Operational Risk Management in Financial Institutions

Objectives

The goal of this two-day workshop is to build an understanding of the importance of operational risk management within the Banking and Finance industry. Specifically, participants will be equipped to:

- Identify the sources of operational risk and how these arise within the context of financial institutions main business activities.
- Understand the governance structures, systems, procedures and cultural aspects necessary for an organisation to successfully manage operational risk.
- Build a knowledge of the main techniques for the measurement and quantification of operational risk and their relative merits and drawbacks.
- Appreciate the approaches available to a bank under Basel III for the calculation of regulatory capital for operational risk and the supervisory requirements for each approach.

Content

Analytic Overview

The aim of this section is to understand the nature of operational risk, identify typical occurrences of operational risk within a bank's business model, and to consider external perspectives on the importance of operational risk management in rating and banking supervision.

- Importance of Operational Risk as part of the firms risk inventory
- Understanding the nature of operational risk: "Dimes and disasters"
- Current industry drivers of increasing operational risk in financial institutions; complexity, innovation, technology, transaction velocity and litigation
- Motivations to manage operational risk: financial loss, legal and regulatory requirements, reputational risks, capital management and planning
- Management perspectives/requirements; understanding the risk, information systems, quantification, mitigation and hedging decisions, cultural and behavioural aspects
- Identifying categories of operational risk in financial institutions:
  - Core operational capacity
  - People risks
  - Client relationships & Fiduciary risks
  - Transactional systems
  - Safe custody
  - Reconciliation and reporting
  - Fraud
  - Legal risk
  - Change and new activities
  - Expense volatility
- External perspectives on operational risks:
  - Incorporation of operational risk criteria in rating agency methodologies
  - Regulatory and industry perspectives on the importance of operational risk control
  - Exercise: Identifying sources of operational risk across business lines in a major financial institution

Operational Risk Governance

The objective of risk management is to add maximum sustainable value to the activities of an organisation. It therefore needs to be a continuous and developing process that operates in conjunction with the development and implementation of the organisation's strategy and whose aim is to increase the probability of achieving the overall objectives of the organisation and reduce the probability of failure.

To achieve this, operational risk management must be integrated into the organisation and led by the most senior management. This section of the course will therefore look at the key role of the board in setting an organisation's operational risk policy and the key characteristics of how it is implemented.

- Risk management process – Operational risk as an integral part of the enterprise risk management framework
- Roles and responsibilities of the board, senior management and support functions.
- Defining risk appetite for operational risk. What is it and how can it be expressed?
- Evaluating corporate governance standards
- 3 lines of defence – an explanation of the traditional three lines of defence and the allocation of risk responsibilities.
- Exercise: Operational risk corporate governance (Rabobank)
- Operational risk framework – how the components of operational risk management fit within strategy and risk policy.
- Operational risk cycle – the components of the risk cycle: identification; assessment and measurement; mitigation and management; monitoring and reporting.
- Regulatory perspective – rules and guidance on operational risk governance and risk management structures; IMMR framework; BIS Guidelines
- The role of culture in the organisation-wide management of operational risk
    - Why culture forms such an important aspect of operational risk management
    - Characteristics of poor versus effective operational risk cultures
    - Fostering an effective risk management culture
- Case study: Refco: Cultural aspects to operational risk

Management of Operational Risk

The objective of this section is to consider the main techniques used to identify and to manage operational risks, within a financial institution environment.

- Objectives of operational risk management; avoidance of catastrophic losses, promote organisational understanding of operational risk, anticipate risks more effectively, objectively measure performance, change culture and behaviours, streamline products and services and ensure that adequate due diligence is performed in any takeovers or merger
- Operational risk policy – the key components of an organisation's operational risk policy
- Identifying the organisations operational risks through risk control and self-assessment
    - RCSA techniques – advantages and disadvantages
    - Cultural aspects to the RCSA
    - Defining frequency and impact scales
- Assessing the full range of potential impacts of operational risk
- Understanding controls and how risk is modified
    - Relationship Inherent risk, residual risk, expected risk and targeted risk
    - Assessing how controls modify risk
    - Exercise: identifying control functions
- Scenario Analysis
    - Using the RCSA to identify likely scenarios
    - Scenario design techniques and avoiding assumptions/bias
    - Use of external data in scenario design
    - Exercise: designing scenarios
- Key Risk Indicator Analysis

- Types of KRI and relationship to risk levels
- Characteristics of and identifying useful KRI's
- KRI calibration approaches
- Operational risk incident recording
  - Objectives of risk incident recording
  - Internal data collection, parsing and emerging risks identification
  - The importance "Lessons Learned" processes
  - Impact of new products, processes, business lines & locations
- Improving the organisations operational risk process
  - Strategies align operational risk to risk appetite: the ATAC matrix.
  - Measuring progress and improvement

Bank Regulatory Capital Requirements for Operational Risk

This section aims to demonstrate how the management and measurement techniques explored in the previous sections are applied by the Basel II and III capital accords.

- Fundamental nature of bank regulatory capital requirements
- The challenges of calculating unexpected versus expected loss for operational risk
- Exercise: Identifying expected versus unexpected loss for operational risk
- Fundamental Basel approaches for operational risk capital requirements
  - The Basic Indicator Approach
  - The Standardised and Alternative Standardised Approach
  - The Advanced Management Approach (AMA)
- Basel III proposed changes to simplified approaches
- Regulatory criteria for adoption of Standardised and AMA approaches
- The Advanced Management Approach
  - Classification of risks under the AMA
  - Qualitative risk management standards
  - Quantitative system and data standards
  - Typical methodologies and system architectures employed under the AMA
- Pillar 2 and Pillar 3 requirements for operational risk
- A review of implementation standards and regulatory capital allocation at major global banks.
- Case study: identifying and comparing the elements of operational risk capital systems at major global banks

Specialist Operational Risk Management Areas

The objective of this section is to discuss current areas of topical importance within operational risk and how these areas are impacting the way in which financial institutions manage operational risk

- Financial crime and cyber risks
  - Types of cyber-crime and relative scale and importance
  - Recent high-profile incidents
  - Information security policies and procedures
  - Regulatory initiatives to increase financial system resilience to cyber-risks
- People risks
  - Fraud, key man and capacity driven people risks
- Business change risks: sources and potential consequences
- Case study: Co-operative bank, the role of people risks and business change risks in the near-failure of a financial institution.

Peter Chudy

Peter Chudy has recently joined Fitch Learning following an extensive career in risk management at large global banks. Mr. Chudy's course work can be tailored for the client to meet strategic initiatives and regional issues. His course range includes: Financial Institution Analysis, Corporate Credit Analysis, Real Estate, Securitization, and Regulatory & Risk Management. Mr. Chudy has a strong understanding of regulatory requirements and has had to develop and oversee projects, which met credit, market and operational risk requirements. Specialized topics include Building and Managing Teams of Risk Professionals and Managing through a Crisis.

Mr. Chudy has proficiently formed the skills of risk professionals over many years. He has developed and presented educational materials to risk, sales, and trading staff and has made presentations on strategic information to Board Members and Regulators. As Chairman of the Capital Markets Credit Analyst Society, he managed educational programs for industry professionals. His deep involvement with numerous financial crises provides interesting narratives that support course materials. Mr. Chudy has delivered training on over 12 different Fitch Learning Courses, which have covered financial institution analysis, traded products, and regulatory and risk management related to Credit, Market and Operational risks.

Prior to joining Fitch Learning, Mr. Chudy spent 12 years as a Managing Director at UBS, including the role of Chief Risk and Operating Officer of the asset manager for the SNB StabFund. He helped in establishing the fund, which provided Swiss Government support to UBS for $38 billion of global exposures related to the 2008 financial crisis. Prior to that role, he was the Global Chief Risk & Credit Officer for Real Estate and Securitization, and previously had been Chief Credit Officer for the Americas at Nomura.

Mr. Chudy holds an MS in Finance from Boston College, has earned the CFA charter, and completed the Chase Manhattan Bank's Corporate Finance Training Program. He has managed teams of professionals based in New York, London, Tokyo, and Sydney.