution. The Guidance note also states that the Board of Directors are responsible to approve an appropriate operational risk management framework and Senior Management is responsible to implement the framework. Further Basel Committee on Banking Supervision (BCBS) guides the banks to develop, implement and maintain an Operational Risk Management Framework that is fully integrated into the bank's overall risk management processes. Hence it is imperative for the banks to put in place an ORMF encompassing all the elements related to operational risk.

3.OPERATIONAL RISK MANAGEMENT FRAMEWORK:

This section examines the different Operational Risk Management Frameworks as contributed by various research papers and leading global consultancy agencies arranged in a chronological order.

Credit Suisse (2003) presented an Enterprise – wide ORMF comprising of six components which are Strategy, Risk Policy, Risk Management Process, Risk Mitigation, Operations Management and Company Culture. The first component is the Strategy to manage operational risk which must be aligned with the stakeholders of the bank and integrated with credit and market risk strategy. The strategy should put in place targets that are realistic for the organisation. The second component is the formal operational risk policy statement which must define the organisation structure, roles and responsibilities, accountabilities for measuring and managing operational risk. The third is the process involved in managing operational risk. The process for managing operational risk includes risk identification, assessment, measurement and reporting. Next component is risk mitigation encompassing operational risk mitigation strategies and mitigation tools. The fifth component is the operations management concerned with the design and control of operations in the organisation. The last component is the risk culture involving proactive risk management, continuous training and taking corrective actions in the organisation.

Haubenstock (2003) provides an ORMF comprising of four components - Strategy, Process, Infrastructure and Environment. The first essential element was regarded as building the Strategy to achieve business objectives. Strategy starts with the definition of operational risk followed by its classification into broad risk categories. The Strategy must provide for an appropriate Operational Risk Governance Structure and also Policy Statement regarding management of operational risk. Operational Risk Policy Statement generally begins with risk management objectives and covers the governance structure, the roles and responsibilities, risk management principles defining the organisation culture and the use of various tools and techniques to measure, monitor and manage operational risk. The second component is the Operational Risk Process comprising of Risk identification; Control Framework; Assessment; Monitoring and Measurement followed by Reporting. Operational Risk Management Process involves the day to day activities conducted to identify, control, assess, monitor and measure operational risk. Risk Identification entails identifying the activities and business units exposed to operational risk and the degree to which it is exposed. Risk Control Framework describes the approach to control/mitigate the operational risk exposure of the activities and business units identified. Tools for control/mitigation include a sound internal control system, insurance cover, training, process controls etc. Further Assessment of operational risk is a qualitative method of assessing the exposure to operational risk, looking at what the organisation is doing to control/mitigate these and who are responsible for it. Risk measurement and monitoring involves measuring magnitude of risk and regularly monitoring the exposure to operational risk. Various tools used to measure operational risk include key risk indicators, risk drivers, loss database and causal models. Finally reporting these exposures to senior

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management and Board aid them in taking appropriate decisions and actions. The third component is the Infrastructure which relates to the tools that assist in the operational risk management process. Infrastructure comprises of systems, technology, policies and processes, data and methods. The last component is the Environment which basically refers to the risk management culture and communications in the organisation. Organisation Culture must emphasize the importance of operational risk throughout the organisation.

McKinsey & Company (2012) revealed five elements that collectively form an effective ORMF. These include Strategy and Culture; Governance; Identification, measurement and monitoring processes; Mitigation process and Enablers to the Framework. The first element requires the financial institutions to develop their enterprise-wide Operational Risk Strategy and Tolerance limits which guide the bank regarding the levels and kinds of operational risk the bank is ready to take. Also a strong operational risk management culture consistent with the overall strategy is important for the banks. The second element of Governance includes the Governance Structure as well as the Operational Risk Policy and Guidelines. The third element constitutes the processes of operational risk identification, measurement and monitoring. A sound measurement system must consist of loss database, risk control and self assessments framework, key risk indicators and the use of scenario analysis. The fourth and the most important element is the mitigation process wherein operational risk mitigation strategies are implemented and effectiveness of these strategies is continuously monitored. Ex-post mitigation is also important which involves deciding upon the actions to be taken after the operational loss event has already occurred. Finally the enablers to the framework include a common language for operational risks throughout the organisation to make sure that there is uniformity in the operational risk terms, controls and processes. Also an appropriate technology and system support is required to enable operational risk management process.

KPMG (2013) presented an operational risk management framework comprising of five elements and three pillars to support the framework. These Elements comprise of Risk Policy and Strategy; Risk Identification; Risk Assessment; Risk Reporting; Risk Management and Monitoring. The essential pillars to the Framework include Governance and organisation; Culture and Awareness and Operational Risk Policy, Strategy and Procedures. The first element of Overall Risk Policy and Strategy guides the management to align the operational risk exposure with the overall risk appetite of the institution. This is followed by the process of operational risk identification where in activities vulnerable to operational risk are detected with the help of various tools including key risk indicator breaches, external losses, claims fro customers, audit findings, change of business etc. Thereafter Risk Assessment is carried out to assess the risk exposure both in qualitative and quantitative terms. Qualitative risk assessment can be done through RCSA (Risk and Control Self Assessment) and quantitative assessment using approaches like Monte Carlo Simulation Approach and Loss Distribution Approach. The next element of Risk Reporting intends to timely inform the Board and the senior management regarding the material risks and changes in the actual risk profile of the bank, to enable them to take most appropriate action or mitigation measures. Further risk management and monitoring involves implementing the mitigation strategies and continuously monitoring the effectiveness of these strategies. Moreover the Framework stands on three essential pillars. The first pillar of Governance and organisation includes the Organisation Structure and roles and responsibilities of all individuals related to operational risk management. The second pillar of Culture and Awareness emphasizes the awareness of operational risk at all levels of personnel and a strong risk management culture in the organisation. The third Pillar is the Operational Risk Policy, Strategy and Procedures directing the organisation towards a Comprehensive Operational Risk Policy, Sound Strategy and implementation of processes for managing operational risk.

4.CONSTITUENTS OF AN EFFECTIVE OPERATIONAL RISK MANAGEMENT FRAMEWORK:

Examining the different Operational Risk Management Frameworks as provided by the past studies and consultancy agencies provided a deep understanding of the constituents or essential elements forming an effective ORMF. An ORMF should begin with developing a Strategy to manage operational risk aligned with the overall risk management strategy of the bank. Banks should provide their own definitions for operational risk based on their loss experiences and judgement. Moreover the strategy must indicate acceptable levels of operational risk. It should also state the risk management objectives for various units and departments to impart clarity in achieving targets for managing operational risk.

The second constituent to an effective ORMF is the Governance and Organisation Structure. Banks must lay out the Operational Risk Governance Structure defining the roles and responsibilities, authorities and accountabilities of bank wide Operational Risk Management Function.

The third constituent appears to be the Operational Risk Policy Statement of the bank. Banks need to put in place a comprehensive Operational Risk Management Policy outlining the overall strategy of the bank

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to manage operational risk. Policies should incorporate the objectives of risk management, tools of risk management and the staff expectations for operational risk identification, assessment, monitoring and mitigation; along with the reporting mechanism and expectations from reporting.

The fourth constituent of an effective ORMF is the Operational Risk Management Process. The Operational Risk Management Process comprises of Risk Identification, Risk Assessment, Risk Monitoring and Risk Mitigation. However Risk Mitigation has been treated as the fifth constituent because of its importance in ORMF. These processes are the day to day activities of the bank in managing operational risk. Risk Identification is the process of identifying the activities vulnerable to operational risk. Risk Assessment involves measuring the exposure to operational risk, looking into where the risk resides and evaluating the effectiveness of control processes employed. Risk Monitoring is concerned with regular monitoring of changes in the operational risk profile of the bank.

The fifth constituent is the Operational Risk Mitigation Process. Since Operational Risk Mitigation is the most important step in the process of Operational risk management, therefore it is treated as a separate component. Banks must have adequate policies and procedures to control/mitigate operational risk. A powerful Operational Risk Mitigation Strategy should incorporate a Sound Internal Control System; Effective Internal Audit function; Business Continuity and Disaster Recovery Management; Vigilance function and an Insurance Policy covering operational risk losses.

The sixth constituent is the Operational Risk Management Culture and Awareness Programs. Developing a risk management culture stressing the significance of operational risk management throughout the banking organisation is crucial. Creating awareness among the personnel helps in achieving the objectives of operational risk management, leading to an improved level of personnel participation in the day to day risk management activities of the bank.

The last component includes the Enablers to an effective ORMF. These enablers include Infrastructure, Operational Risk Taxonomy and Technology and System Support. Infrastructure refers to the tools which aid the operational risk management process. Operational Risk Taxonomy refers to having a common language for operational risk throughout the organisation. Technology is essential to support the implementation of tools used for operational risk management process.

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