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Operational Risk Management

by Dorothy L. Andrews

What is operational risk? For a long time, many preferred to consider a risk an operational risk, if it could not be classified as a market risk, a credit risk, a strategic risk or a business risk. This definition did not survive for very long in the banking community, where the identification, quantification and mitigation of risk, is paramount to staying in business. In September 2001, the Basel Committee on Banking Supervision (BCBS) endorsed defining operational risk as "the risk of monetary losses resulting from inadequate or failed internal processes, people and systems, or from external events." Risks arising from external events, such as natural disasters and terrorists' acts, are difficult to mitigate and require catastrophic planning. However, these are low probability events. It is more likely that a business will suffer a loss in the near term as a result of events internal to its organization. The due diligence in an organization must be directed at installing infrastructure to minimize economic loss from internal operational inefficiencies.

Every organization's first step toward mitigating operational risk must be the development of a risk policy. The advantage of a risk policy is it provides a framework for separating the personal interests of individuals from those activities that are in the best interest of an organization's economic health. With a business-focused operational risk policy in place, the decision makers of an organization can be measured on how well their choices support the objectives of the business. This means the risk of self-promotion becomes mitigated under a balanced and well-focused risk policy. It is important to note that in a risk context, we say "mitigate" rather than "eliminate," because risk cannot be eliminated totally and completely. At best, we are merely substituting one risk for a lesser of two evils, where the preferred risk has a lower probability of occurrence.

There are many examples in history where the absence of a risk policy led to the downfall of an enterprise. One of the most notable is the fall of Barings Bank of London. Nick Leeson was the general manager and head trader of Barings Futures (BFS), and as such he was in charge of both the front office and the back office of BFS. His position violated a basic tenet of good risk management—separation of duties. Leeson had too much authority to approve and execute trades and he did so without supervision from a higher authority. Leeson traded in options, which he was not authorized to do, and he maintained positions overnight. He did not have authority to conduct this activity, either. In fact, Leeson consistently exercised more authority than he was granted, and he could get away with it because Barings did not have a system of procedures and controls in place to monitor his trading activity. When it was all over, the losses he amassed were in excess of £800 million (or US $1.3 billion).

The collapse of Confederation Life is the result of a violation of another basic tenet of good risk management accountability. According to Rod McQueen in "Who Killed Confederation Life," the board of directors did not hold senior management sufficiently accountable for their actions. The officers of the company were irresponsible in their work practices, paying no regard to policyholder interests. Because of the size of Confederation Life and its importance to the local economy, regulators were reluctant to react to early warning signs that the company could be headed for trouble. Local politicians were as reluctant to act as the regulators. Finally, the auditors failed to uncover a weakness in the financial statements of Confederation Life. They were 71 percent invested in real estate and no one thought this was a red flag. When it was all over, the cost of insolvency was in excess of $2 billion, topping the losses incurred by Barings Bank of London. Obligations to many policyholders remain outstanding and over 4,000 jobs were lost.

A third notable collapse of a financial institution is that of Executive Life. Executive Life was near bankruptcy in 1974 when Fred Carr took the reigns of the company. The company was in short supply of capital and Carr had a plan to solve the problem. Carr was a risk taker and was known by many as a "gunslinger"—a reputation he earned as a stockbroker in the sixties, when the mutual fund market exploded. Well, he was

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