Lecture

IAQS | INSTITUTE OF ACTUARIAL & QUANTITATIVE STUDIES

Class: TY BSc

Subject : Basel

Subject Code:

Chapter: Unit 1 Chapter 1

Chapter Name: Operational risk and principles of sound management

Today's Agenda

1. Introduction
1. Role of supervisors
1. Operational risk
1. Fundamental principles

1 Introduction

Principles for the Sound Management of Operational Risk and the Role of Supervision – incorporates the evolution of sound practice and details eleven principles of sound operational risk management covering
(1) governance,
(2) risk management environment
(3) the role of disclosure.

2 Role of supervisors

- Supervisors conduct regular independent evaluations of a bank's policies, processes and systems related to operational risk.
- Supervisors ensure that there are appropriate mechanisms in place.
- Supervisors also seek to ensure that, where banks are part of a financial group, there are processes and procedures in place to ensure that operational risk is managed in an appropriate and integrated manner across the group.
- Supervisors identify deficiencies in the banking mechanism and use tools most suited to the particular circumstances of the bank and its operating environment.
- Supervisors continue to take an active role in encouraging ongoing internal development efforts by monitoring and evaluating a bank's recent improvements and plans for prospective developments.

3 Operational risk

Operational risk is any risk that arises from your company's business processes and could result in financial loss or disruption to your ability to serve customers.

- Operational risk is inherent in all banking products, activities, processes and systems, and the effective management of operational risk has always been a fundamental element of a bank's risk management programme.
- Operational risk management (ORM) is the art of protecting your company from such risks and minimizing any damage that may occur.
- Operational risk is a broad concept.
- Examples include internal issues such as employee misconduct, human error, poorly designed business practices, and weak internal processes. External events such as cyber security breaches and natural disasters qualify as operational risks, too. The common factor in all these events is their ability to affect your daily operations and create a risk of loss.

3.1 Principles for management of operational risk

- Risk management generally encompasses
  - the process of identifying risks to the bank,
  - measuring exposures to those risks (where possible),
  - ensuring that an effective capital planning and monitoring programme is in place,
  - monitoring risk exposures and corresponding capital needs on an ongoing basis,
  - taking steps to control or mitigate risk exposures
  - reporting to senior management and the board on the bank's risk exposures and capital positions.

- Sound internal governance forms the foundation of an effective operational risk management

- Common industry practice for sound operational risk governance often relies on three lines of defence – (i) business line management,
  (ii) an independent corporate operational risk management function
  (iii) an independent review

4 Fundamental principles

Principle 1:
The board of directors should take the lead in establishing a strong risk management culture. The board of directors and senior management should establish a corporate culture that is guided by strong risk management and that supports and provides appropriate standards and incentives for professional and responsible behaviour. In this regard, it is the responsibility of the board of directors to ensure that a strong operational risk management culture exists throughout the whole organisation.

With respect to Principle 1, the board of directors and/or senior management should:

1. Provide a sound foundation for a strong risk management culture
2. Establish a code of conduct (or ethics policy) for all employees
3. Provide risk training

4 Fundamental principles

Principle 2:
Banks should develop, implement and maintain a Framework that is fully integrated into the bank's overall risk management processes. The Framework for operational risk management chosen by an individual bank will depend on a range of factors, including its nature, size, complexity and risk profile.

With respect to Principle 2, the board of directors and/or senior management should:

1. Thoroughly understand both the nature and complexity of the risks
2. Ensure that the Framework is fully integrated in the bank's overall risk management plan

4 Fundamental principles

Principle 3:
The board of directors should establish, approve and periodically review the Framework. The board of directors should oversee senior management to ensure that the policies, processes and systems are implemented effectively at all decision levels.

With respect to Principle 3, the board of directors and/or senior management should:

1. Establish a culture and processes that help bank managers and employees understand and manage operational risks.
2. Regularly review the Framework.
3. Provide senior management with guidance regarding operational risk management.
4. Ensure that the Framework is subject to independent review.
5. Ensure that management is following best practices.
6. Establish clear lines of management responsibility.

4 Fundamental principles

Principle 4:
The board of directors should approve and review a risk appetite and tolerance statement for operational risk that articulates the nature, types and levels of operational risk that the bank is willing to assume.

With respect to Principle 4, the board of directors and/or senior management should:

1. Consider all relevant risks when approving the bank's risk appetite and tolerance statements.
2. Review the risk appetite and tolerance statements

4 Fundamental principles

Principle 5:
Senior management should develop for approval by the board of directors a clear, effective and robust governance structure with well defined, transparent and consistent lines of responsibility. Senior management is responsible for consistently implementing and maintaining throughout the organisation policies, processes and systems for managing operational risk in all of the bank's material products, activities, processes and systems consistent with the risk appetite and tolerance.

With respect to Principle 5, the board of directors and/or senior management should:

1. Establish systems to report and track operational risks and maintain an effective mechanism for resolving problems.
2. Translate the Framework approved by the board into specific policies and procedures used to manage risk. Ensure that operational risk managers communicate clearly with personnel
3. Ensure that CORF managers should have sufficient stature in the bank.
4. Ensure that the staff is well trained in operational risk management.
5. Develop a governance structure of the bank that is commensurate with the size and complexity

4 Fundamental principles

Principle 6:
Senior management should ensure the identification and assessment of the operational risk inherent in all material products, activities, processes and systems to make sure the inherent risks and incentives are well understood.

With respect to Principle 6, the board of directors and/or senior management should:

1. Consider both internal and external factors to identify and assess operational risk

4 Fundamental principles

Principle 7:
Senior management should ensure that there is an approval process for all new products, activities, processes and systems that fully assesses operational risk.

With respect to Principle 7, the board of directors and/or senior management should:

1. Maintain a rigorous approval process for new products and processes.
2. Thoroughly review new activities and product lines.

4 Fundamental principles

Principle 8:
Senior management should implement a process to regularly monitor operational risk profiles and material exposures to losses. Appropriate reporting mechanisms should be in place at the board, senior management, and business line levels that support proactive management of operational risk.

With respect to Principle 8, the board of directors and/or senior management should:

1. Continuously improve the operational risk reporting.
2. Ensure that operational risk reports are timely.

4 Fundamental principles

Principle 9:
Banks should have a strong control environment that utilises policies, processes and systems; appropriate internal controls; and appropriate risk mitigation and/or transfer strategies.

With respect to Principle 9, the board of directors and/or senior management should :
Have a sound internal control system as described in LO 35.e (an effective control environment)and LO 35.f (managing technology and outsourcing risks).
Banks may need to transfer risk (e.g., via insurance contracts) if it cannot be adequately managed within the bank. However, sound risk management controls must be in place and thus risk transfer should be seen as a complement to, rather than a replacement for, risk management controls. New risks, such as counterparty risks, may be introduced when the bank transfers risk. These additional risks must also be identified and managed.

4 Fundamental principles

Principle 10:
Banks should have business resiliency and continuity plans in place to ensure an ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

With respect to Principle 10, the board of directors and/or senior management should:

1. Implement an information and communication technology (ICT) program
2. Oversee the effectiveness of ICT risk management on a frequent basis.
3. Ensure the ICT program can accommodate potential stress and disruptive events.

4 Fundamental principles

Principle 11:
A bank's public disclosures should allow stakeholders to assess its approach to operational risk management.

With respect to Principle 11, the board of directors and/or senior management should:

1. Establish continuity plans to handle unforeseen disruptive events (e.g., disruptions in technology, damaged facilities, pandemic illnesses that affect personnel, and so on).
2. Periodically review continuity plans.

4 Fundamental principles

With respect to Principle 12, the board of directors and/or senior management should:

1. Write public disclosures such that stakeholders can assess the bank's operational risk management strategies.
2. Write public disclosures that are consistent with risk management procedures. The disclosure policy should be established by the board of directors and senior management and approved by the board