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FINANCIAL SERVICES

Navigating Operational Risk Management: A Business Manager's Handbook

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Operational Risk: A Business Manager's Mission

Executive Summary

In today's market, most financial services firms have a Chief Risk Officer or even more specifically a Head of Operational Risk. Few would argue that these roles exist as a means to solely satisfy regulators anymore. These roles are critical to protecting a firm's earnings and reputation. In addition, many have found that having a solid operational risk strategy can deliver significant additional benefits.

Despite the importance of these roles, the day to day responsibility for operational risk does not lie with the CRO or Head of Operational Risk. These individuals are primarily responsible for promoting proper management of and measurement of the amount of operational risk across the organization. It is a firm's Business Managers who control the resources that control operational risk.

Unfortunately, not enough Business Managers engage in formal operational risk strategies. As a result many firms face unnecessary threats to the successful achievement of their financial objectives.

This needs to be addressed. Today, global financial institutions face pressure to continuously tackle mounting regulatory change and growing market scrutiny while striving to increase customer confidence, drive competitive advantage, and optimize stakeholder value. Paramount to their success is their Business Manager's ability to accurately monitor internal processes and procedures to manage risks and business opportunities.

This document is intended to provide a foundation for related conversation and agreement between Business Managers, Chief Risk Officers and Heads of Operational Risk so that a structured, pragmatic operational risk strategy can be put in place or optimized if already existing.

Why You Should Care About Operational Risk

Unexpected losses resulting from sub-optimal people, processes and systems are common in today's complex, dynamic business activities.

For example, in the span of a few days, a single 'rogue' trader lost US$1.3 billion for a long-established bank in London called Barings Bank. This caused the 233-year old bank to collapse and disappear. Investors saw their savings wiped out, 1,200 employees lost their jobs, and the Dutch bank, ING, bought Barings and assumed their debt for a mere one British pound.

Some losses are more sensational than others, but many times it is the small day to day losses that add up and fly under the radar costing firms significantly more money over time. Issues are not also limited to trading losses.

Several years ago, a major north American bank released a new version of their internet banking system which included two lines of code that were inserted at the last minute. This code was not properly tested and caused the firm's internet banking system to not post any salary credits into people's accounts. It did, however, allow mortgage payments to be made. As a result, a lot of people went overdrawn. The natural reaction of the bank was to refund account holders interest on their overdraft accounts until they estimated this cost at about Can$140 million. The bank decided to instead manually restore the entries to their correct posting dates. Unfortunately, this effort was not completed until six weeks later.

Losses can occur across any enterprise to greater or lesser extents. In 2008, the Basel Committee on Banking Supervision (BCBS) asked banks to participate in its third Loss Data Collection Exercise and the results were published in July 2009. The number and value of losses from over 100 participating banks for the three years (2005 to 2007) can be seen in the Table 1 below. Within this sample, the BCBS said that the typical bank lost $155,500 per $1 billion of consolidated assets and that is only after considering reported losses greater than US$28,600. That figure would be expected to be significantly higher if all losses were taken into consideration. In addition, these figures don't take into consideration the indirect

cost of effort expended in trying to deal with the loss, to investigate the cause, to seek a potential recovery, the cost of insurance and more.

	2005	2006	2007
Numer of Participating Banks	108	115	117
Number of Losses > $28,600	33,216	36,386	36,622
Total Value of Losses	$13.9 billion	$10.7 billion	$11.3 billion
Average Loss Per Bank	$128.9 million	$92.5 million	$96.2 million

Table 1: Loss Collection Data from BCBS 2005-2007
(Source: Bank for International Settlements 2009)

The good news is that it is possible to investigate causes of loss incidents, strengthen the control environment, and to understand the potential for unexpected losses across lines of business through control testing. In consequence, a bank or any other financial services business for that matter will reduce the cost of errors and reduce the risk of unexpected losses in the future.

Your Role as a Business Manager

Managers play the most critical role in promoting a controlled risk culture. As a manager, you have an obligation to ensure that you and your staff are conducting business efficiently, honestly and fairly.

If you do not keep this obligation, regulators can impose sanctions on the firm and individual staff members who have violated these requirements. Hefty damages, lost jobs and irreparable damage to the firm's reputation may follow if you do not constantly pursue effective leadership and supervision.

Being a manager means more than having a bigger office and a larger paycheck. It means that you have a special duty to protect your company. You are accountable and responsible. It is necessary to be proactive and to trust your instincts when you think that something might call for an investigation.

Operational risk needs to be a priority in the management agenda. Managers have specific responsibilities that they must carry out in order to meet regulatory and fiduciary requirements.
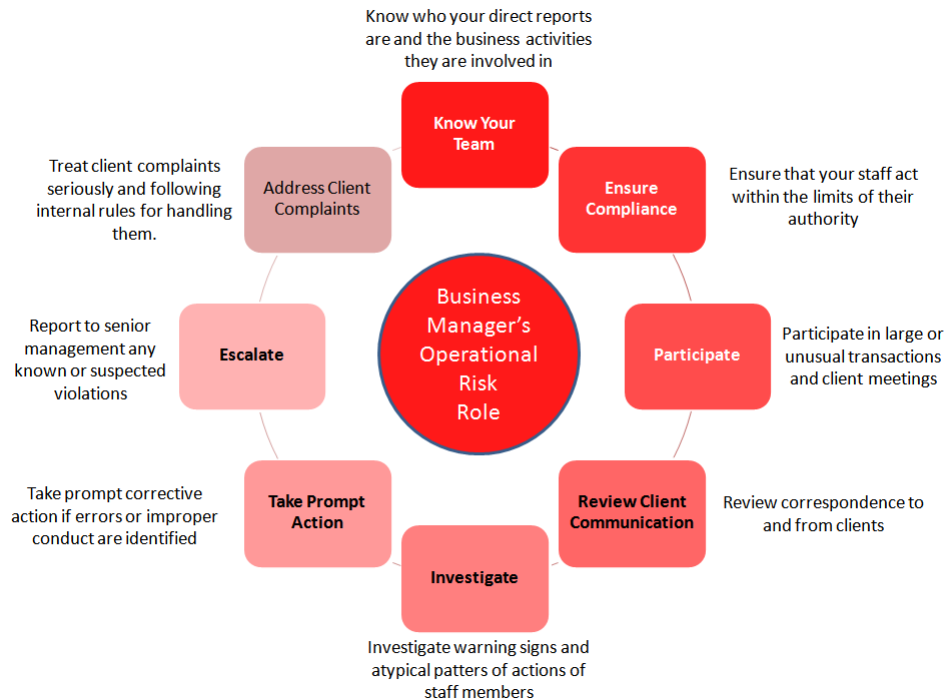
Figure 1: The Role of a Business Manager for Operational Risk

The good thing about this list of duties is that it highlights activities that good business managers are likely already doing as part of their current day's work. These are common sense items that should not add significant overhead to one's existing workload. The benefit of documenting this list of responsibilities is that it removes ambiguity of what is expected from a supervisor.

Managers are the leaders in an organization. They must set an example for all staff to follow. They set the tone for how an organization goes about its business. Their behavior tells staff, clients, regulators and shareholders who the firm is and how they work. A good operational risk methodology and management structure will promote appropriate behavior.

How to Establish an Appropriate Management Structure

When one looks to establish an appropriate management structure, a Business Manager must understand that each firm is different and, while the principles may be the same, what works for one institution might not work for another.

It is also important to understand that a management structure will need to complement the firm's overall operational risk methodology. A good operational risk methodology should be a collaboration between Operational Risk Managers and Business Managers to achieve well-considered risk assessments. These assessments should be based on thorough research into all the risks which exist in each business unit, looking at the potential for a loss on a near term basis as well as a worst case basis. This will also vary by organization as some may feel a more controls based approach works for them, whilst others may believe examining risks and controls along processes is more in keeping with the way they consider things. This methodology will also likely include the usual questionnaires, scorecards, causal factors, etc.

Regardless of the organization or operational risk methodology selected, a strong management structure is likely to require the following from a manager:

Provide Leadership

A Business Manager must set a personal example of appropriate business behavior. Whether it is intentional or not, you are a role model. As a leader, it is imperative that you consistently and regularly communicate the importance of risk management to your teams. This will create a "tone at the top" message and give people who report to you a clear indication of what you expect from them.

Know Your Business

You must know the markets, participants, institutions, intricacies, operations and regulations of the business you operate in.

Staff and Resource Properly

To be effective, your management systems should have sufficient authority, personnel, and other resources to accomplish set objectives. You must resist the temptation to allow budgetary constraints to compromise what you know is best for your business. You should manage resources in such a way that your ability to comply with regulatory requirements is not compromised.

Delegate Appropriately

If you delegate tasks to someone else, that person must be qualified and adequately trained. Delegation must be documented. You must monitor that person to ensure that the delegated tasks are being completed correctly. Remember, you may delegate the task but not the responsibility.

Require Training

Appropriate training must be delivered to all employees and it must be well documented. You need to ensure that staff know the risk management components of their jobs and ensure that employees are able to perform the functions necessary to address these. Risk management training must be built into existing training programs for new hires.

Check for Understanding

Managers should test how well training has been absorbed and applied. This will reinforce operational risk management practices. You should use results of this testing as a critical source of feedback to both managers and to the CRO team about the ability of your business to "do the right thing."

Establish Consequences

Make consequences a reality. It is a pre-requisite to a strong operational risk management culture that there be disciplinary consequences for risk management violations. Otherwise, you are not setting the right tone.

Institute Procedures

You must establish policies and procedures designed to support the risk management culture and which gives reasonable assurance that laws, regulations and policies governing your group's activity will not be violated. These procedures must be in writing. You and your staff should know where the procedures are located. Procedures must be current and updated regularly to reflect changes in your business initiatives and workflows. You must ensure that procedures are being followed and be able to prove it when asked.

Review and Update

You should regularly review and update your management structure and written management procedures.

Monitor

There must be a system for monitoring your group's activity and the outcomes from the monitoring must be documented. The monitoring must occur at an appropriate frequency and be focused on ensuring that procedures are being followed. You should institute regular staff meetings where you can discuss procedures, ask questions, probe for problems, discuss complaints. Minutes should be taken and distributed.

Take Immediate and Effective Action

You must ensure all potential and possible warning signs are promptly investigated and brought to a satisfactory conclusion. All suspected violations of policies must be reported to the Operational Risk Team, Compliance, Human Resources and Legal as appropriate. A failure to report a violation can be considered a failure to supervise. You must establish the appropriate escalation procedures with respect to reporting problems, they must be documented and communicated to all staff.

How to Identify and Avoid Management Failure

Identifying and avoiding the potentially negative consequences of management failure or more importantly being a successful Business Manager takes a great deal of effort. One can considerably improve the chance of success by regularly reviewing the current management data and its structure and being knowledgeable about some of the common mistakes business managers make.

Review Your Current Management Data and Structure Regularly

On a regular basis, Business Managers should examine and review their current management systems and execution, identify areas for improvement and make the necessary changes.

Critical to this review is the availability of timely, complete and reliable related data. Where in most cases the Risk Management team takes on responsibility for organizing, collecting and maintaining this data, it is the Business Managers who can extract real value from it. Business Managers should be taking the lead in using this data to reduce losses by strengthening controls where necessary, perhaps stream-lining some processes after examination and consultation with internal audit. More controls are not always the solution; simplifying processes can improve controls too in certain situations. In this activity, the Operational Risk Manager will prove an invaluable partner by doing nearly all the work leaving the Business Manager to do what they do best and that is make decisions based on recommendations.

There is usually a lot of data to be collected and kept up to date. In addition, this data needs to be analyzed and regularly reviewed. To maximize the benefits of this analysis, most mature financial firms find it best to rely on a unified computer system that gives flexibility to a manager to manipulate and analyze varied selections of related information. This is very difficult to do when risk managers keep different Governance, Risk and Compliance information in spreadsheets or in different systems that were designed at different times with different architectures. This fragmented approach often produces data barriers across business units and leads to inefficient and costly maintenance and operations. Firms that are able to readily access and use critical data across traditionally disparate business unit silos, will be able to increase their data integrity while more effectively quantifying, analyzing, and measuring the effectiveness of their Governance, Risk and Compliance initiatives. Having all this information in one, unified system, that allows busy Business Managers to quickly see all the different types of risks and the state of controls in that part of the organization for which they are responsible, enables them to make good decisions about whether changes are required.

6 Common Mistakes of Business Managers

No matter how senior a manager you are, the fast pace and information avalanche common in today's business environment makes it difficult to account for every potential risky scenario. Knowing the typical areas where managers tend to cut corners will allow you to stay vigilant in your efforts.
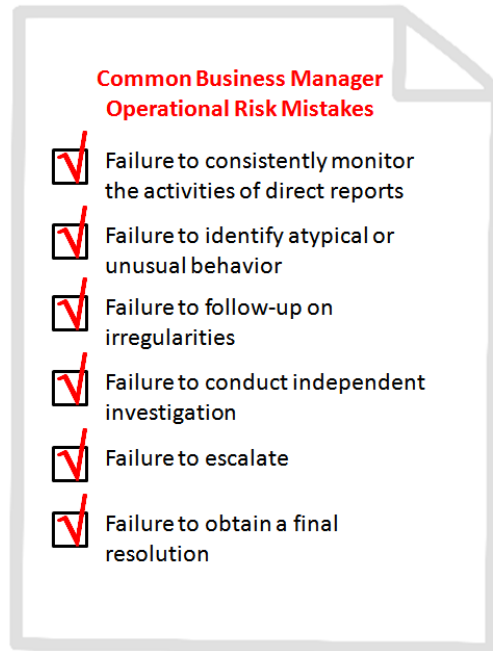
Common Business Manager Operational Risk Mistakes

☑ Failure to consistently monitor the activities of direct reports

☑ Failure to identify atypical or unusual behavior

☑ Failure to follow-up on irregularities

☑ Failure to conduct independent investigation

☑ Failure to escalate

☑ Failure to obtain a final resolution

Figure 2: 6 Common Mistakes of Business Managers

What's in it for You: Benefits of Implementing an Operational Risk Strategy

As the people responsible for generating value, Business Managers need to understand the benefits a good operational risk strategy can provide. Otherwise it will be very difficult to motivate themselves and their team to continue to focus on executing that strategy.

The following table details the sort of benefits a financial firm can expect to realize by establishing an operational risk methodology, a related business management strategy and supporting a unified operational risk system.

Reduction in Unexpected Losses	• A reduction in the number of unexpected losses through a stronger control environment in which controls have been tested.
Improved Rood Cause Analysis	• A reduction in operational losses through recognizing the cause of each loss and taking remedial action to prevent re-occurrence.
Clearer Accountability	• Promotes a culture where staff are much more conscious of risks and the joint avoidance of losses.
Increased Transparency	• Improved monitoring linking internal loss events to failed controls highlights inadequacies of the control environment.
Reputational Enhancement	• Promoting a system of strong risk identification and control, enhances a firm's reputation as a well-managed organization.
Improved Market Standing	• A strong control environment, avoid damage to or a related discount on a firm's share price and cost of funds.
Insurance Benefits	• Allows for reduction in insurance costs through negotiation or by having better information for right-sizing coverage.
Complete Business Process Visibility	• Promotes the documentation of a process to be assessed and related risks n its entirety allowing for optimization.
Distributed Responsibility	• Spreads the burden of assessing risks and controls beyond members of the operational risk team minimizing overhead.
Improved Timeliness	• Allows for more frequent testing of controls and material risks, leaving smaller risks for later avoiding 'assessment fatigue'.
Better Tracked Action Plans	• Provides transparency into the list of related action plans and their progress for specific risks or loss event s.

Table 2: Benefits of Coordinated Operational Risk Strategy

In summary, it is possible to reduce the volume of costly errors in any organization by making people more risk aware, examining why errors occur and address root causes of incidents to prevent reoccurrence. It is also possible to proactively examine the potential for unexpected losses by improving an organization's understanding of its core processes. Thus, a firm can put in place better controls even before an incident occurs.

We are not suggesting it is the Business Manager's job to do this themselves, that is primarily the task of the Operational Risk Manager, but we believe a good Business Manager understands the benefits of a strong OR strategy and, by setting the right 'tone' and leadership can actively reduce losses and make their part of the enterprise more resilient in the event of the unexpected event. This benefits the firm's reputation too.

It is not possible to prevent every loss, but a good operational risk strategy and engaged Business Manager participation should lead to a stronger organization better able to serve the needs of its customers and shareholders. Business Managers will benefit from this directly because after all, they are generally the people who get rewarded for doing a good job in the business.

Contact Us

For information on how Oracle Reveleus can help to address Operational Risk and Regulatory Compliance issues within a firm, please visit http://www.oracle.com/us/industries/financial-services/046740.html or email us at financialservices_ww@oracle.com.

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August 2010

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