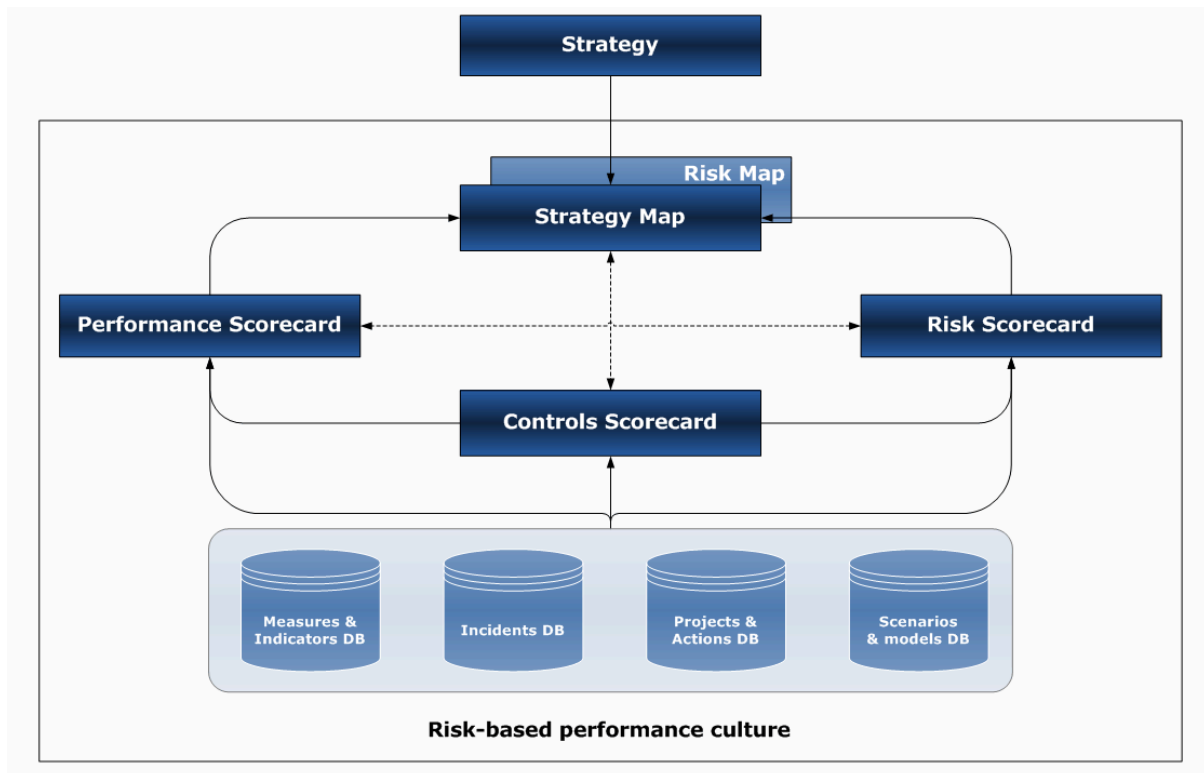


## Risk-based performance

*The future of Operational Risk is Strategic Execution*

April 2008



*"Linking the scorecard to manage operational risk seems like an excellent idea"*

*– Professor Robert Kaplan, father of the Balanced Scorecard*

## Executive Summary

**What is the future of operational risk?** This is the question posed by many in the financial services industry. This was also the question posed at OpRisk Europe 2008.

This paper answers the question by arguing that the future of **operational risk management must be a future centred on strategic execution**. Whilst recognising the importance of the more technical side of operational risk management, we believe that the operational risk agenda must be integrated with the strategic execution agenda to create value for the organisation. Integrating risk reporting and decision-making with regular, management reporting and decision-making is a critical first step to creating an integrated strategic execution process and delivering value.

Operational risk management focus needs to move out of the risk committee(s) and into the boardroom, ultimately becoming a regular component of the strategic execution agenda.

Risk-based performance will be introduced as a methodology which provides the conceptual framework and management tools that integrates both performance management and risk management processes into a holistic strategic execution process. The integrated process is designed to deliver management information that informs high quality management discussions, decision-making and action-taking.

In addition to arguing that the future of operational risk centred on strategic execution this paper will provide a summary of a year-long research project which asked the question, **How can UK financial services organisations integrate and align their corporate performance management (CPM) and operational risk management (ORM) processes to enhance strategic execution?**

## The future of operational risk management

**Understanding Strategic execution ...** What is strategic execution all about? Whilst many people have created various definitions, simply put strategic execution is about 'making it happen'. It could also be described as closing the gap between what a company's leaders want to achieve and the ability of their organisations to deliver it.

The fact that there is a gap between what organisations are seeking to achieve and what they actually can and do achieve is well established. Strategic execution is about understanding our organisational goals, where we are now in relation to those goals and what actions we need to take to close the gap.

**The facts and figures ...** One only need to look at the newspapers or the back of the OpRisk&Compliance magazine to realise that current operational risk management practices are not fully meeting the needs of financial services organisations. OpRisk&Compliance magazine reported that one month's top five financial services **operational risk losses** alone **totalled \$369m**.

The potential reward from improvements in operational risk management is highlighted by the following research;

- One study found that the average short term financial loss on large risk events (greater than \$1m) is **US\$65m**, but with a **tail loss after 120 days climbing by a factor of 12**— an average of **US\$ 780m**
- A study between 2001 and 2005, found Risk related losses at the top 12 US banks represented **4%-5% of their net income**.
- A study of operational risk losses at 200 financial services organisations between 1997 and 2002 found **150 cases** of significant financial distress at **90 organisations**.
- More surprisingly, these three studies generally agree that **50%** of these losses were caused by factors within the organisations control, thus they were **preventable**.
- It is estimated that a **25%** reduction in regulatory capital can be achieved by implementing performance and risk processes and systems to meet the demands of BASEL 2 (AMA).
- One leading expert suggests that reducing operational losses offers the potential for **greater cost savings** than tradition cost cutting approaches.

**Nothing new ...** Operational risk management as part of the strategic execution agenda is NOT a new concept. It is an argument previously made by many in the operational risk field but one which, over time, sounds increasingly hollow because the operational risk profession has failed to clearly demonstrate it's 'value add' to senior management.

The weaknesses and failures of many operational risk management processes are being painfully exposed in the credit crunch and much of the industry is taking a renewed interested in risk management. However, given that the nature of operational risk is different from other types of risks we suggest it is time to take a different management approach.

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**In a world of imperfect information ...** One of the major differences between operational risk and other types of risk (such as credit and market risk) is that the latter has more readily available data of a higher quality than the former. Consequently operational risk is less suited to statistical modelling and analysis. This is not to say that efforts to develop such models are a waste, they are not. However these models should be part of an overall management approach that recognises that organisations operate in a world of imperfect information. Therefore operational risk professionals would benefit from looking to areas such as corporate performance management (CPM), Balanced Scorecard (BSC) and strategy as they seek to deliver risk management information which supports strategic execution and adds value.

**Moving beyond performance-only management information ...** Learning lessons from the corporate CPM, BSC and strategy fields appears to be an approach supported by many financial services organisations. However, our research shows that the management information processes used by many financial services organisations suffer from the following key weakness;

- A lack of strategic context, such as clearly defined strategic objectives or business drivers with aligned key risks.
- A heavily data-centric, indicator approach, generating too much data and not enough information.
- Misuse of KPI's to describe any and every type of measurement, i.e. using KPI's to measure your risk profile (*use KRI's – Key Risk Indicators*) and controls effectiveness (*use KCI's – Key Control Indicators*).

As these organisations struggle to survive the credit crunch, and face the very real prospect of a new wave of regulations, it is time to move beyond the performance-only focused management processes to a more integrated approach.

**Out of the risk committee(s), into the boardroom ...** With its natural focus on people, processes and systems, one would expect operational risk to be embedded into the decision-making of an organisation. Often however, it is not. Instead silo processes are created that fail to deliver the required integrated management information, thus reducing the quality of decision-making. There are three things to consider when effectively integrating operational risk processes into strategic execution processes,

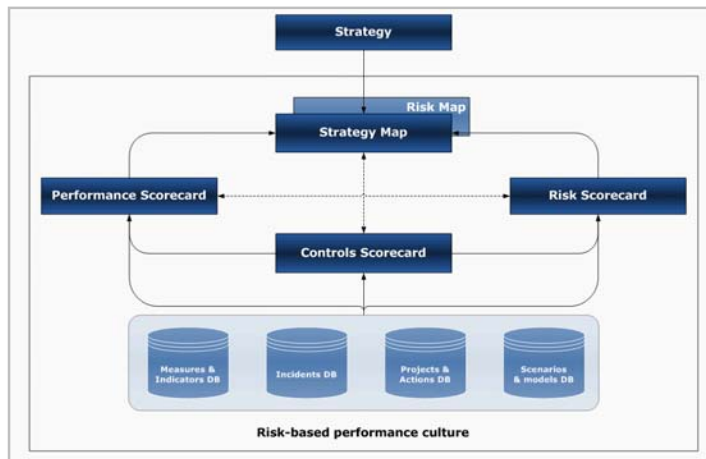
1. There must be a framework in place which is specifically designed to engage management in the risk management process, as a normal part of their management processes.
2. The language and presentation of operational risk management must be the language and presentation of management.
3. Integrating operational risk management into the overall management processes will ultimately enhance strategic execution by reducing the number and impact of risk events. Additionally, it will help identify opportunities that can be exploited due to superior risk management capabilities.

## The Risk-based performance methodology

Building on the Balanced Scorecard and COSO frameworks, Risk-based performance integrates performance management and risk management processes and tools to provide the information demand by executives to manage the trade-off between risk and reward. Moving beyond the traditional technical approach to operational risk, Risk-based performance provides a comprehensive management framework to drive strategic execution.

Taking a pragmatic and 'keep it simple' approach, the methodology addresses some of the traditional issues within performance and risk management. These include

Figure 1 - Risk-based performance methodology



- Providing a framework and tools to integrate operational risk management processes and reporting into the strategic execution agenda.
- Providing a framework to engage management in the risk management process via regular risk rating and reviews and adopting an integrated ownership model.
- Providing the tools that enable management to review risks as an integrated component of their management information.
- Increasing the clarity of management information whilst reducing the cost, complexities and volume of data within management packs.

## Case study – Investment Bank

One of the early adopters of the Risk-based performance methodology was the global IT function within a London based investment bank.

In addition to the dual challenges of meeting BASEL 2 and Sarbanes-Oxley, the global IT function was faced with the challenge of delivering an enterprise-wide risk and controls project. This involved overcoming some specific internal cultural issues, around achieving buy-in and the embedding of planned processes into the everyday culture.

Initially traditional Risk & Controls matrices' were developed and implemented using ad-hoc processes supported by spreadsheets, however short comings were quickly identified. A Balanced Scorecard was already in place, so there was particular concern about the duplication of processes and information, and the negative impact on staff of yet another measurement process.

At this point, Manigent suggested a more strategic and integrated approach that would build on both the existing Risk & Controls matrix and the Global Balanced Scorecard.

The Risk-based performance methodology was introduced to provide a 'conceptually sound' framework to guide the development of an integrated performance and risk management process supported by a specialist software application. The resulting processes and system were deployed globally to 32 centres, providing information to multiple levels of management and also reporting to multiple regulators and external stakeholders.

Applying the principles and approaches within the Risk-based performance methodology, the final 'solution' achieved a high level of buy-in and support because we were able to reduce process and reporting complexities whilst delivering a focused set of management scorecards, dashboards and reports. Delivering risk identification and assessment within the context of their strategic objectives allowed our client to reduce the number of key risks to tens instead of hundreds of items with similar reductions in the number of measures, indicators and volume of data.

In the face of tighter market conditions brought about by the credit crunch, the Risk-based performance methodology is being rolled out to guide the development of a more resilient operating model environment, leading to improved decision-making information and reduced operational errors.

## Research project

The Risk-based performance methodology was developed working with financial services clients however it was refined and validated through a year-long academic research project.

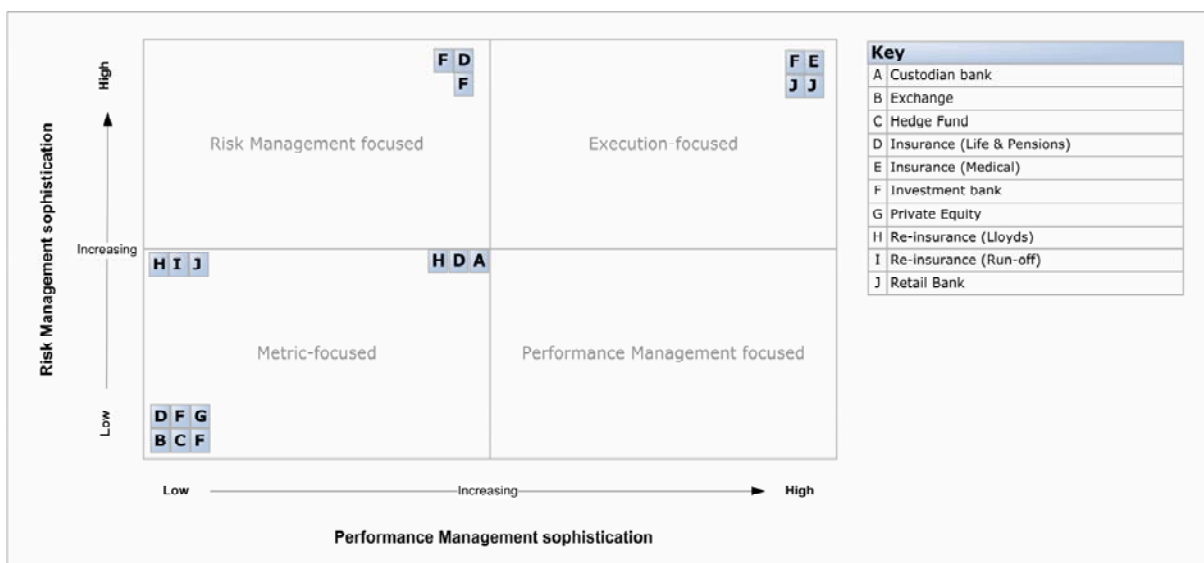
The major assumption behind the research project was that financial services organisations generally implemented performance and risk management process (specifically operational risk processes) as isolated, silo processes. Given that the data, processes, systems and ultimate ‘consumers’ for the management information are the same or very similar, organisations would benefit significantly from taking an integrated approach, as supported by the Risk-based performance methodology. Additionally we contend that taking a silo approach leads to significant reduction in the quality of management information and significant increase of related costs and risks.

The research project involved 21 executives from 19 UK based financial services organisation. There was a balance of types of organisations and participants from the following roles; Finance, Risk Management, Operations and IT roles. Supporting the field research was extensive literature and case research.

## Key findings

The research confirmed that the UK financial services industry is becoming increasingly competitive and regulated. They demonstrate a lack of strategic approach by reacting to regulatory demands more readily than competitive demands and are being driven by largely metric-focused decision-making. The reliance on metric-focus processes is highlighted below.

Figure 2 - Performance & Risk Matrix



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In addition our research confirmed or found the following:

- **Silo processes...** Performance and risk management processes are generally implemented as isolated, silo processes. Nine research participants identified this as a major issue.
- **Risk and compliance boundaries...** There was a lack of clarity around the focus and boundaries between the Risk and compliance functions. Whilst this was an issue for a number of organisations, two participants provided solutions. They suggested the Risk function should focus on the organisation's strategic agenda whilst compliance focuses on the regulatory agenda.
- **Lack of adoption of the Balanced Scorecard...** An interesting point to emerge was the apparent lack of adoption of the Balanced Scorecard. Only two organisations (both execution-focused) were able to definitively state they used a Balanced Scorecard, with another three stating they 'might' use one and ten saying they did not use one. This is surprising as business literature portrays financial services as being heavy adopters of the Balanced Scorecard.
- **A tactical, indicator driven approach...** Given the previous point, maybe it is not surprising that we found the industry takes a very tactical, indicator driven approach with eight participants confirming this approach. There is a lack of use of strategic objectives and an over use of 'Key Performance Indicators' (KPIs) to report on everything, including risk and controls.
- **Culture is the challenge...** Developing the 'right' culture and embedding performance and risk considerations into daily decision-making and action-taking was highlighted as major issue. Seven participants characterised the 'right' culture as an "open, honest, no surprises" culture and four participants suggest performance and risk management should be 'everyone's job'.
- **A lack of maturity...** A lack of maturity around performance and risk management processes and practices was clearly identified, with fourteen participants highlighting this issue.
- **Overwhelmed by data...** There seems to be a perception that performance and risk processes must be totally data centric, leading to many organisations being data rich and information poor. Often management teams are somewhat overwhelmed by data, but lack actionable information and a mechanism to incorporate management judgement and experience.

Generally the Risk-based performance methodology was seen by clients and research participants as an appropriate framework for enabling the realisation of these benefits. It is a proven approach to addressing many of the challenges financial services organisations face related to management information, summarised as:

- Reductions in risk related losses
- Cost savings by eliminating duplicated processes and removing complexities
- Significant enhancement in the quality and 'actionability' of management information
- Enhanced strategic execution
- Potential to reduce regulatory capital and the cost of capital

## Conclusion – time for a strategic approach

**What is the future of operational risk?** Within this paper we have argued that the future of operational risk management must be a future **centred on strategic execution**. Whilst recognising the importance of the more technical side of operational risk management, we believe that the operational risk agenda must be integrated with the strategic execution agenda to create value.

The ‘hard’ facts and figures presented show operational risk management continues to be a challenge for many organisations, and so they continue to suffer unacceptable losses from largely preventable events damaging their ability to execute strategy and deliver shareholder value.

To address these challenges operational risk management processes must be designed to inform decision-making in a world of imperfect information. It is time to move beyond performance-only management information and time for operational risk to move out of the risk committee(s) and into the boardroom.

The Risk-based performance methodology shaped by our client engagements and our own research is the solution. By providing a comprehensive framework for integrating performance management and risk management information and processes to drive strategic execution, this methodology supports financial services organisations as they race to meet current and emerging market and regulatory challenges.