

Operating in a risk-free bank:

Eliminating risky situations in banking operations

“Banks belong to a sector that is particularly susceptible to risks from events that occur in their normal business operations”

- Funmi Carew
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Risk is a phenomenon that all businesses, regardless of the industry they operate in, must confront. However, a holistic understanding of the potential risk areas involved in a particular business line, a clear definition of the risk appetite of the company and a strategy that highlights how the identified risks can be managed effectively with minimal effects, can ultimately lead to the creation of shareholder value. Although studies have revealed that with the right appetite for risk taking, an organisation could potentially increase its market value, evolving trends have shown that many organisations are tilting towards operational models in which risks are avoided as much as possible. However, rather than assume this position in which risks are avoided out rightly for fear of loss, companies should consider focusing on striking a balance between the risk exposure level of the firm and its entrepreneurialism.

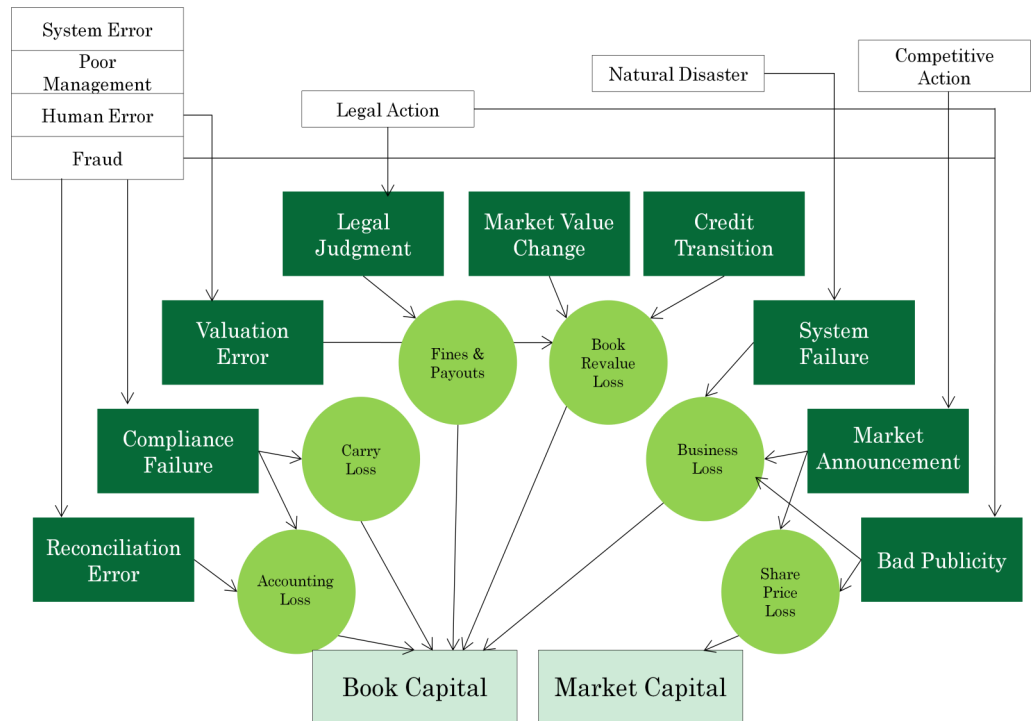
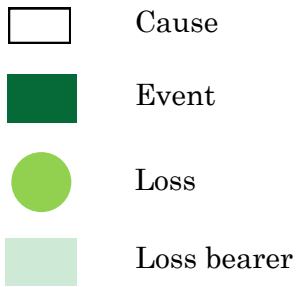
Banks belong to a sector that is particularly susceptible to risks from events that occur in their normal business operations. Since they deal with money, they face a significant level of risks relating to their day-to-day transaction processing activities. The high volume of transactions could potentially lead to significant loss due to causes such as errors, fraud and system failures. Financial institutions and government regulators recognise this situation and have imposed internal compliance audits, external audits and management controls to alleviate it. However, although these checks have gone a long way in reducing the risk exposure level in banks that adhere to them, there is a growing concern that

operational risks represent potentially large losses and more effective counter measures must be taken. To achieve optimal results, one fundamental way of managing operational risks is by complementing the standard checks and audits with additional information and improved analytical capability.

Operational risk is not a new phenomenon as banks have had to deal with it from the evolutionary phase of banking. A newly-established bank is confronted with operational risks even before it issues its first credit facility or it decides on the position it intends to take within the market. Operational risk refers to the uncertainties related to losses resulting from inadequate systems or controls, human error or management; the risk of losses resulting from inadequate or failed internal processes or routines, incorrect systems or external events. This definition includes causes ranging from the broad categories of human failure and competitive action, as well as, events such as computing the wrong value or the introduction of new products without commensurate education of client. In discussing operation risks, the risk management subgroup of the BASEL Committee on banking supervision states that

“The most important types of operational risk involve breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial losses through error, fraud, or failure to perform in a timely manner or cause the interests of the bank to be compromised in some other way, for example, by its dealers, lending officers or other staff exceeding their authority or conducting business in an unethical or risky manner. Other aspects of operational risk include major failure of information technology systems or events such as major fires or other disasters”

Figure 1:
Cause and effect of operational risk



Managing risks successfully is not just about limiting the downside. Banks with robust approaches to managing operational risk can often take on and succeed in businesses that others are unable or unwilling to accept. Banks with better operational-risk practices also will enjoy improved market sentiment and, ultimately higher share prices. Studies reveal that most banks focus their operational-risk systems on measuring risk rather than mitigating it. Clearly defined methods for dealing with potentially risky business practices are not often in place and where they do exist, they are rarely efficient. Seemingly ‘negligible’ issues such as front-office culture and the concerns of clients are typically overlooked.

Making it work

1. Banks need to understand that operational risks go a long way in affecting their reputation, which ultimately affects their book and market value. With this in mind, banks need to review their archaic methods of controlling and managing risks. Unlike other risk areas such as market and credit risks, operational risks are highly unpredictable and since they occur as a result of the inadequacy and failure of people, processes and systems, its previous occurrence does not serve as guidance towards mitigating future occurrences.
2. A sample survey of about 15 Nigerian banks revealed that few of them operates a decentralized system of managing risks. The centralized model can only work for predictable risks like market risks and credit risks and although it can be used to monitor and manage regulatory developments that affect the entire bank, it lacks the sort of insight required to manage and respond promptly to operational risks. Since most operational risks evolve from the local level, business processes should be embedded with risk management components so that it is easier to detect festering risks and address them as soon as they occur.
3. Like every other industry, the banking sector is ever evolving and regulatory bodies such as CBN enact policies that affect the landscape of banking operations regularly. Since the adaptation of the new policies could potentially lead to implementation technicalities within the banks' operations, the management must apply a stringent 'hands-on' approach to risk management. Research has shown that banks' managers often get comfortable with managing old risks that the fail to detect and act upon new ones within their systems. For example Bank A acquired Bank B during the bank recapitalisa-

tion exercise, which led to a sudden increase in the product line of the Bank A. The changes happened so fast that senior management of the 'new' bank had not had the time to devise a standard method for managing the new product portfolio. Due to the lack of a standard mode of operating, the front line executives exercised their individual discretion thereby exposing the bank to all sorts of risks.

4. In mitigating this, Bank A's management should have recognised and prepared adequately for the situation by re-evaluating its priorities and ensuring that it had ample time to understand the potential risk areas and be fully prepared to handle it. A training program should have been conducted to educate all the client facing personnel on how to handle the new portfolio.
5. Banks should ensure that they create an environment that encourages a risk awareness culture as this goes a long way in improving the way employees handle risk related matters and its related effects. To achieve this, they need to impose formal controls such as mandatory reporting lines before taking on specified transactions.
6. Banks must also provide periodic education and training in risk management, establish effective incentives to encourage the right attitude to risk decisions at the forefront and reprimand risk offenders. Ultimately, people must be held responsible for their behaviour. Good risk management behaviour should be acknowledged and rewarded while clear penalties must be meted on employees that violate risk policies and processes.

Managing operational risk is a continual process. It is not something one does and simply forgets about. According to an old saying, "operational risk management is a journey, not a destination". The reality is that even

world class financial institutions cannot completely erase the possibility of unforeseen risks. However, banks that successfully establish best practice systems in operational risks have a lower tendency to encounter operational risks surprise.

References

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