Response by John Thirlwell to the Basel Committee on Banking Supervision's consultative document: 'Sound Practices for the Management and Supervision of Operational Risk'

My connection with operational risk goes back to my work as a Director of the British Bankers' Association and initial surveys of operational risk management in member banks starting in 1995. I founded and chaired the BBA's Global Operational Risk Database (GOLD) and, although I left the BBA in 2003 to pursue a portfolio career as a risk management adviser and non-executive director in financial services, I have maintained strong links with thinking in relation to operational risk management. I am a Fellow of the Institute of Operational Risk and am co-author, with Tony Blunden, of *Mastering operational risk*, which was published by Financial Times Prentice Hall in August 2010. Further details of my background and experience, as well as the numerous conference speeches I have given and my publications can be found on my website, *www.johnthirlwell.co.uk*.

The original Sound Practices paper, published by the Committee in 2003, has in my view remained a beacon of light on the subject and I am pleased that the Committee has decided to update it. With further years of experience of the subject it is able to go further than its predecessor, but its emphasis remains in practical operational risk management, which is to be commended.

I have not commented on the paper in detail, but there are three areas where I wished to add to the numerous responses which the SIG will receive. They reflect my own experience in the subject over the last 15 years. I trust they will be helpful to the Committee in its deliberations.

'Operational risk is inherent in all banking services and activities' (CP, para 10)

This point cannot be emphasised too much in the eventual published Principles. Operational risk forms a material part of credit, market and liquidity risks. The fundamental threats to the business are all elements of operational risk and its management. People risk and behaviours, a fundamental cause of the banking crisis are a core element of operational risk and are highlighted as one of its core components in the standard definition of operational risk. Having been co-author of the progenitor of the BIS definition[1], I know the emphasis we wished to place on this core element.

The way in which capital is calculated has tended to isolate operational risk into a silo of 'anything which isn't credit, market or liquidity risk'. In a paper which is dealing with operational risk *management*, rather than capital calibration, the role of operational risk management as the essential part of business risk management needs to be brought out as fully as possible.

It is because of this fundamental point that it is not surprising that the paper slides seamlessly in many places from operational risk management to risk management and back again. This is especially true in the discussions relating to Principles 5, 6 and 9. In my view, the two are virtually synonymous.

Independence of the operational risk management function (Principles 3, 5 and 9)

These Principles include comments about the role of the CORF. They appear to suggest that the CORF is in some way equivalent to other central functions which provide oversight of financial risks such as credit and market risks. In my experience, there is not a direct correlation, nor should there be, because operational risk, by almost any measure, is fundamentally different from the other major risk types. A key part of the credit risk function is the exercise of some form of discretionary authority. It is able to sanction or reject risks, or to limit them. This is not true of operational risk or its management, either in the business or in a CORF.

Following on from my argument above (para ##), and as stated in the paper, operational risk is integral to all of a firm's activities and risks. I therefore believe that the independence of the CORF should be no higher than that expressed in the Committee's paper, published last year, *Principles for enhancing corporate governance*:

' . . . the risk management function should be *sufficiently* (my italics) independent of the business units whose activities and exposures it reviews. . . . it is also important that risk managers are not so isolated from business lines – geographically or otherwise – that they cannot understand the business or access necessary information.' (para 75)

A tendency for supervisors to emphasise the importance of the risk function's independence has, in my view, had a detrimental effect on the operational risk function. It has encouraged risk managers to retreat to a centralised function when, in the case of operational risk, they can provide an important advisory and support function by operating within business units. If their independence as reporters is compromised, then I would hope that governance procedures were robust enough to allow them to escalate such a problem. But suggestions that operational risk managers should reside in a separate, independent location should be expressed very carefully indeed.

Measurement and assessment (CP, paras 11 and 39)

I was delighted to read that Principle 6 speaks of identification and *assessment*, and not identification and *measurement* (my italics). Unfortunately, para 11 uses the second of the two combinations. Operational risk management, if it is a science at all, is akin to a social science, rather than a physical or mathematical science. Friedrich von Hayek, in his Nobel acceptance speech,[2] emphasised the dangers of relying on such quantitative data as is available, whilst another Nobel economics laureate, Kenneth Arrow, memorably wrote,

'Our knowledge of the way things work, in society or in nature, comes trailing clouds of vagueness. Vast ills have followed belief in certainty.'[3]

It has always seemed to me that 'assessment' is a far better way in which to describe what we can do in estimating exposure to operational risk, rather than 'measurement', which has a flavour of certainty about it. I recommend that para 11 should be changed accordingly.

[1] RMA and PricewaterhouseCoopers, *Operational Risk: the next frontier*, RMA, BBA, ISDA, 1999 (p.29)

[2] Hayek, *The pretence of knowledge*, Nobel acceptance speech, 1974

[3] Arrow, *I can tell a hawk from a handsaw*, CUP, 1992 (p.46)