

OPERATIONAL RISKS

An abstract graphic consisting of several parallel diagonal lines of varying thicknesses, extending from the bottom right towards the top right of the page.

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MOST IMPORTANT LESSON OF TODAY'S CLASS:

Operational risks are not quantitative – not like credit risk etc

Operational risks are inherent – you can never totally eliminate them

They are directly connected to the degree of internal control in your business

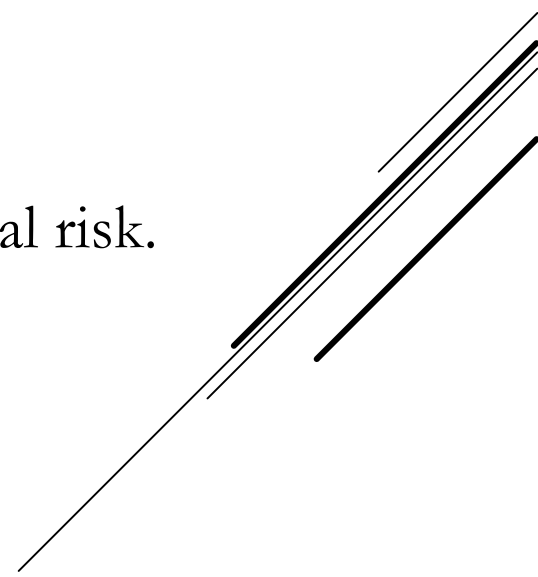


DEFINITION OF OPERATIONAL RISK



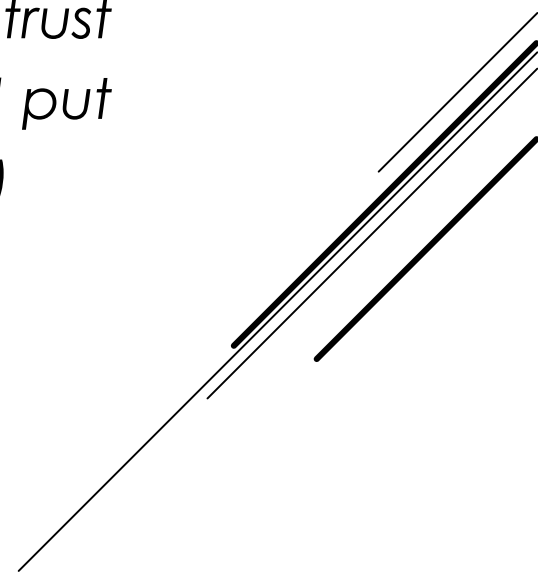
"risk of loss resulting from inadequate or failed internal processes, people and systems or from external events".

This includes legal risk.



OPERATIONAL RISKS ARE NOTHING NEW

O my children, do not enter capital of Egypt by one gate but go into it by different gates. However know it well that I cannot ward off you Allah's will for none other than He has nay authority whatsoever. In Him I have put my trust and all who want to rely upon anyone should put their trust in Him alone." (Surah Yusuf: Verse 67)



HOW DO THE OPERATIONAL RISKS OCCUR?

1. Internal fraud
2. External fraud
3. Employment practices and workplace safety
4. Client, products & business practices
5. Damage to physical assets
6. Business disruption and system failure
7. Execution, delivery & process management



OKEY. BUT HOW DOES THIS
WORK OUT IN REALITY?

THE BORDERLINE BETWEEN RISK TYPES

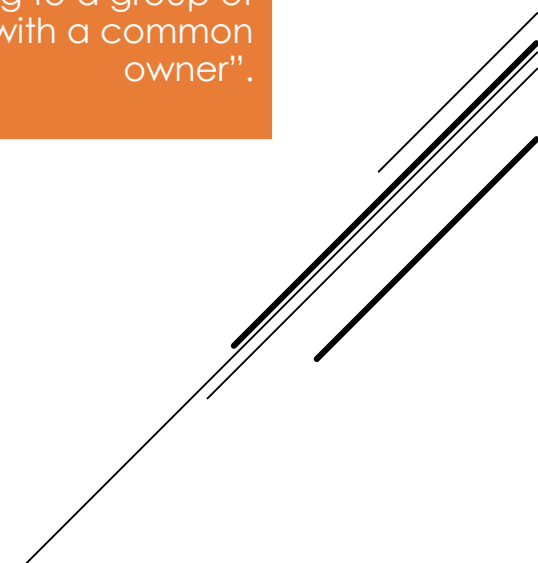
Compliance report:

"...the instruction steering the total exposition to costumers has been violated. Recently has a significant break against the regulation been discovered by the compliance office."

Risk report:

"An credit loss has been taken. The loss is 1 mSEK and the reason appears to be lending to a group of companies with a common owner".

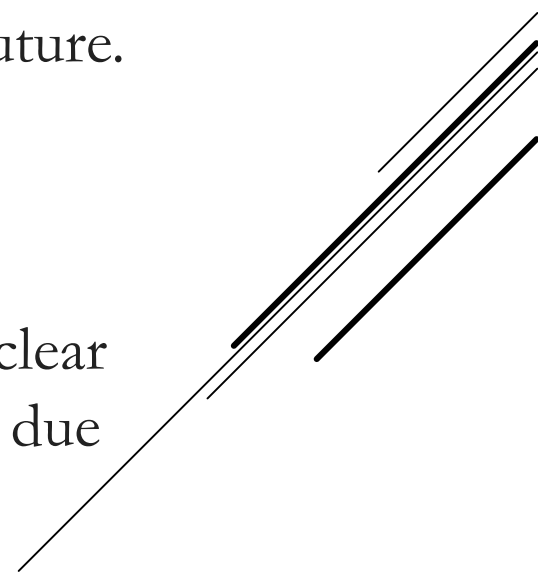
The two boards reports may be seen as two different situations/incidents, when they actually are reporting the same thing from to different views.



CLASSIFICATION OF RISKS

Instead, it should of course look as follows: " ... The bank has recently suffered a credit loss of 1 billion due to violation of the internal rules on clustering connected customers. The Bank has initiated a project to investigate how this could happen and how we can prevent the departure from the framework takes place in the future. "

The advantage of analyzing credit loss in this way provides not only the cause of the loss, but also a clear indication of how it should be classified - as a loss due to operational risk!



IF CREDIT RISK IS YOUR LARGEST RISK...

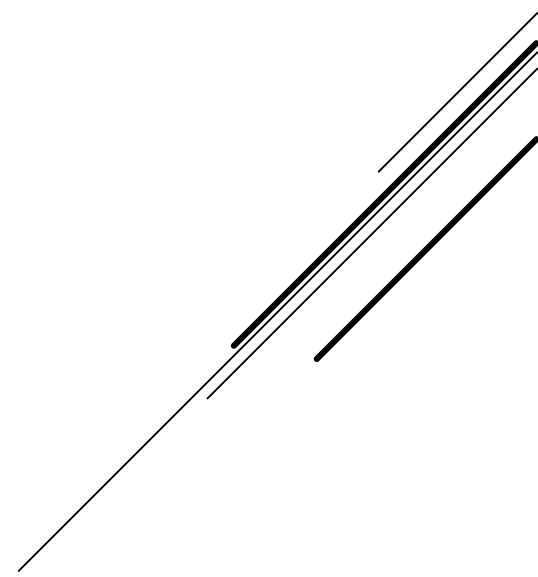
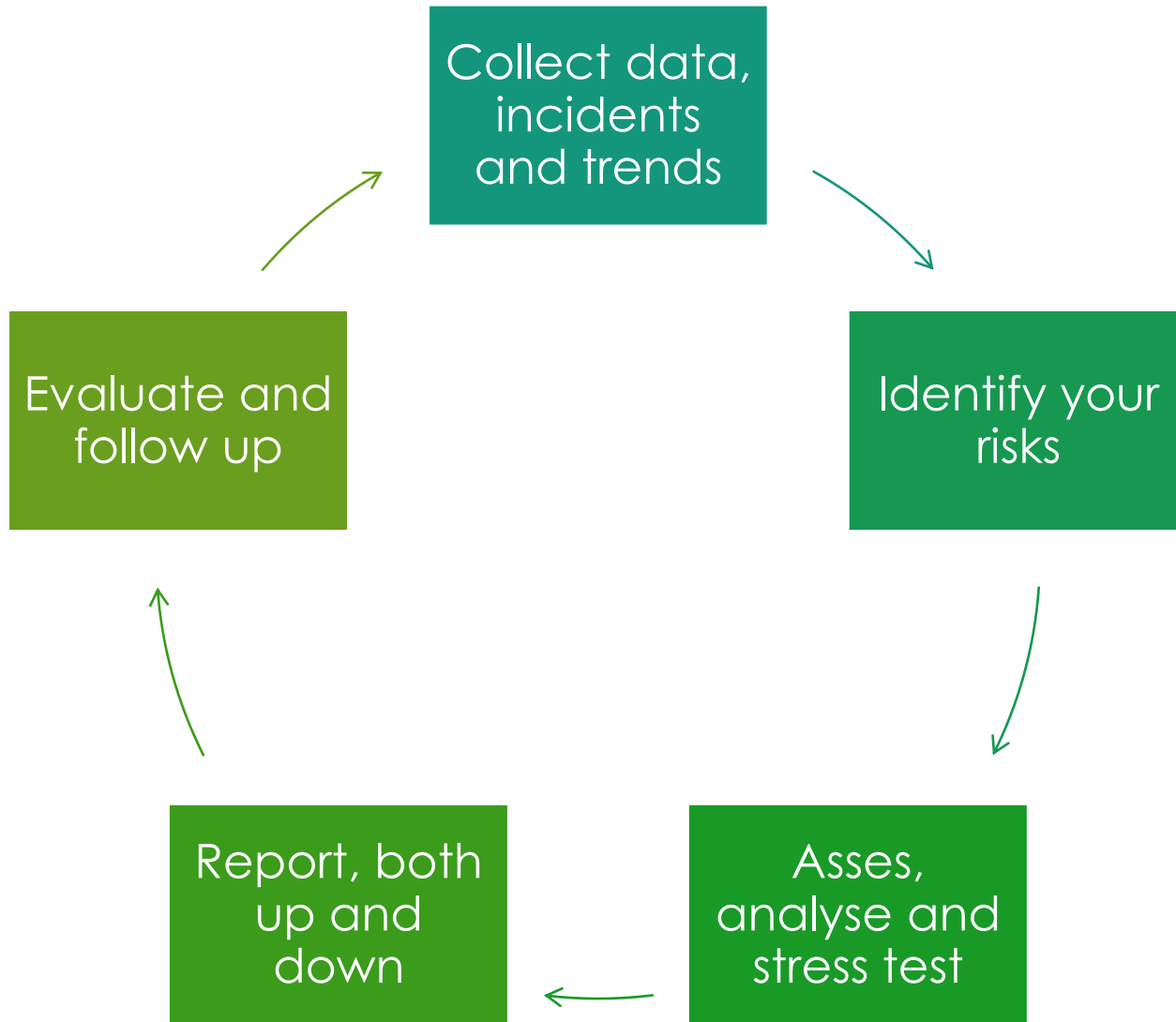


"More than 80 % of our
Credit Risk is really just
Operational Risk"

*Senior Risk Officer,
Large German Bank*



SO, WHAT DO MATTERS THEN?



Total risk

Risk typs

Credit risk

Market risks

Operational risk

Business risk

Liquidity risk

Reputational risk

Risk areas

Personalrisk

Verksamhets- och processrisk

It & informations-säkerhet

Extern risk

Risk drivers

Arbetsförhållanden och arbetsmiljö

Interna oegentligheter

Kompetens och bemanning

Personberoenden

Rådgivning

Ledning och kultur

Manuell hantering

Felaktiga processer

Dokumentation och underlag

Modeller och beräkningsverktyg

Organisation och styrning

Regelefterlevnad

Projekt och förändring

Spårbarhet i system

Avbrott och kontinuitet

Åtkomstskydd & behörigheter

Systemkvalitet

Utvecklingsprocess

IT-drift och kommunikation

Informations-tillgångar

Fysisk säkerhet

Incidentrapportering

Extern brottslighet

Angrepp, olyckor och katastrofer

Leverantörer och utläggning

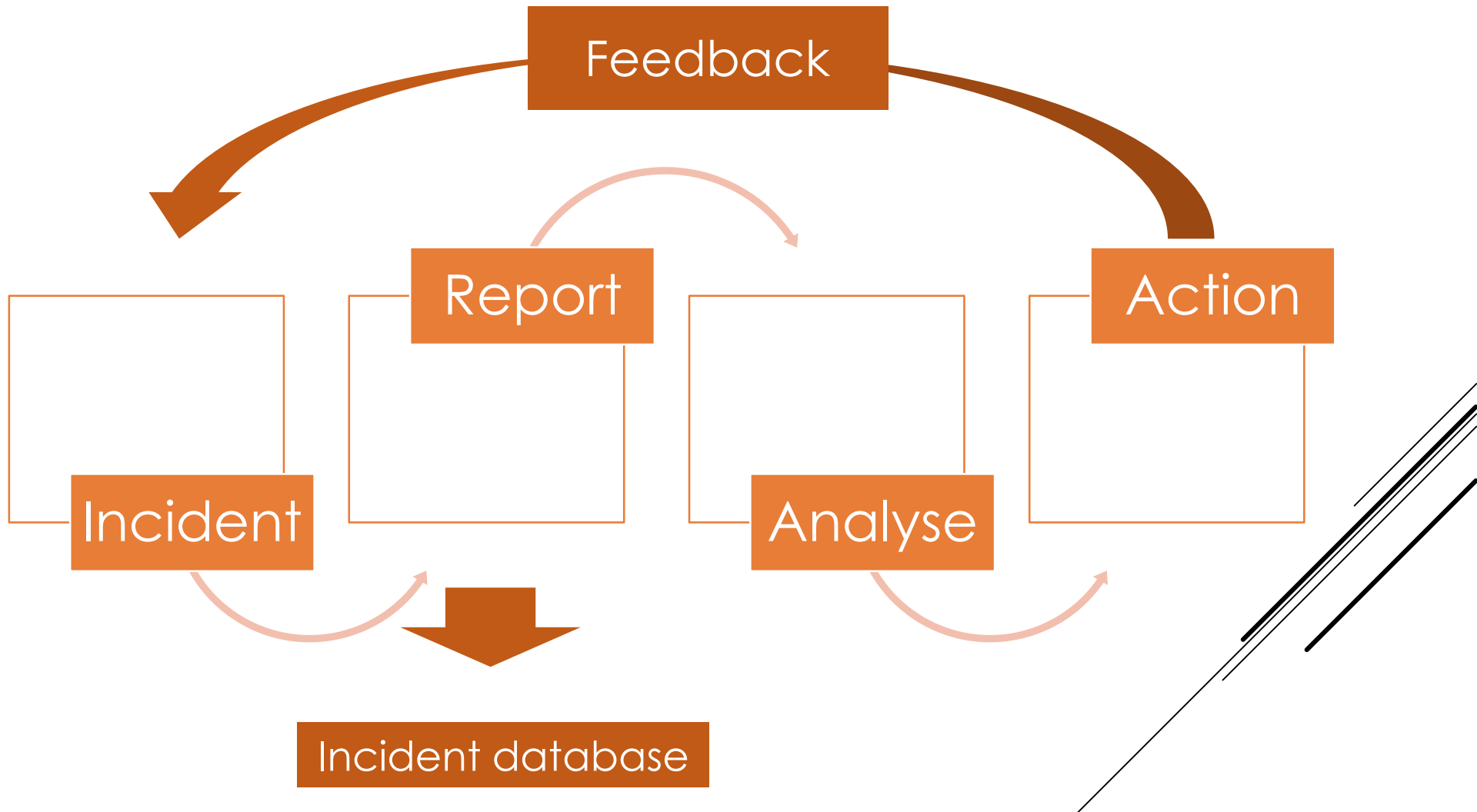
Infrastruktur

Kundberoende och kundbeteende

Regelförändringar

Politik och myndigheter

INCIDENT REPORTING AND THE NEED OF FEEDBACK



WHY KEEP REPORTINGS SMALL INCIDENTS?

Get out the noise !

- Empiric from bad financial periods shows:
 - Higher price volatility
 - More chances are taken in deals
 - Internal fraud increases
- So, if you work with small losses/incidents in good times, do not have to see them grow in bad times



IS IT POSSIBLE TO CALCULATE THE
OPERATIONAL RISKS?

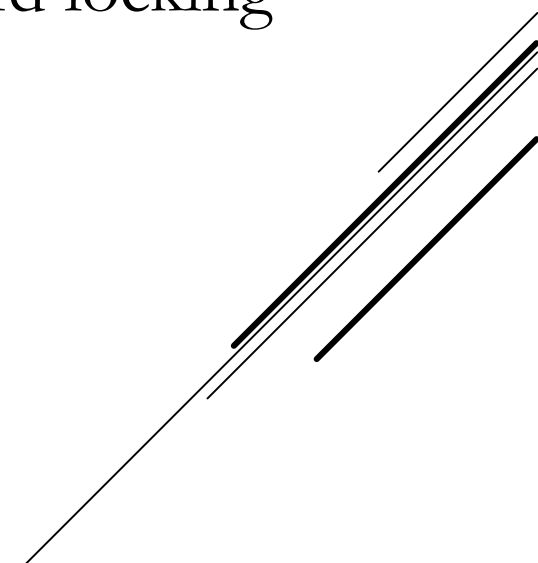
TWO WAYS TO GO...

Loss Distribution Approach:

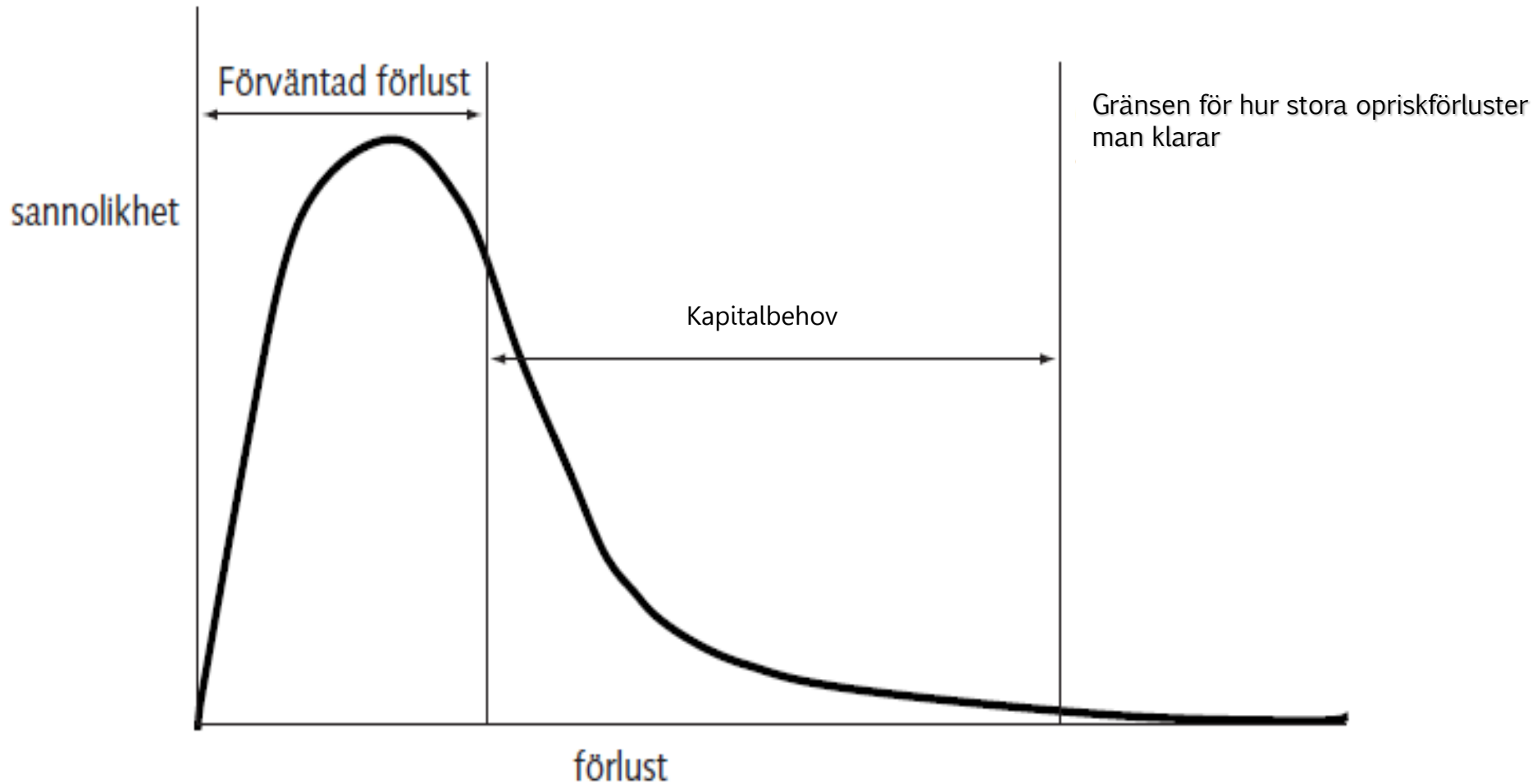
- History repeats its self
- Repetitive data
- Processes are stable

Self assessments:

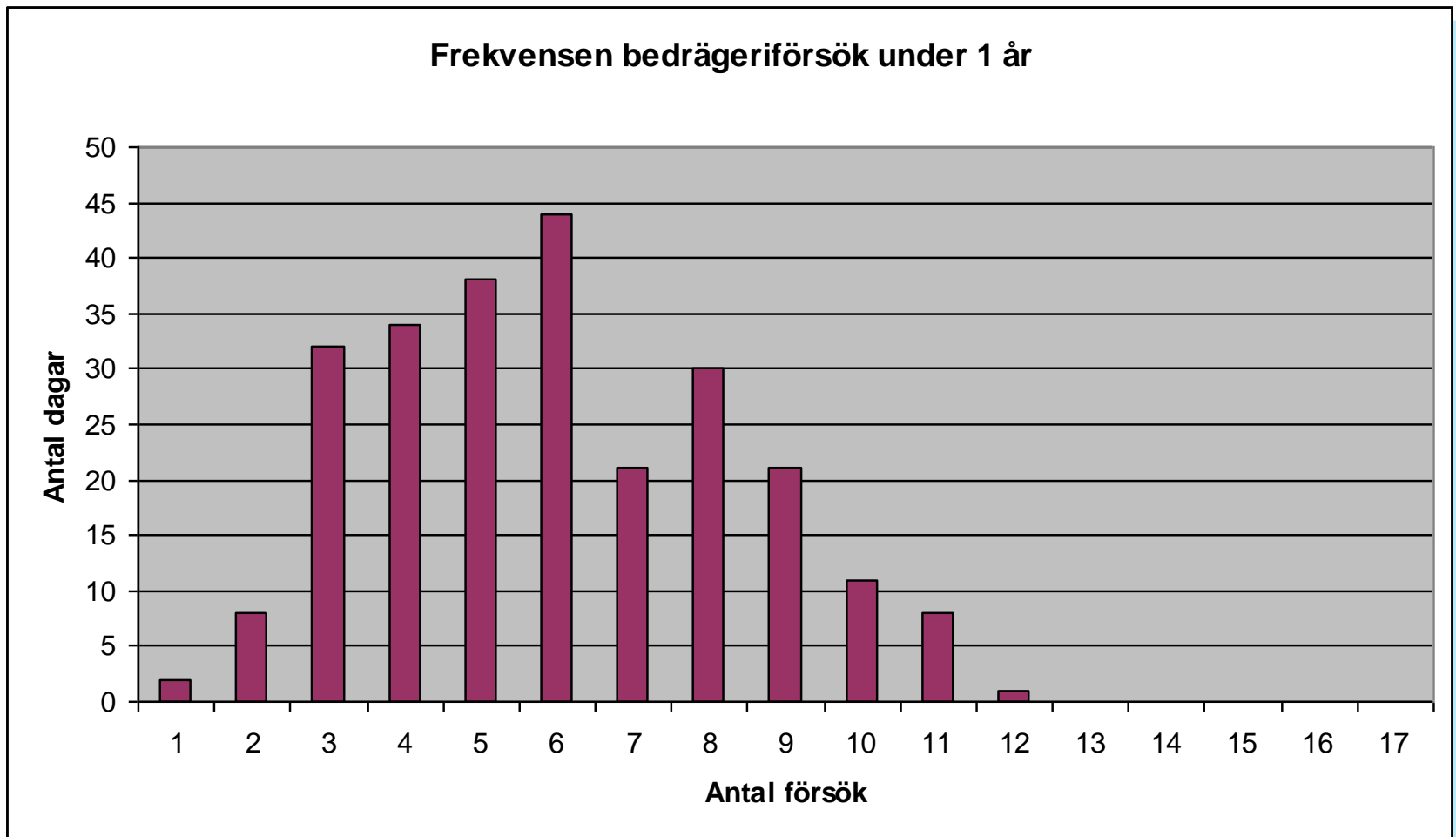
- Relays on experts
- Forward locking



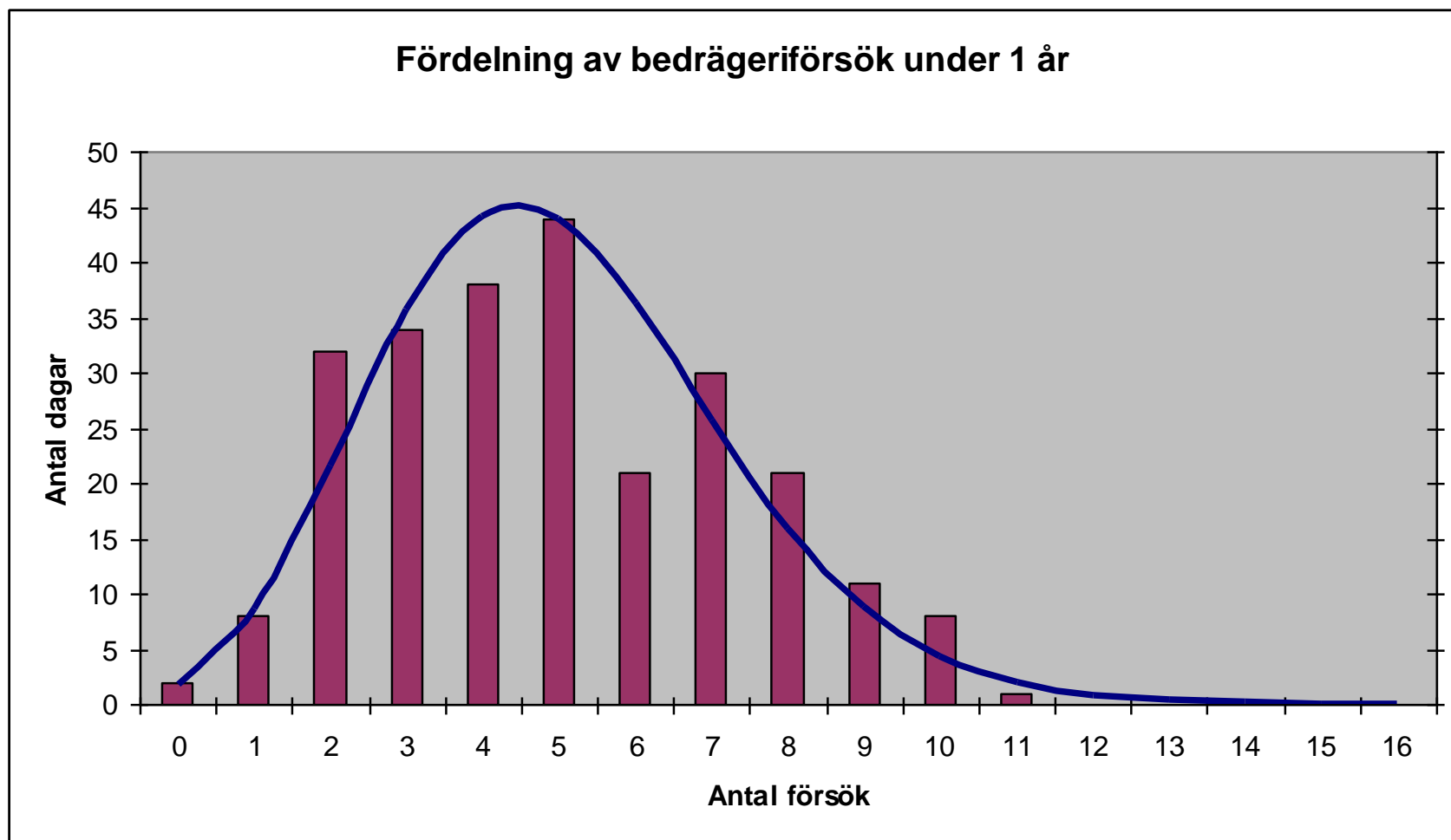
REGULATORY CAPITAL NEED



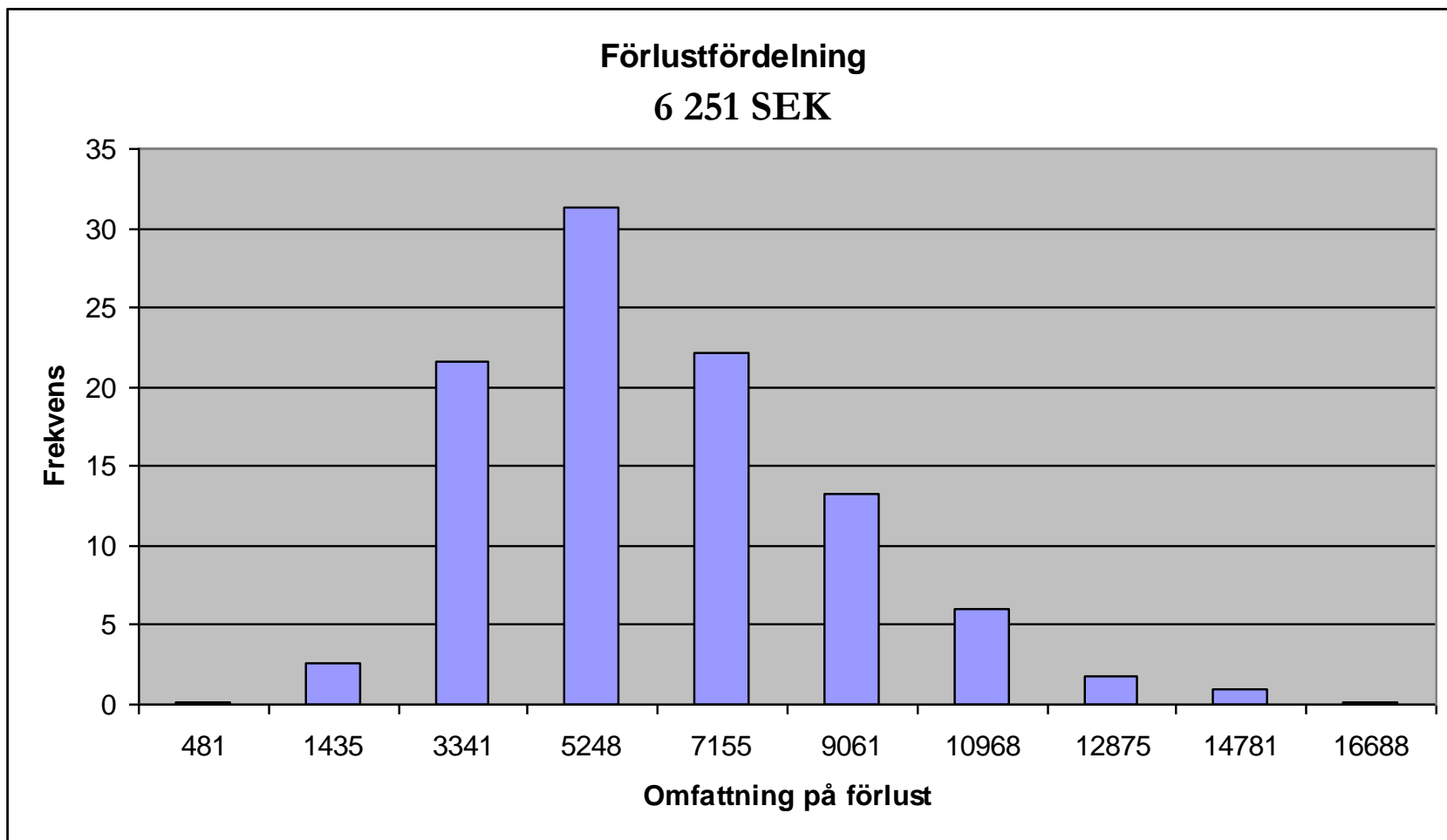
THE NUMBER OF FRAUD ATTEMPTS AS A BANK EXPOSED TO 1 YEAR



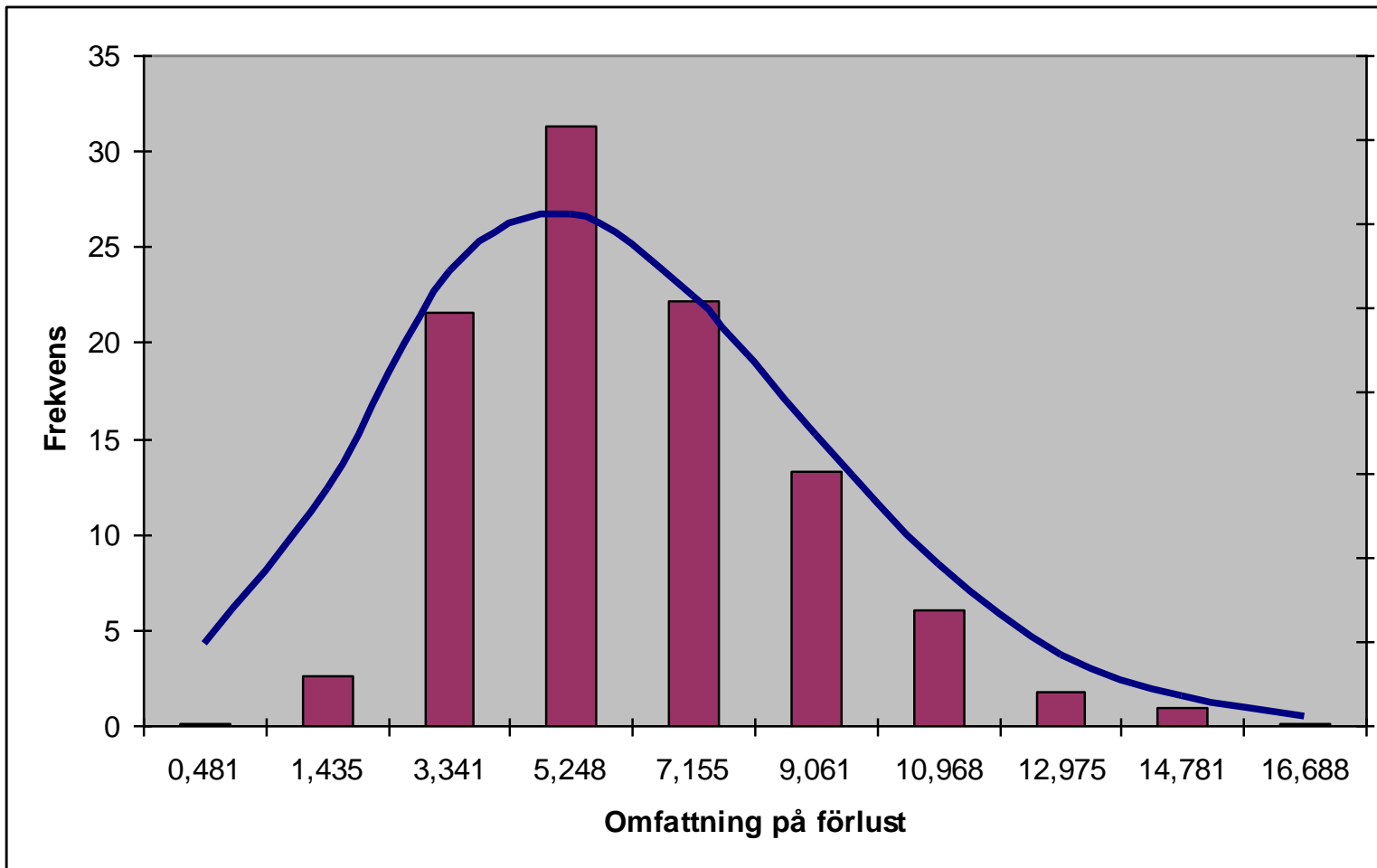
POISSON DISTRIBUTION



LOSSES ON FRAUD ATTEMPTS



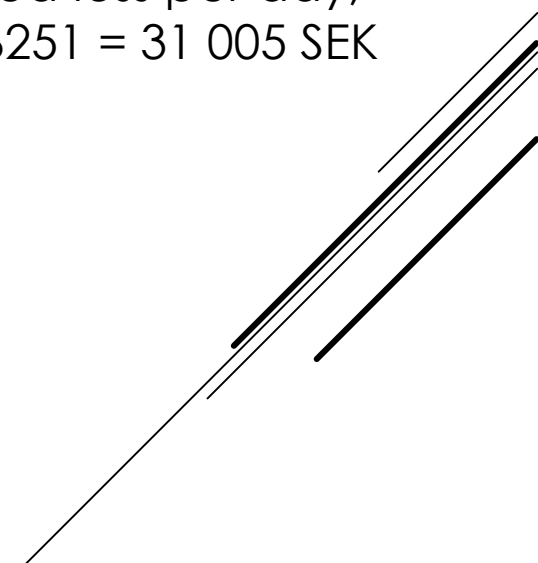
ADAPTATION OF THE WEIBULL DISTRIBUTION TO THE LOSS OF DATA



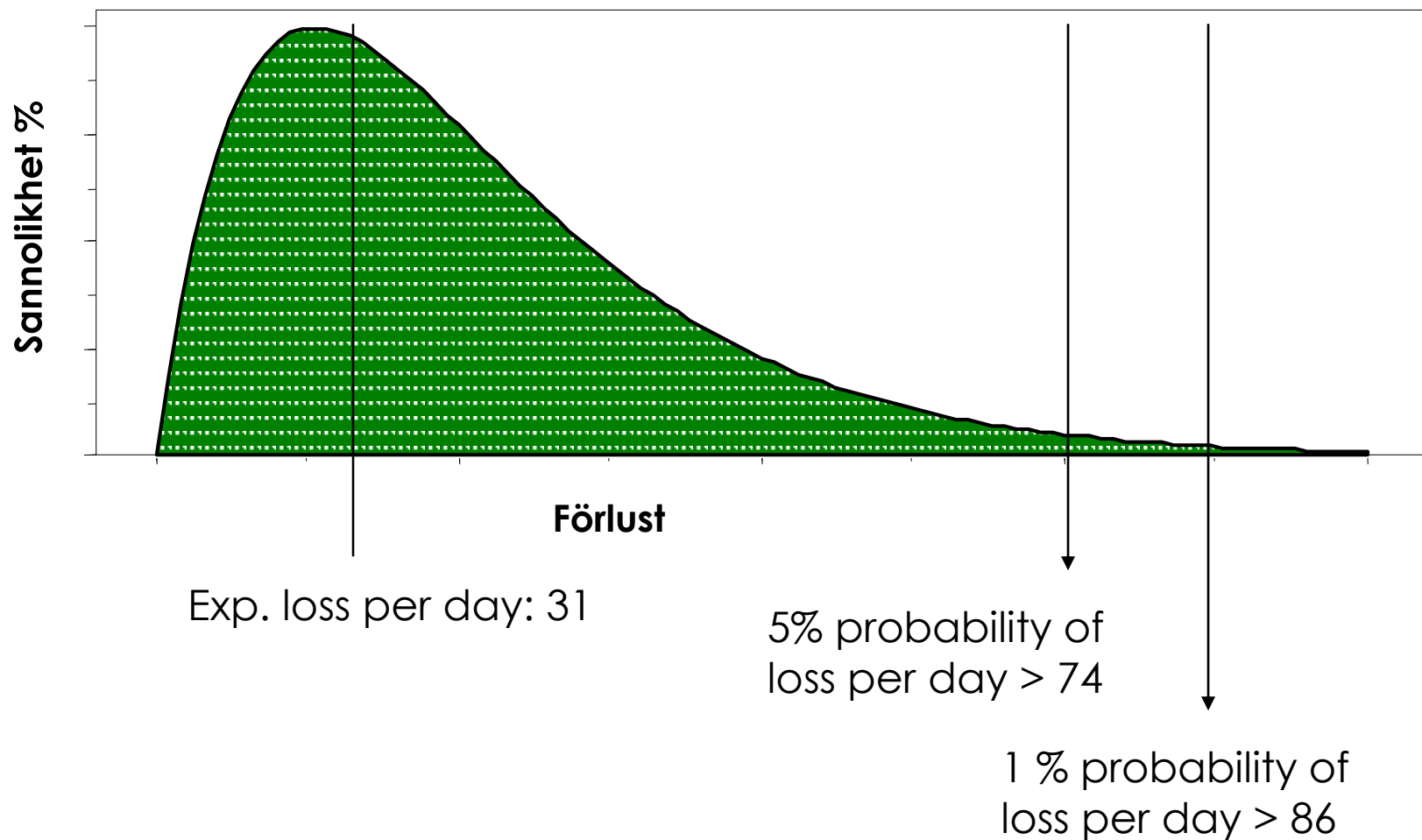


WHAT IS THE EXPECTED LOSS PER DAY ?

- On average 4.96 pc scam attempts per day
- Average loss of 6 251 SEK
- Expected loss per day;
 $4.96 \times 6251 = 31\ 005$ SEK



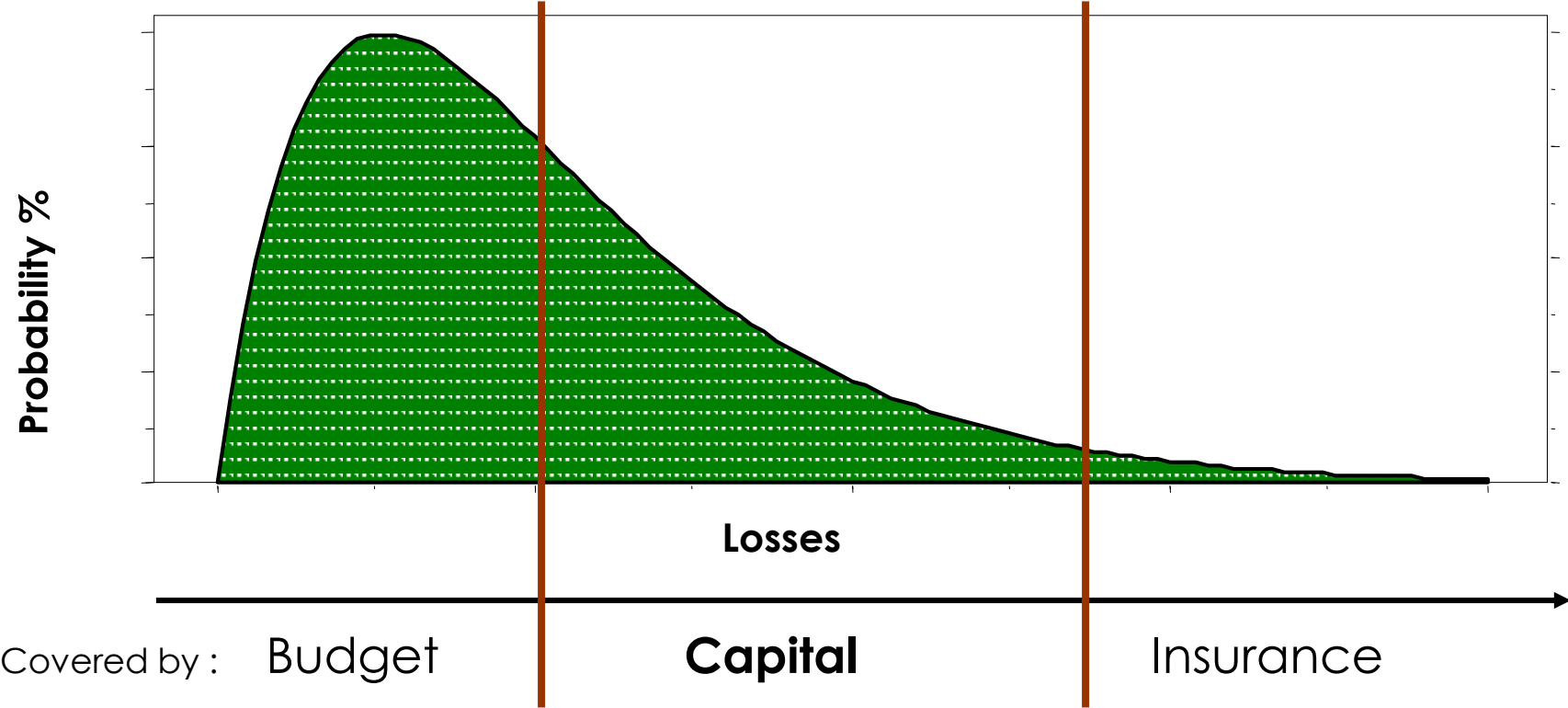
LOSS ALLOCATION OPERATIONAL RISK



MANAGEMENT OF OPERATIONAL RISK

Expected losses
(high probability / small losses)

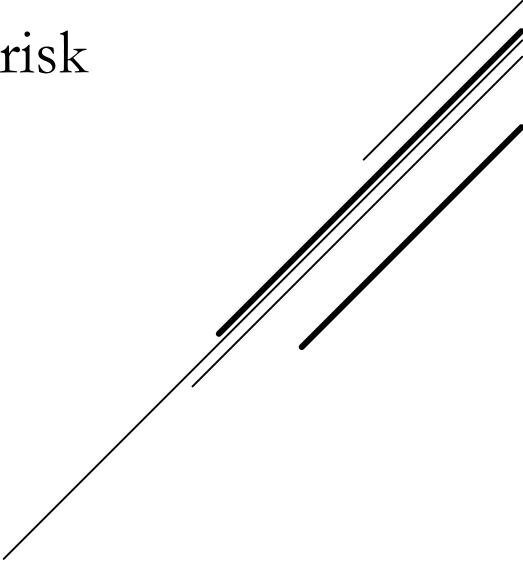
Un expected
(low probability / large losses)



SOME PROBLEM

- Definition of operational risk
- The scarcity of data
- Changes in processes
- Changes in staff
- Insurance – does them really work?
- Correlation – operational risk correlate to everything and nothing
- Inherent risk

"risk of loss resulting from inadequate or failed internal processes, people and systems or from external events"
incl. legal risk



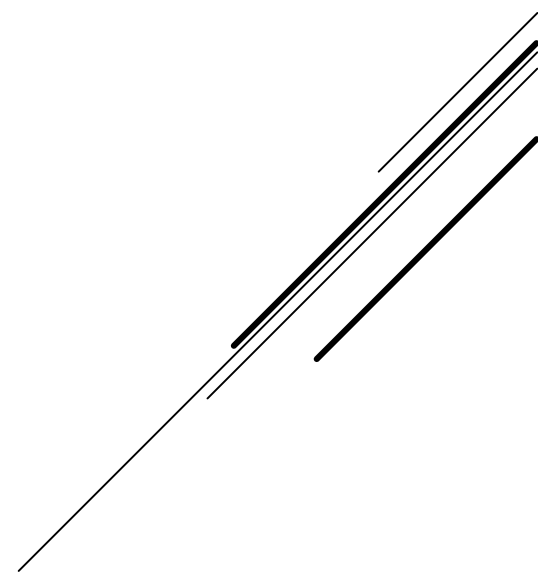
RISK REDUCTION

Internal reduction:

- Stop doing business
- Adding new controls
- Train/recruit
- Technology upgrade
- Restructure processes

External reduction:

- Using insurance
- Risk derivatives



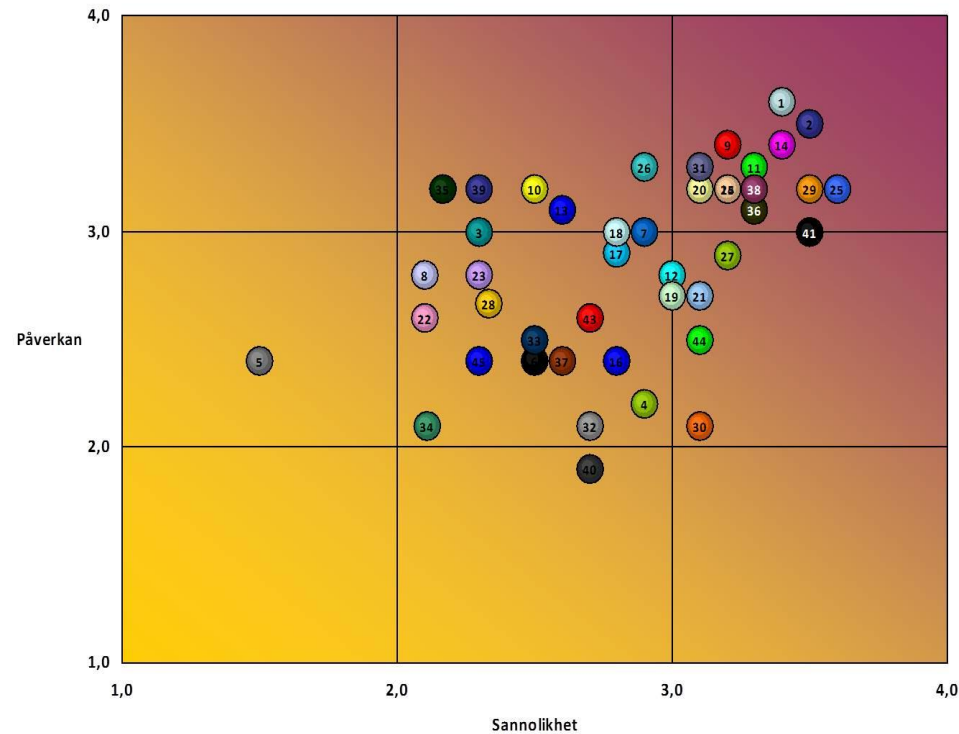
SO, WHAT DO MOST FIRMS DO?

SELF ASSESSMENTS

1. Identify
2. Assess
3. Evaluate
4. Report
5. Follow up

Define:

- ▶ Probability
- ▶ Effect



NEW REGULATIONS WITH BASEL 3

THE FIVE LINES OF DEFENCE



FSA

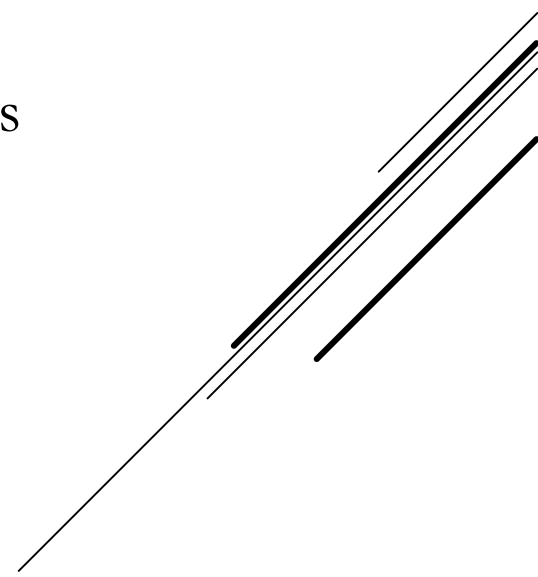
**External
audit**

Internal audit

**Compliance and risk
control**

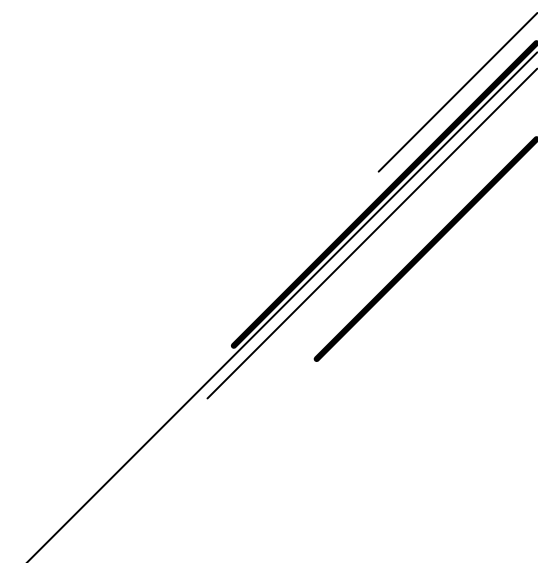
Business and risk management

NEW REGULATIONS REGARDING INTERNAL GOVERNANCE

- Board of directors – responsibility, skills, knowledge and work flow
 - Qualifications for board members – fit and proper
 - Conflict of interests
 - Independent risk control and compliance offices
 - Report lines
 - Outsourcing
 - Internal audit
- 

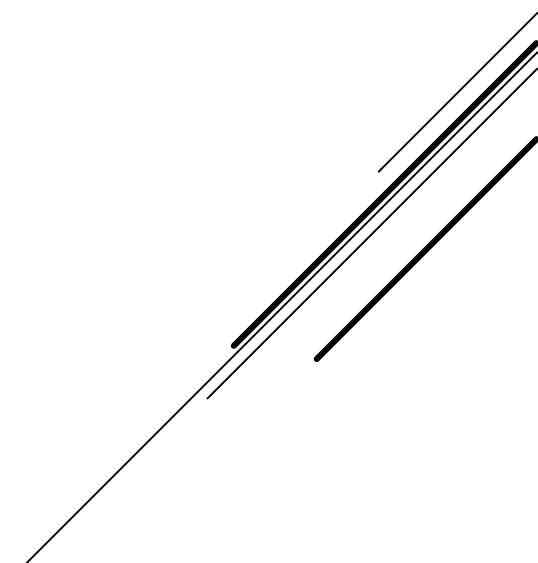
NEW REGULATIONS REGARDING OPERATIONAL RISK

- process control business
- clear job descriptions
- risk identification, analysis and actions
- incident reporting
- key risk indicators
- detailed reporting to the Board
- NPAP; new product approval process
- continuity plans
- whistle blowing



NEW REGULATIONS REGARDING INFORMATION SECURITY

- framework of information security
- role of the board increases
- risk and vulnerability assessments
- information classification
- increased demands regarding deposit systems



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