Editorial

The financial crisis and operational risk management: Unfinished business

Regulators have always fostered an expectation that capital is what sustains banks in periods of stress and prevents them from failing. In the midst of the present financial crisis, it is perhaps more appropriate to view the capital reserves that banks are forced to hold as the ruler by which an organisation counts down to failure rather than the system that proactively prevents it.

So, if it isn't capital, what does offer banks the greatest protection against failure? Quite simply, it is the risk culture embedded in its people and processes. At the core of any risk culture are (1) the incentives for individual compensation that balance risk and return with short-term self-interest and long-term stakeholder goals and (2) the early warning systems that highlight growing exposures to risk. Here, the yet-to-be-implemented operational risk framework, the final piece of Basel II intended to foster a risk-adjusted performance culture, offers the greatest hope for preventing future crisis.

Basel II defines operational risk as 'the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events'.[1] Meanwhile, federal regulators have called for a 'consistent and comprehensive capture and assessment of data elements needed to identify, measure, monitor, and control the bank's operational risk exposure. This includes identifying the nature, type(s), and underlying cause(s) of the operational loss event(s).'[2]

It is precisely this final piece of Basel II that should be preventing such crisis while fostering the creation of a risk-adjusted performance culture. Unfortunately, the financial industry is still building operational risk management systems around self-assessments, indicators and scenario analyses that project capital requirements, rather than enterprise systems that create a true risk-adjusted performance culture around people, their processes and the data with which they interact. For it is in people, in their processes and in the data upon which they act that risk exposures arise.

Basel II classifies operational loss events as resulting from internal fraud, external fraud, employment practices and workplace safety, clients/products/business practices, damage to physical assets, business interruption and systems failures, or execution/delivery/process management. Within these categories are the subcategories of model risk, faulty reference data risk, faulty product structures, process and control risk, and inappropriate sales to counterparties.

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Many of the recent headline-grabbing events can be slotted into one or more of these categories. Citibank reported that its market value-at-risk does not include the positions of its collateralised debt obligations due to the difficulty in valuing them; MF Global announced a $141m trading loss resulting from a systems control problem; Merrill Lynch acknowledged $43bn of over-the-counter derivative cash flow improperly recorded on its balance sheet; Credit Suisse took a $2.8bn write-down for pricing errors; Société Générale reported a $4.9bn loss from trader fraud; Bear Stearns nearly collapsed because it could not price its mortgage portfolios; Lehman went bankrupt because its mark-to-model valuations for securitised mortgage portfolios proved untrustworthy; Freddie and Fannie were nationalised because they got caught holding poorly-constructed asset-backed securities when there were no buyers for the securitised mortgage pools they were selling; and Washington Mutual, HBOS and others still to come have been taken over by stronger financial institutions which kept to their disciplined business practices.

More significant, however, was how the fiduciaries watching over the trillions of dollars of retirement funds blindly accepted the credit agencies' labelling of these products as investment grade. Anyone doing their due diligence, and who understood what they were looking at, could see the quicksand of the faulty assumptions that underpinned the models' elegant mathematics.

The failure in risk management at Société Générale, Bear Stearns, Lehman Brothers and the many others are egregious examples of operational loss exposures not monitored and risk-adjusted performance gone awry. Even more egregious, however, are the pay schemes that are endemic in investment banks — the pay schemes that reward those who take big risks with shareholders' capital and manage to make it to bonus day, when they can take their winnings off the table. Here, somewhere between internal fraud, employment practices and workplace safety, and clients/products/business practices, are operational risks taken in each business line that are yet to be measured or protected against.

A key decision in any financial institution is how to allocate capital to each business line. The business line is where stakeholders' capital is put 'on the line' in the risk versus reward culture of today's investment banks. First, in order to manage capital in this way, the organisation must be structured into appropriate business units within a hierarchy of accountability. Following this is the implementation of transfer-pricing schemes, cost accounting systems, and performance attribution and incentive compensation structures. All are prerequisites to fostering a capital-based risk-adjusted performance culture across business lines.

Secondly, operational risk exposure measures for the defined Basel II operational risk loss categories have yet to be developed. It is perplexing to do this because, unlike market and credit risk (the more developed categories of Basel II for which capital is set aside), operational risk has no naturally occurring monetary measure. A robust risk-adjusted performance culture depends not only on being able to properly accumulate historical data on market prices and credit default histories but also on accumulated measures of operational risk, a task yet to be accomplished.

Further, although historical data on market prices and credit defaults are robust, the links between the identities of issuers of debt and equity and their identities as counterparties in trades or as borrowers are not made in a meaningful and consistent way. This is proving difficult to resolve because there is no standard identity for issuers, counterparties or obligors, or any hierarchical structures to link them. There should be, and some trade associations in conjunction with regulators are now focused on this.

Finally, operational losses can be generalised as failures in either manual or automated processes or their interaction with faulty data. They occur either as one-time events or as the culmination of multiple failures over extended periods. There is a need for an exposure-to-risk measurement mechanism to quantify such exposures as they accumulate. This was, and remains, a key objective of the framers of Basel II.

Creating exposure-to-risk measures, typically key risk and performance indicators, in the form of operating metrics that are responsive to changes in causal factors, is the province of operations people. Equating such measures to loss frequency and severity, the province of risk managers, is still to be developed. Work in marrying the two into a common set of objectives needs to be undertaken, if it is ever to be useful in preventing another financial crisis. Help here can be provided by regulators, by adding capital reduction incentives for mitigating operational risk exposure above the arbitrary 20 per cent threshold now allowed. This would further stimulate financial institutions to build enterprise-wide operational risk systems, as has been the case for some time with market and credit risk.

The Basel II operational risk framework is sound and still relevant; it simply needs to be put into practice in the way the regulators envisioned it. A key component of the remaining implementation is operational risk. Getting on with it should now be a top priority.

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