MANAGING OPERATIONAL RISK

WHAT FINANCIAL SERVICES CAN LEARN FROM OTHER INDUSTRIES

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A long history of incidents, ranging from rogue trading to IT breakdowns to mis-selling of products and services, testifies to the dangers that lie beyond the intentional financial risk-taking inherent to the financial services business model. Financial services are not alone in being exposed to large, catastrophic operational risks. Other capital-intensive industries, such as energy, aviation, and natural resources, have their own histories of calamity, including nuclear accidents, plane crashes, and oil spills.

Despite the shared exposure to such losses, operational risk management in financial services has developed along a path that differs markedly from the path taken by other industries. There are some good reasons for this: financial firms have distinctive characteristics. Still, financial firms can learn a lot by looking at how other capital-intensive industries manage their operational risk.

Consider two illustrative but realistic examples:

1. **A pipeline in an oil field corrodes, releasing an explosive gas into the atmosphere and putting the site at risk.** Within minutes, a prearranged crisis response is initiated, containing the leakage and informing management. The severity of the incident determines the subsequent steps to be taken, which include an investigation. Initial findings identify the source of the crisis: A maintenance worker failing to inspect the line. Subsequent analysis finds a lack of risk-mindedness in the responsible mid-level manager who unduly prioritized cost reduction over risk control. Two actions result from the investigation: The objectives and performance targets of the relevant management positions are modified and the cost-efficiency program currently underway is enhanced to accommodate the impact of cost reduction on risk. The incident and lessons from it are widely communicated across the organization.

2. **A bank suffers a serious rogue trading incident.** While controls had been designed to prevent the incident, unclear roles and responsibilities across the bank's three lines of defense allow their effectiveness to decay over time. Now that the incident has taken place, there is no clear process for what happens next. The unwinding of the trader's position is delayed, leading to a larger than necessary loss.

   Meanwhile, the risk management team is busy mitigating the loss's unfavorable impact on its internal capital model. With Risk, Compliance, and Middle Office variously being blamed for the incident, each puts forward additional preventative controls. Under pressure from their regulator, management imposes these on business, pushing up compliance costs and frustrating the front line. Because it is still unclear who is responsible for the controls' ongoing effectiveness, the controls quickly decay.

Regulators are demanding ever higher standards of risk measurement and reporting from banks and insurers. But this does not necessarily have the intended effect of reducing risk. An overbearing regulator can make financial firms passive, relying on prompts by regulators to take action. And the activity required to meet regulatory demands often crowds out genuine risk management.

Firms in risky industries that are comparatively unencumbered by capital adequacy regulation have developed operational risk frameworks that better support their business objectives. Common characteristics of these frameworks are a healthy balance between prevention and response and an emphasis on continuous improvement of control systems. We commonly find this is supported by a culture that ensures the organization is risk-aware and ready to learn from mistakes.

In a study of 27 firms across financial services and capital-intensive industries, we looked at firms' responses to operational risk events. Across the categories evaluated, we found financial services lagging other capital-intensive industries. (See Exhibit 1.)

What, then, should financial services firms look to learn about operational risk management from their counterparts in other industries?

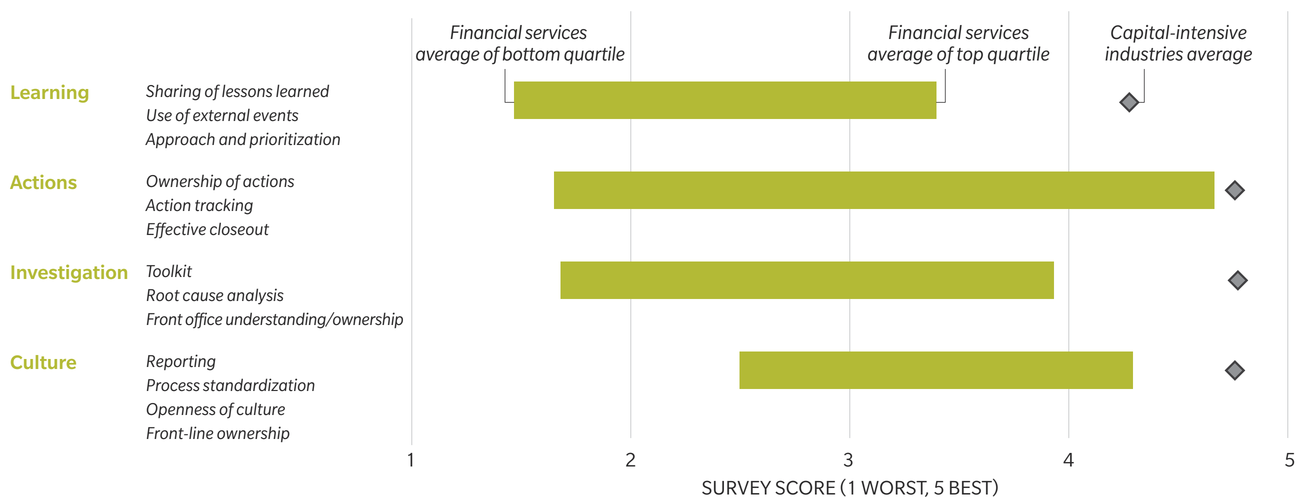
PREVENTION IS GOOD; BUT MITIGATION IS IMPORTANT, TOO

The best frameworks among industrial firms display a healthy balance between prevention and mitigation. There is often a diminishing return from controls that prevent the occurrence of an event, but a lot can be gained from mitigating its impact. Capital-intensive industries have focused on perfecting lessons-learned processes and now routinely issue detailed guidance and toolkits to identify underlying causes, preconditions, and ultimately, failed controls that contribute to an observed event. (See Exhibit 2.)

THE JOURNEY NEVER ENDS

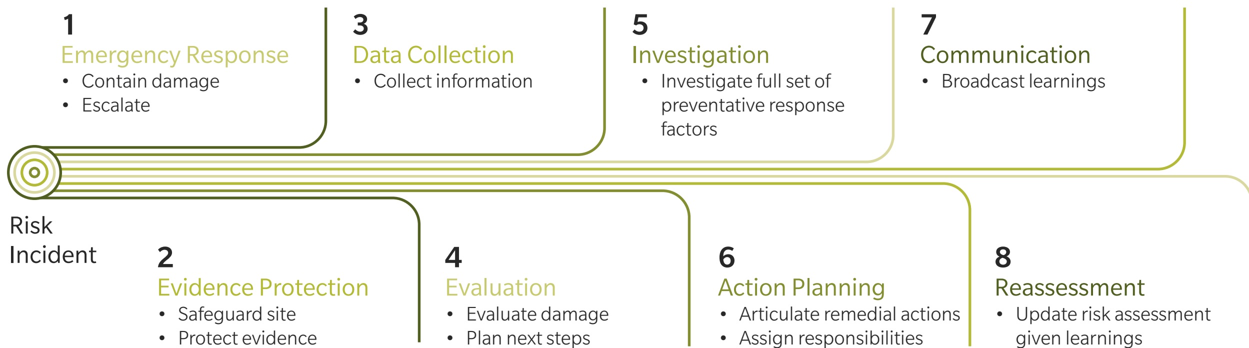
Rather than piling layer upon layer of controls, the most efficient frameworks continuously review business processes for redundant and overlapping controls.

EXHIBIT 1: FINDINGS FROM A RECENT CROSS-SECTOR STUDY OF OPERATIONAL RISK RESPONSE CAPABILITY



Source: Oliver Wyman analysis

EXHIBIT 2: BEST-PRACTICE INCIDENT RESPONSE PROCESS



Source: Oliver Wyman analysis

This involves taking a view on emerging risks, assessing the efficacy of controls, and estimating the effort and other costs of employing them. Once set up, such ongoing reviews often reduce costs by avoiding the duplication of controls and assurance work.

CULTURE CLUB

Firms most successful at learning from mistakes exhibit strong leadership with regards to risk culture. Senior managers go beyond perfunctory missives, ensuring that the desired staff behavior is consistently articulated and explicitly valued by management. Their corporate culture is geared toward promoting risk awareness, transparency, and respect. This makes it easy for staff to challenge the status quo and contribute to better processes and controls, which includes a healthy lessons-learned process. These firms also have clear ownership of risk and controls. This is supported by a system of incentives that goes beyond penalizing "breaches" and measures, and toward rewarding good behavior.

CONCLUSION

When it comes to operational risk, financial firms are far more heavily regulated than firms in other risky and capital-intensive industries. This limits the ability of financial firms to adapt their approach to their circumstances and to experiment with new techniques. And it means that progress in operational risk management is most likely to be made outside of the financial industry.

Banks and insurers must continue to comply with regulations. But to discover ways of making real progress in operational risk management, they should look to their counterparts in more lightly regulated, non-financial, capital-intensive industries. Without the subsidy of bailouts and the tax of regulation, that's where the best trade-offs between risk, profit, and operating cost are being made.

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