MAKING YOUR POINT

PUSHING RISK CONTROL UP THE AGENDA

Malcolm McCaig suggests how operational risk managers can get the attention of the Board

It's the Board meeting again, with another thick sheaf of papers to be read in advance and then debated under tight time constraints. Buried in the pack is the operational risk manager's report. If the author is lucky, the Chairman has allocated five to 10 minutes for discussion and questions. In practice, he or she may not even get that much time. Is that all there is to life for the frustrated operational risk manager? Should they be doing something differently?

Why is the Board perspective important?

As we all know, the Board is the representative of the shareholders and the legal custodian of the company. As a collective, the Board has ultimate responsibility for the control of risks taken by the firm. As individuals, each director has a personal liability as well as their own reputation to consider. Even when dealing with subsidiary Boards in a larger group, these accountabilities cascade through the governance structures. It therefore follows that a Board should be engaged and interested in operational risk as one of the major classes of risk facing a firm.

However, although a Board is highly sensitised to risk, in practice the level of engagement on operational risk may be fairly low. In some cases, Board members have the annoying habit of ignoring the operational risk manager until something goes wrong, and then demanding to know why they were not warned in advance.

In current conditions, where there is extreme pressure on liquidity, toxic waste from poor credit, and volatility in the markets, some of the other risk classes may (quite rightly) come further up the priority list. There is also the age-old problem that focus gravitates to the things that need fixing today, rather than those things that might go wrong tomorrow, and financial institutions have a lot on their plates at the moment.

But these are convenient excuses that hide an important issue about how operational risk managers are actually engaging with their Boards, and the need for improvement in this interaction. The immediate reaction of the operational risk manager is to assume that it is the Board that needs to improve. Maybe the Board should devote more of their precious Board meeting to the topic, or perhaps receive some training on operational risk?

There is sufficient recent evidence of executive fraud, with incidents such as Madoff and Stanford, to warrant Board members looking carefully at the activities of directors and senior management.

All of this may be true, but the bulk of the solution lies much closer to home.

What gets the Board's attention?

Large, cataclysmic events will always get a Board's attention. Hopefully these are few and far between, but one does not have to wait for the crisis to happen in order to provoke a reasonable debate.

Warning signs will be heeded when they are grounded in reality, rather than coming across as theoretical "what if" scenarios dreamt up for capital modeling purposes.

For example:

- Repeated failure by management to address an issue, such as delays in updating or testing a business continuity plan;
- A trend that is getting progressively worse, lessons from a "near miss", or a favourable performance variance that can not be readily explained;
- A major project that is behind schedule and/or over budget, putting its business case in jeopardy;
- A major incident that has recently happened in a competitor firm.

Nightmare scenarios need to be tabled, no matter how unpleasant. For example, the threat of regulatory sanctions should invite a healthy debate on the firm's culture as well as its systems and controls. And fraud, one of the highest operational risk losses in the externally pooled databases, should not be relegated to third party hackers and disgruntled employees.

What turns them off?

Responsible Board members will want to understand the overall operational risk profile of their firm and where they need to engage their attention. Unfortunately, in many cases, the information presented to them does not help and can even be a disincentive.

This includes, for example:

- Risk registers, particularly if there is no indication of what has changed since the last month's or quarter's report;
- Proposals and progress updates on further development of the operational risk framework, which is really an implementation issue for management;
- Signing off the operational risk capital. Ultimately, it is just a number, and what most Board members want to know is whether the firm can afford it and has someone independent validated the modeling;
- Bland statements on operational risk appetite, like "we have a low tolerance for operational losses and incidents".

A Board will become weary of repetitive reports coming from various assurance providers, all saying roughly the same thing. It will also become annoyed at conflicting or inconsistent information. The operational risk manager may only see his or her own report, but the Board member has the whole pack to read through.

Lessons to apply

The first lesson is for the operational risk manager to look at his or her report through the eyes of a Board director. The time available for a Board to spend on operational risk is not going to increase dramatically, so the time has to be used to best effect. Operational risk managers are the ones best placed to optimise focus in the information presented.

It is also important for the operational risk manager to have an opinion. If operational risk management is just a process that collates information on behalf of line management, then the Board will not waste time talking to operational risk management. Instead, they will go straight to the source and engage with line management. When this happens, operational risk management will be marginalised as a source of assurance.

Finally, operational risk considerations need to be embedded in the decision-making of a firm, including its Board. In some cases, this means stepping outside of the functional reporting line and being an active contributor to other proposals and updates that are put to a Board for consideration.

How does the operational risk manager know when they have got it right? Here are a few tell-tale signs:

- there is more discussion on the nature of the risk and the appropriateness of the mitigation than on the layout of the report and the interpretation of the scoring
- quality rules over quantity, with a meaningful "deep-dive" discussion on a few risks (or even just one risk) instead of a canter through the lot;
- the feeling at the end of the discussion is one of being alert, in the same way an athlete would be described as being "on top of their game", rather than being bored or scared;
- operational risk goes back onto the agenda for an update at the next Board meeting.

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