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# Basel's brushstrokes: implications for managing operating risk

OPERATIONAL RISK MANAGEMENT HAS EMERGED AS ONE OF THE HOTTEST TOPICS IN THE FINANCIAL SERVICES INDUSTRY, ESPECIALLY SINCE THE BASEL COMMITTEE ON BANKING SUPERVISION RELEASED ITS SECOND ROUND OF PROPOSED REFORMS TO BANK CAPITAL RULES.

One of the most controversial aspects of the vaunted reforms focuses on banks and financial institutions for the first time being required to reserve capital to cover their operational risk exposure.

The proposed reform of the accord will directly affect all authorised deposit taking institutions (ADIs) in Australia: banks, building societies and credit unions.

The proposal comes at a time when there has been an increasing focus on operational risk. This is due to factors including electronic disintermediation, a closer network between banks globally which increases systemic risk; and an increased reliance on internet and ebusiness technology, raising security concerns.

Operating risks are real – not just potential – dangers. While not only due to operating risk issues, the National Australia Bank's disastrous \$3 billion HomeSide write-off demonstrates a major warning.

There are a number of implications for Australian banks and financial institutions, including how the reforms will affect capital requirements.

## An old but growing problem

Operational risk in banking is not new. It can stem from computer failures, lax procedures, fraud, errors, theft and accounting mix-ups, to name a few. However the problem areas seem to be growing and becoming more complex, raising heightened concern in the industry.

IBM's global head of risk management and financial market strategist, Francis Lacan, says that, regulatory pressures aside, a number of issues are driving an increased focus on operational risk. These include process inefficiencies, day to day mistakes and failures which have resulted in significant losses for a number of banks globally.

A particular concern has been security breaches, piracy, fraud, major system failures and computer viruses.

"As you move into wide area networks and the internet systems you need more and more protection against intrusion," Lacan says. "This in turn requires more focus on, and investment in, the technology related to major operational risk issues."



A further reason banks are turning their attention to risk is the complex nature of today's financial structures. There are more counter-parties involved in dealmaking and more custodians and agents who carry messages. The sheer complexity and sophistication of some types of transactions have increased operational risk concerns.

According to Brad Gravell, the ANZ Bank's head of group operating risk measurement and policy, the increasing general regulatory and compliance environment has made banks a lot more aware of operational risk.

Yet he also emphasises the inherent risks of human failure have also been key drivers. "No matter what actually occurs, any bank's biggest vulnerabilities and contingency plans depend on the quality of the people it has," he says.

The importance of people has not eluded other banks such as the National Australia Bank. The bank uses an operating risk field force to constantly discuss new and emerging risks (and prevention measures) with the business units. The bank started this at the time of Y2K "millennium bug" preparations (remember those?) and has continued with it as a major focus.

### What Basel means

The Basel committee's rules have been the global benchmark for banks' capital adequacy for more than a decade. The committee consists of central banks and bank supervisory agencies from the G10 countries, operating under the auspices of the Bank for International Settlements (BIS).

The Australian Prudential Regulation Authority believes the objective of the reforms is to develop more risk sensitive and internationally accepted capital adequacy guidelines, aligned more accurately with individual risk profiles of particular institutions.

The proposed new rules will also lessen regulatory arbitrage opportunities and offer greater regulatory flexibility to recognise and encourage the use of more sophisticated risk management techniques, APRA says.

However, one of the most significant parts of the reforms will be the requirement for banks and financial institutions to make new and explicit capital charges for operational risk.

### What is operational risk?

The Basel committee has proposed a very wide definition of operational risk: "the risk of direct or indirect loss resulting

from inadequate or failed internal processes, people and systems or from external events". Strategic and reputation risk is not included in this definition for the purpose of a minimum capital charge.

A number of banks in Australia regard operational risk as being closely aligned to the Basel definition. However at least one bank – the ANZ – goes further than Basel's black and white definition.

"The ANZ's focus is a lot wider as it includes reputation issues, indirect and direct losses, latent losses, near misses and impact on shareholder value," the ANZ's Gravell says.

The Basel focus is more on direct events that hit the bottom line. The proposed rules, for instance, exclude strategic and reputation risk. "We include it and this means that the ANZ is looking at the issue of operational risk in the bigger picture sense, acknowledging that the Basel accord is not the only driver of what is occurring."

The NAB's executive general manager global risk management, Chris Lewis, says his bank's definition aligns more closely with the Basel definition. But he also believes the formal definition contains a number of grey areas. "For instance, there may be greyness in deciding whether a particular loss is a lending or an operational risk loss," he says.

"For example, you make a loan and the customer does not pay. You go to enforce security but the customer goes to court and we find that the security is not perfect and a loss ensues. Is that a credit loss or operational loss?"

Lewis says another common situation is when a bank poorly executes a customer request and a document has to be redone. "Is that operational risk as opposed to a productivity and operational cost? This in turn raises issues about how you manage your statistical performance and assess what bucket (of risk) it falls into."

### Basel implications

IBM's Lacan says the key issue stemming from the rules – proposed to start on January 1 2005 – is that banks will need to set aside an amount of capital to cover their risk exposure. This is new, as the existing accord only covers financial risk.

Until now, he says, operational risk has been seen as very difficult to capture and quantify. In fact, debate continues



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about whether banks are adequately equipped to measure and quantify operational risk.

Under the proposal, banks will be given a number of options to calculate operational risk. They can also go further and derive more sophisticated techniques.

At this stage, the focus is not so much on calculating a monetary value of the risk, but to start implementing processes that will gradually lead to a better framework for assessing the risk.

Lacan says there is much uncertainty about how the rules will be applied. Nobody knows if banks will be charged more or less than the current charges. The guidelines have not been finalised, with discussions continuing next year.

The ANZ's Gravell believes that the initial draft was too quantitative, focusing on historic data being able to predict future risks. "Not only do you look at the past, but you need to be able to look into the future in terms of what are the new risks that we are facing and our internal management control structure," he says.

According to NAB's Lewis, the bank is now more comfortable with the position of the latest working paper, which allows the use of advanced methods for calculating capital. These are already used by the bank internally.

Lewis says the bank has been working on many of the requirements for the last two years, including the recording of non lending losses and building up data bases.

### Current approaches

As is evident, not all Australian banks are taking the same approach to the issues.

The NAB's Lewis says the bank's solution has been to make pragmatic business decisions about the risks which drive the trend in capital demand, "rather than focusing on whether an amount is absolutely right or wrong".

The ANZ considers itself to be at the leading edge of what is known as the "scorecard method" of measuring operational risk. ANZ has been leading a taskforce of a number of international banks to progress this method with the Basel committee.

According to the ANZ's Gravell, when the Basel accord was first released there was no mention of the scorecard approach, but the methodology is now right back on the agenda.

The scorecard approach centres around internal qualitative controls, rather than historical loss data. The bank's management asks each business unit to fill in a comprehensive set of scorecards every six months. The data is validated by an independent party.

The outputs then determine the capital requirements for each division. Thus there is a real incentive for business units managers to manage risk better, because they get more capital.

But the ANZ stresses that while Basel is a major part of the operational risk drive, it is not the only focus. Another part is about day to day management of actual risks and events.

ANZ's work has been recognised by the Basel committee, which has sought global industry feedback on the "qualitative methodology developed by ANZ Bank". The latest Basel discussion paper gives three alternative approaches, one of which is the scorecard method.

Chris Lewis says that the NAB has been putting capital aside for operational risk for some time. For the current year, he says, the bank has sufficient capital based on the accord, even though it will not become mandatory until 2005.

However until Basel becomes more precise, it is difficult to make an absolute assurance about this. Lewis believes

however, that the banking industry in Australia is well capitalised and will continue to be in order to meet the various hurdles.

### Using technology

As we observed earlier, technology can be a double-edged sword for operational risk. However it is an absolutely critical part of operational risk management.

IBM's Lacan says technology can do much to mitigate risks. It allows an institution to collect and to store the information in a useable form and to be able to translate it into meaningful reports.

One of the key problems with any approach, but in particular with the historic (trend) analysis when applied to operational risk, is that of collecting and storing relevant data. In some circles it is known as the "data desert". You need, according to Lacan of IBM, the broadest range of data that affects your operational risk management and build it into your database. This also becomes relevant in feeding information between financial institutions for creating cross-institutional data stores and is a key for financial institutions to assess and analyse their comparative industry risk.

The ANZ's Gravell says technology allows banks to manage – rather than administrate – risk. "What we tend to find is that if everyone is using disparate forms, templates and spread sheets, energy is spent on administering risk as opposed to managing risk," he says.

"Our technology focus is very much on workflow, so that we implement tools for our risk managers to use as part of their process. The overall aim is to have common technology tools and templates, so that at the group level we are getting information as a by-product, but it is all consistent."

The NAB's Chris Lewis says his bank pursues a statistical analysis based assessment of operational risk.

"Thus the use of technology becomes very important, as you need to capture information out of general ledgers or sub ledgers, loss data bases and other technology that does the number crunching and the quantification."

Yet there are still many technology challenges ahead and further potential for technology to assist with managing operational risk. And banks can learn from other industries' handling of operational risk.

According to the IBM's Lacan, the banks have not addressed the automation of supervision, control and decision making as well as other industries including airlines and the nuclear power industry. While a nuclear plant has extensive control rooms to warn of imminent dangers, banks do not have such a comparative system – they are not so good at capturing data across their organisation.

Lacan notes the chain of events in a bank – from data collection to the various decisions that are made to mitigate risk – is not automated. Thus no-one ensures the right report goes to the right person. This can be enhanced by work flow and supervision technology, as well as a "super layer" of operational risk management.

There is little doubt that operational risk management will become an increasing focus of banks globally. While the Basel moves are adding impetus, local banks have been far from flat-footed in addressing the problems off their own bat. ■

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