

The risk management function and non-financial risks

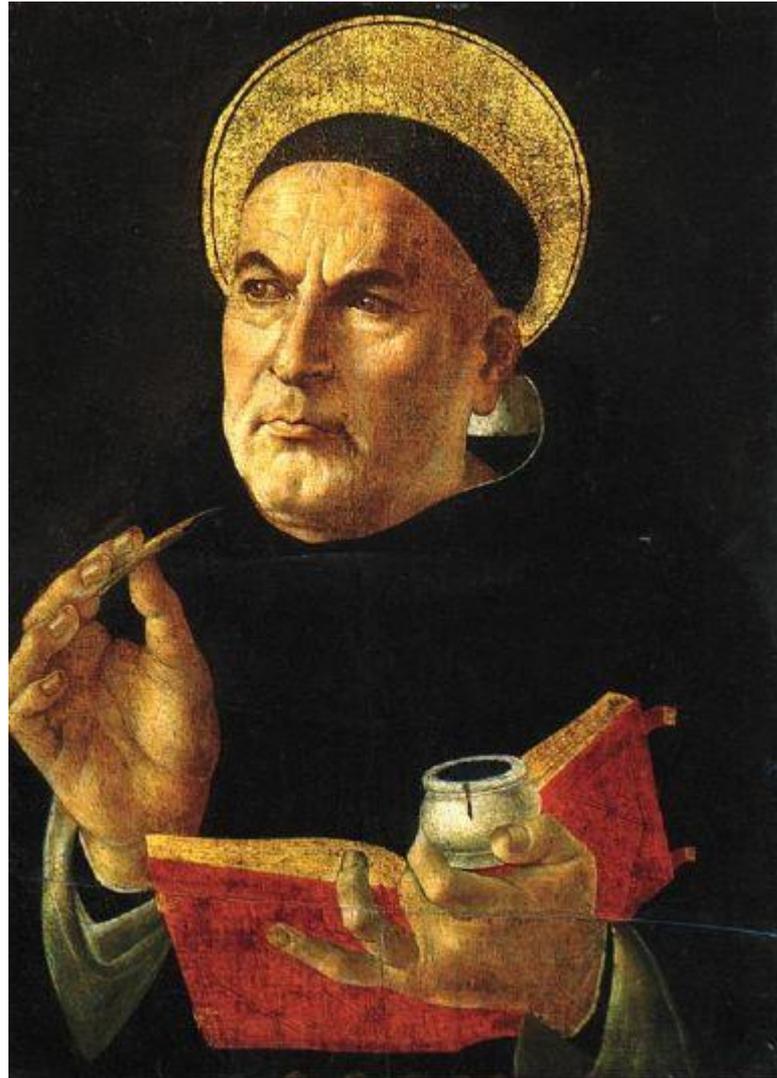
John Thirlwell

ILAG, 2 April 2014

Agenda

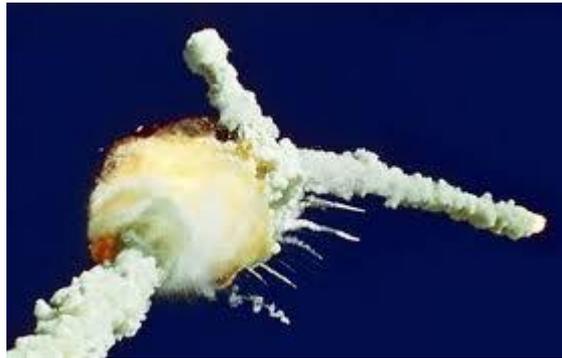
- Risk management and non-financial risks
- Risk management and 'independence'
- Risk management and other functions
- Risk management, strategy and culture

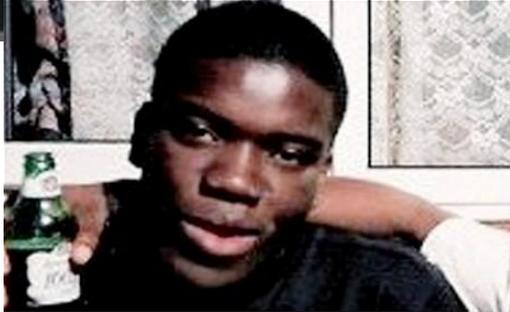
‘The world has never been so full of risk.’



National security strategy (Oct 2010)

TIER 1	TIER 2
International terrorism	Chemical, biological, nuclear, radioactive (CBNR) weapons
Cyber attacks and large scale cyber crime	Overseas insurgency creating environment for terrorism
Major accident or natural hazard, e.g. extensive coastal flooding, pandemic	Organised crime
International military crisis	Satellite communications disrupted





The banking crisis

- The trigger: Asset bubble
 - Sub-prime lending
 - Complex instruments (failure to challenge or understand)
- Organisational design and structure
 - Failure to apply good risk management and governance
 - Rating agencies – over-reliance; incompetent
 - Regulators and the regulatory regime (Basel II)
- Economic and strategic imperatives
 - Profit
 - The banking ecosystem: failure to understand systemic risk
 - Electoral imperatives (politicians)
- Cultural and human factors
 - Human behaviour (greed, herd instinct, bullying, hubris etc) of banks, customers, politicians, regulators

Scope of operational (non-financial) risk

- The Solvency 2 definition:
‘The risk of loss resulting from inadequate or failed internal processes, people or systems or from external events’
- Does your definition cover:
 - Strategic risk? Strategic implementation risk?
 - Conduct risk?
 - Regulatory risk?
 - Legal risk?
 - Reputation risk?

BASEL II	SOLVENCY II
Internal fraud	Intentional misconduct (internal fraud)
External fraud	Unauthorised activities by external parties (external fraud)
Employment practices and workplace safety	Employment practices and workplace safety
Clients, product and business practices	Clients, product and business practices
Damage to physical assets	External events that cause damage to physical assets
Business disruption and system failures	Business disruption and system failures
Execution, delivery and process management	Business process risks

For more detail of categories, see the Basel II Framework (2006), Annex 9 (Detailed loss event type classification), www.bis.org/publ/bcbs128d.pdf

An attempt to frame the unframeable, to assuage fears about the uncontrollable 'rogue others' and to tame the man-made monsters [of the financial system].

Prof Michael Power, *Organized uncertainty : designing a world of risk management* (OUP, 2007)



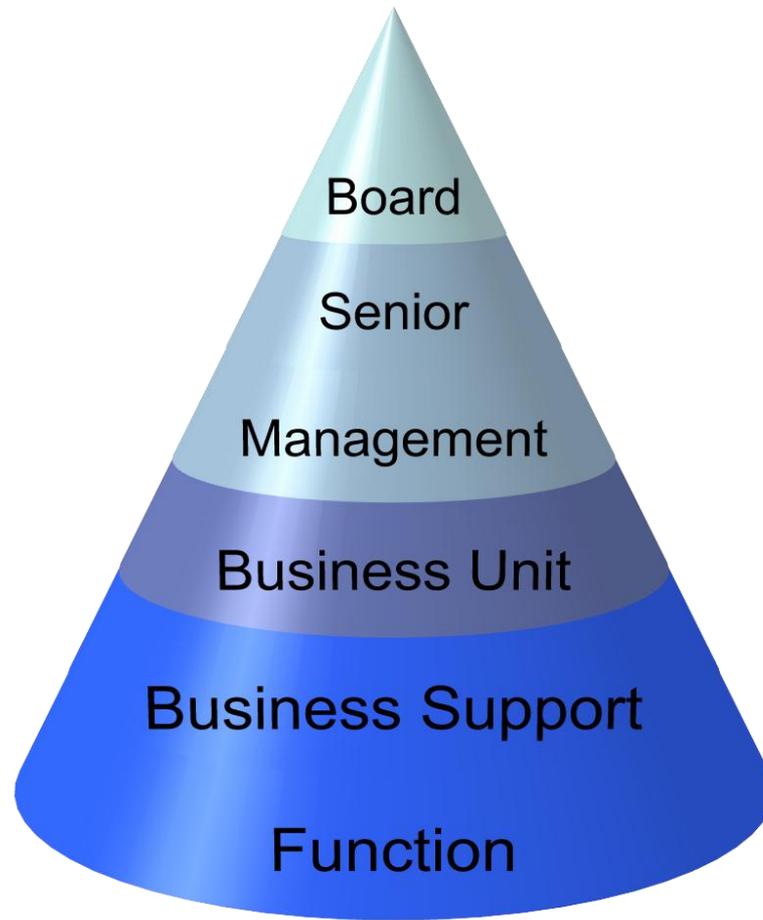
Is operational risk different from other risks?

	Insurance, credit, market, liquidity (financial)	Operational (non-financial)
Is the risk wholly transaction-based?		
Is the risk assumed proactively ?		
Can it be identified from accounting information e.g. the P&L?		
Can audit confirm that every occurrence of the risk has been captured?		
Can its financial impact be capped or limited?		
Can you trade the risk?		

Is operational risk different from other risks?

	Insurance, credit, market, liquidity	Operational (non- financial)
Is the risk transaction-based?	Y	N
Is the risk assumed proactively ?	Y	N
Can it be identified from accounting information e.g. the P&L?	Y	N
Can audit confirm that every occurrence of the risk has been captured?	Y	N
Can its financial impact be capped or limited?	Y	N
Can you trade the risk?	Y	N
Is everybody in the firm responsible for the risk?		

Whose risk is it anyway?



Is operational risk different from other risks?

	Insurance, credit, market, liquidity	Operational (non- financial)
Is the risk transaction-based?	Y	N
Is the risk assumed proactively ?	Y	N
Can it be identified from accounting information e.g. the P&L?	Y	N
Can audit confirm that every occurrence of the risk has been captured?	Y	N
Can its financial impact be capped or limited?	Y	N
Can you trade the risk?	Y	N
Is everybody in the firm responsible for the risk?	N	Y
Does the risk affect every activity?		



Liquidity Risk

Underwriting Risk

Operational Risk

(including Strategic Risk)

Market/Product Risk

Group Risk

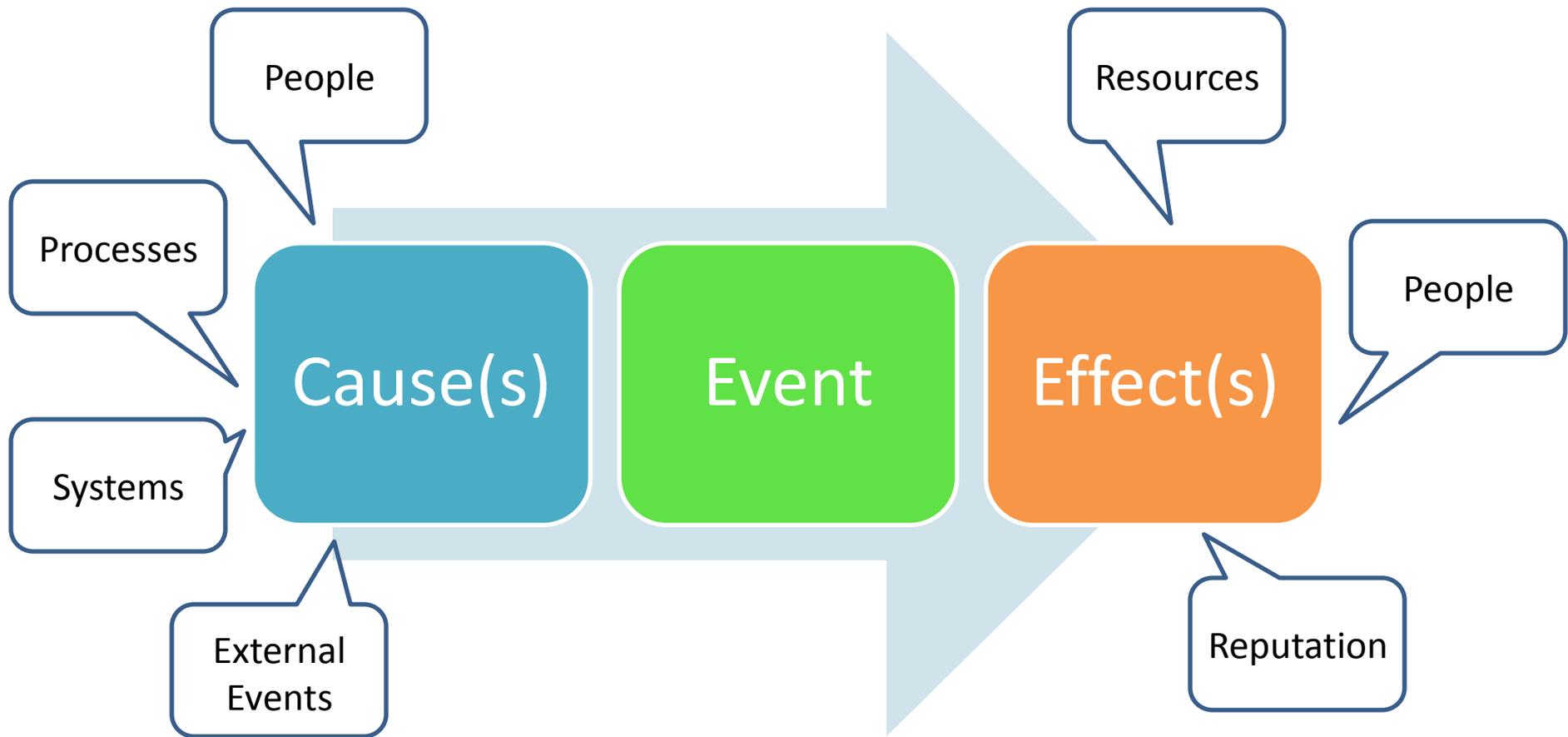
Credit Risk

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.

[Sound practices for the management and supervision of operational risk, BIS, 2011]

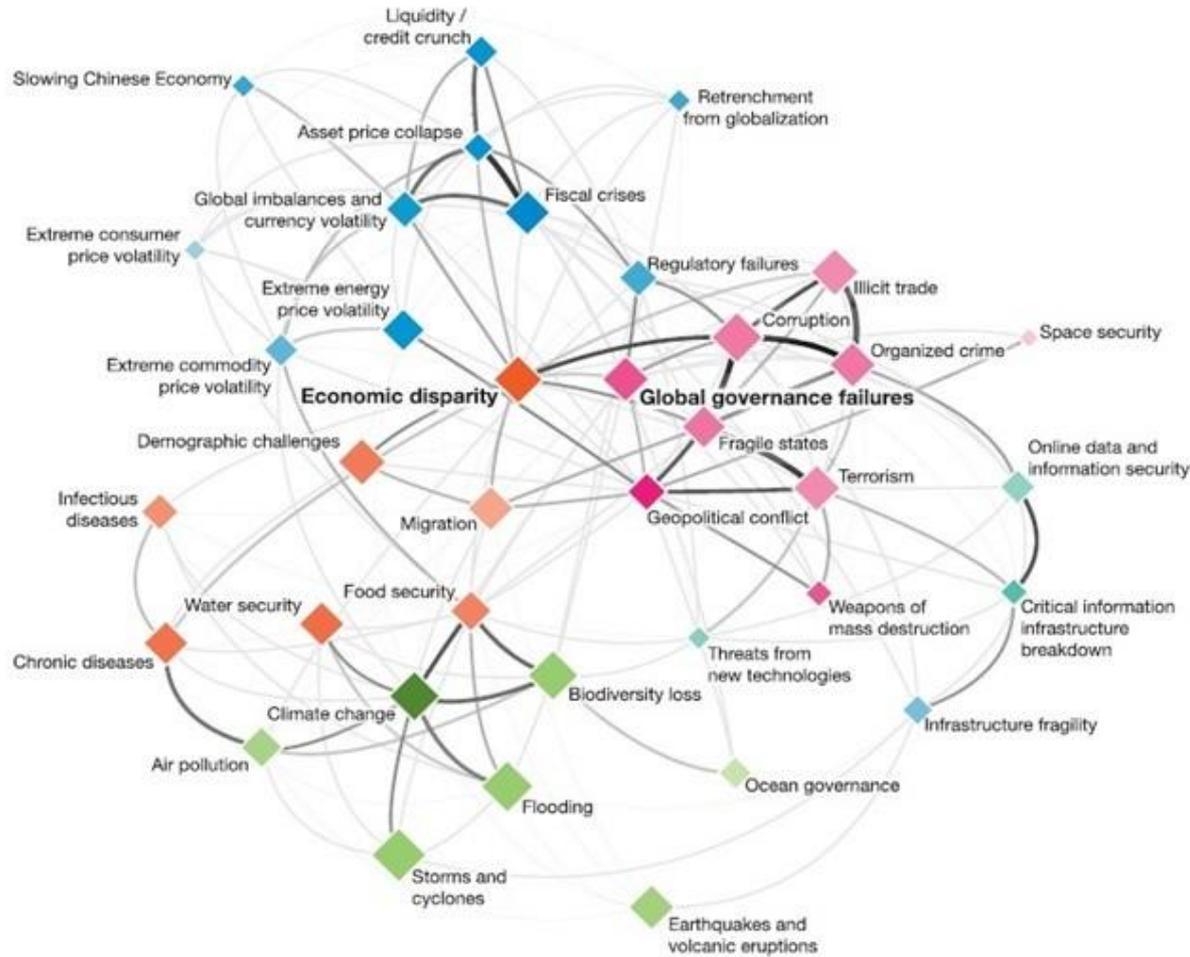
Is operational risk different from other risks?

	Credit, market, commodity, liquidity	Operational
Is the risk transaction-based?	Y	N
Is the risk assumed proactively ?	Y	N
Can it be identified from accounting information e.g. the P&L?	Y	N
Can audit confirm that every occurrence of the risk has been captured?	Y	N
Can its financial impact be capped or limited?	Y	N
Can you trade the risk?	Y	N
Is everybody in the firm responsible for the risk?	N	Y
Does the risk affect every activity?	N	Y



A risk interconnectedness map

(World Economic Forum 2011)



Management and measurement

- Measuring non-financial risks
 - Distributions of (loss?) events?
 - Monte Carlo RCAs?
 - Scenarios?

Who manages non-financial (operational) risks?

- Who actually owns and who oversees or manages the people, process, systems and external causes of insurance, credit, market and liquidity risks?
- Who owns and who manages:
 - Strategic risk? Strategic implementation risk?
 - Conduct risk?
 - Regulatory risk?
 - Legal risk?
 - Reputation risk?

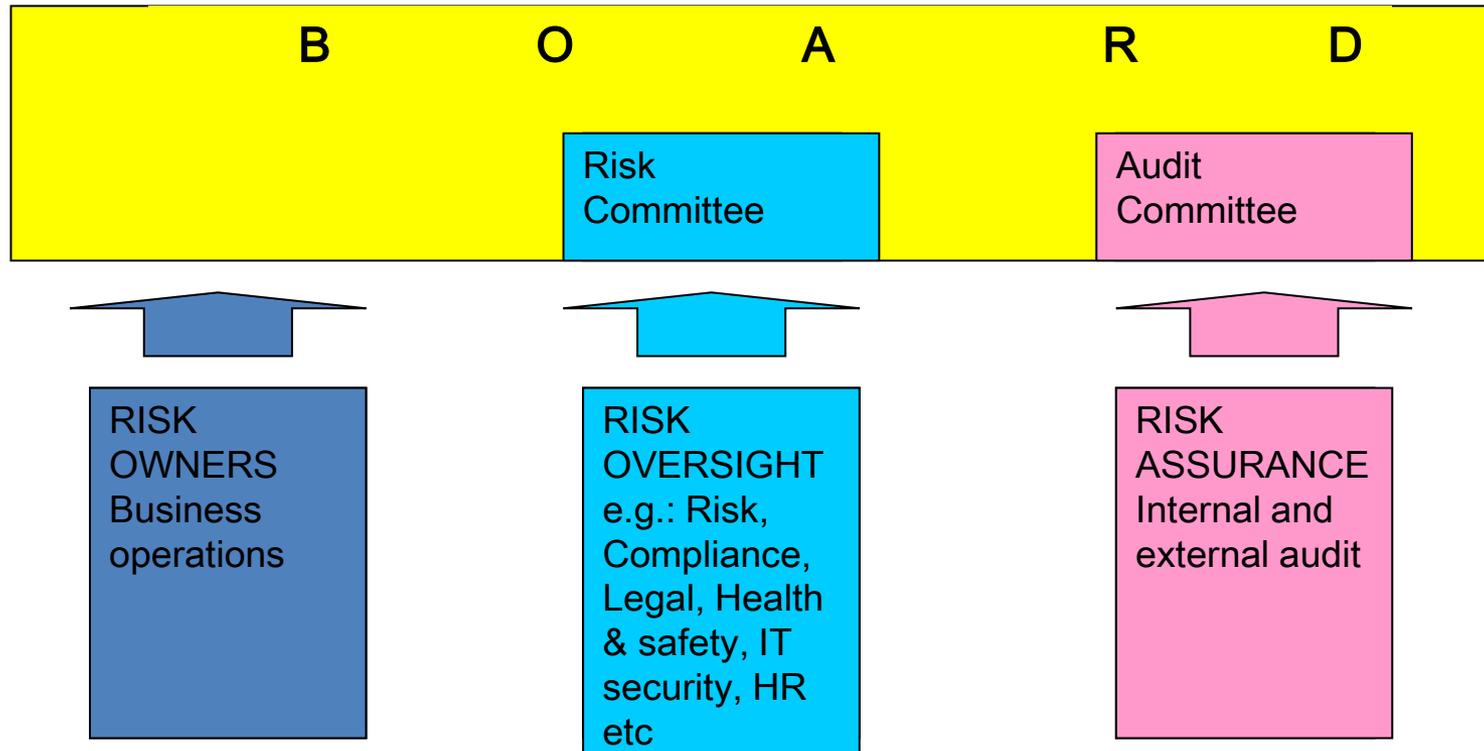
Reputation stakeholders and reputation risk relationship managers

Reputation stakeholders	Reputation risk relationship managers
Customers	Business line
Suppliers	Procurement
Employees	Management and HR
Investors	Investor relations
Regulators	Compliance
Customer interface	Support functions e.g. IT
Third-party agents	Business line
Press	Press and public relations
Politicians	Public affairs or CEO

Agenda

- Risk management and non-financial risks
- Risk management and 'independence'
- Risk management and other functions
- Risk management, strategy and culture

The 3 lines of defence



Non-financial (operational) risk and the 3 lines of defence

- Is the risk function a control or oversight function?
- Should the risk function be independent of the business line?
- If it should, what do we mean by 'independent'?
- If not, how do we overcome any conflicts?

Agenda

- Risk management and non-financial risks
- Risk management and 'independence'
- Risk management and other functions
- Risk management, strategy and culture

To what extent are the following part of the risk management risk function?

- New products
- Business Continuity Planning
- 3rd party dependencies (outsourcing, supply chain etc)
- Insurance-buying
- IT security
- Employment/HR: health & safety; discrimination
 - People risk
- Compliance
- Legal

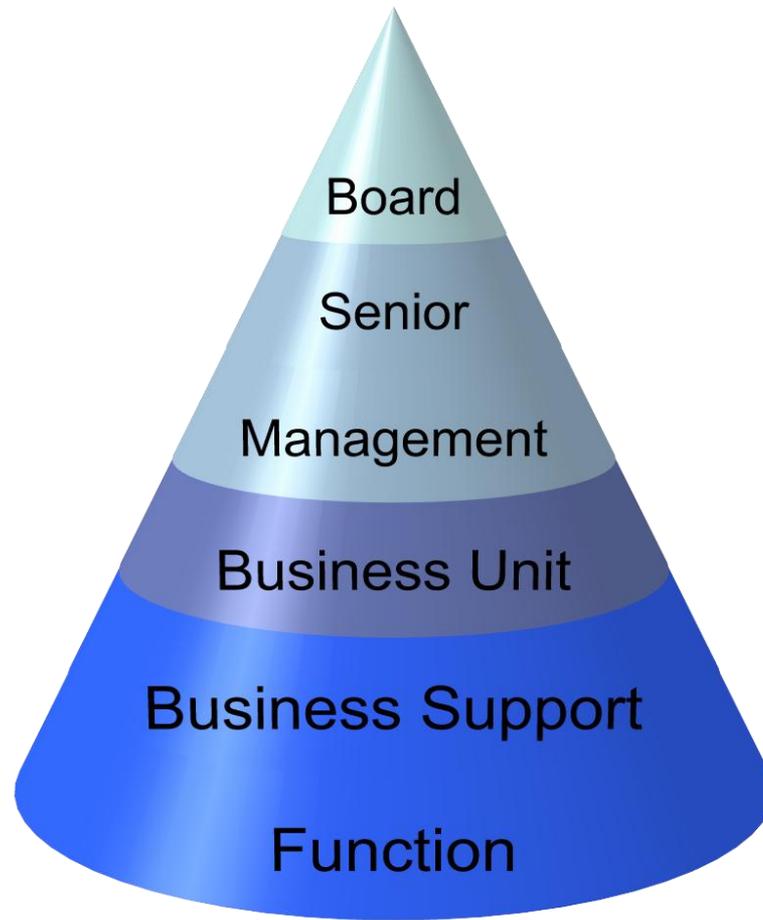
Agenda

- Risk management and non-financial risks
- Risk management and 'independence'
- Risk management and other functions
- Risk management, strategy and culture

Risk management and strategy

- Clarity of strategy and objectives
 - The context for:
 - Risk identification
 - Risk management
 - Risk appetite
 - Risk culture

Whose risk is it anyway?



Risk management and strategy

- Clarity of strategy and objectives - at every level
 - The context for:
 - Risk identification
 - Risk management
 - Risk appetite
 - Risk culture
- Risk at the heart of all business decisions
- CRO at the heart of all business decisions?

Some definitions of organisational culture

- The way we do things round here. (Bower, 1966; McKinsey)
- The way we *decide* to do things round here.
- A pattern of basic shared assumptions learned by a group as it solved its problems . . . (Schein, 2010)
- The culture of a group arises from the repeated behaviour of its members. The behaviour of the group and its constituent individuals is shaped by their underlying attitudes. (IRM, 2012)
- ...the values, beliefs, knowledge and understanding about risk, shared by a group of people with a common purpose ... (IRM, 2012)

Cultural key words

- Organisation
 - Individuals
 - Groups
- Behaviour
- Attitudes
 - Values
 - Beliefs
- Tradition / built over time / repeated / corporate memory – but never static
- Purpose

Cultural key words – Salz review (Barclays, 2012)

‘There was no sense of **common purpose** . . .
Across the whole bank, there were no clearly
articulated and understood **shared values** . . .
and what should guide **everyday behaviours**.’

[para 2.15]

Embedding (risk) culture

- Committed leadership
- Strategy and objectives
- Values and behaviours

- Clear roles and responsibilities
- Open channels of communication
- Selection, induction and training
- Reward

John Thirlwell

Tel: +44(0)781 382 9362

email: info@johnthirlwell.co.uk

www.johnthirlwell.co.uk

