Operational Risk Management in Private Banking

Where to start and how far to go

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Risk Management - The regulatory capital perspective

- Credit risk version 1 - Basel I 1987
- Market risk amendment 1998
- Credit risk version 2 - Basel II (?2005)
- Operational risk - Basel II (?2005)

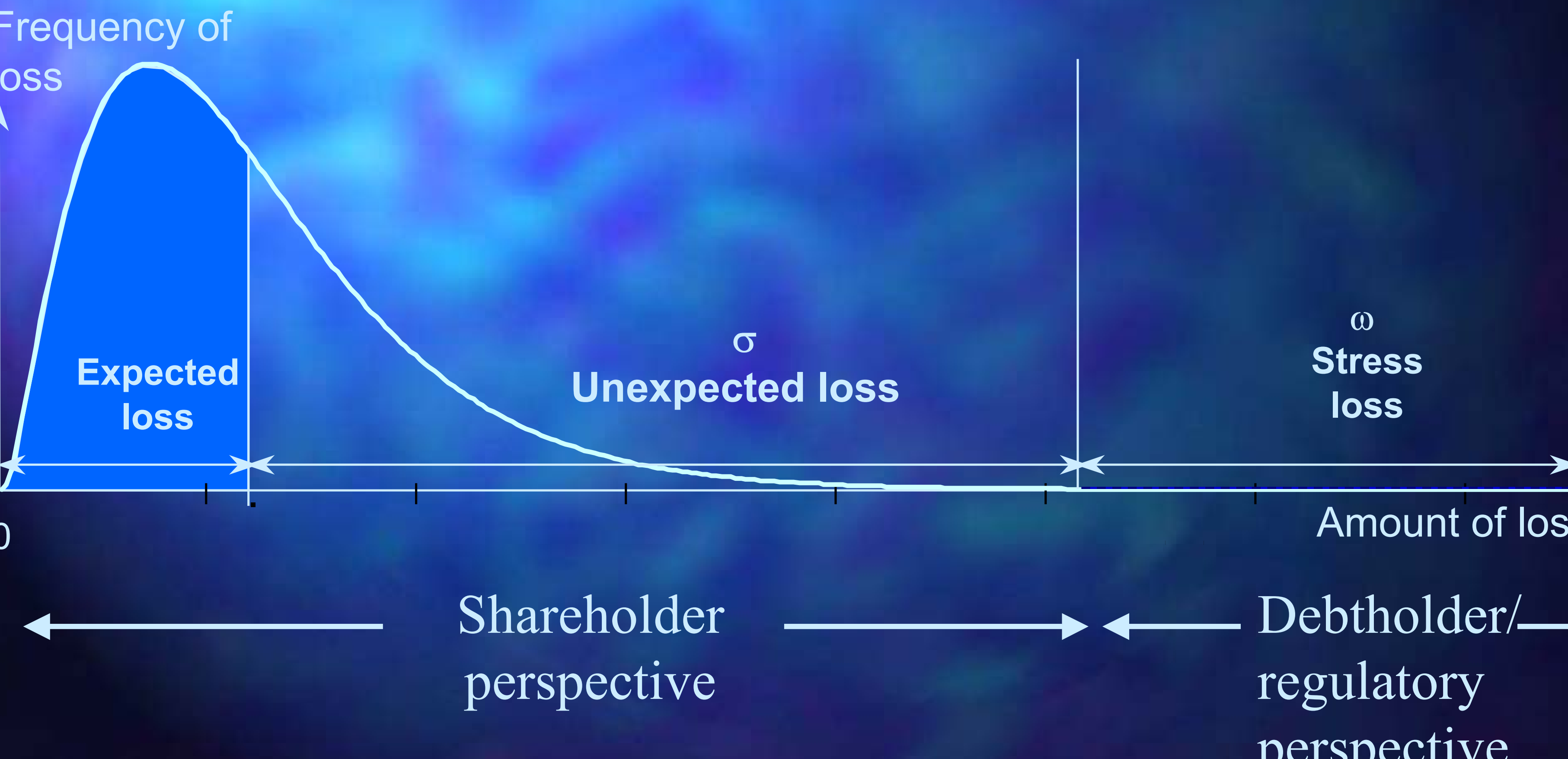
Risk management - the regulatory compliance perspective

- KYC and anti money laundering
- Sales practices
- Product regulation
- Cross border business

Risk management - the business perspective

- Return on capital
- Volatility management
- Value optimisation
- Franchise retention

Risk management - making sense of the two perspectives



Why are things changing?

- Traditionally, risk management has focused on controlling large losses
- Historically large losses have been associated with credit and market risks
- But increasingly large losses come from business and operational failures
- Shareholders require improved value management and lower volatility of earnings

The components of risk

Portfolio risks

- Credit risk
- Market risk

Business risks

- Strategic risk
- Reputation risk
- Treasury risk
- Tax risk

Operational risks

- Transaction processing risk
- IT Security risk
- Legal risk
- Compliance risk
- HR risk

Is private banking really different?

- Credit risk is relatively low
- Traded market risk is low

BUT

- <u>Business</u> exposure to market prices is very material
- Legal/fiduciary risk is high
- Compliance/KYC risk is high
- Processing risk is significant

Implication for effective risk management

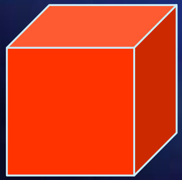
- Process must address risk in both normal and stress conditions
- Process must cover all elements of risk and all material risk factors
- Process must recognize the importance of covariances

The Risk management spectrum
The 6 steps which differentiate the 'best from the 'rest'

Tier 1
Risk Organisations

See little value in proactive risk management. Other than insurance risk management there are few formal management programs. They tend to implement these control mechanisms only when unwanted risk turns into a problem or crisis.

Capabilities are characteristic of individuals, not of the organisation



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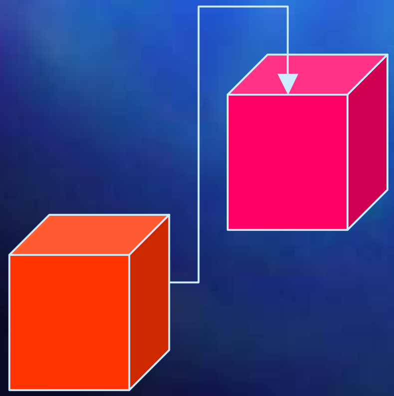
Tier 2
Risk Organisations

Have a general awareness about risk management & some conceptual appreciation for its value, ensuring that not all uncertainties become problems.

Although most business units monitor their risks, there are no centralised processes, no systematic monitoring or aggregation at group level, and no defined accountability for risk management.



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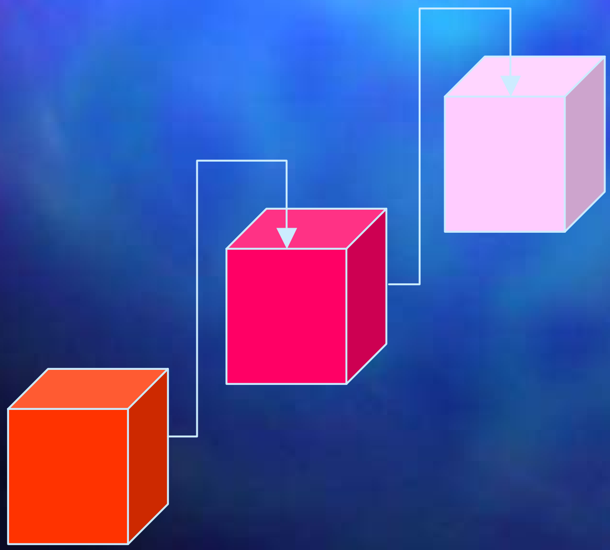
Tier 3
Risk Organisations

Are aware of the need for proactive risk management & set some mechanisms to monitor risks.

Internal Audit typically functions on risk based principles.

Risk practices are based on control and are not linked to the performance objectives of the enterprise



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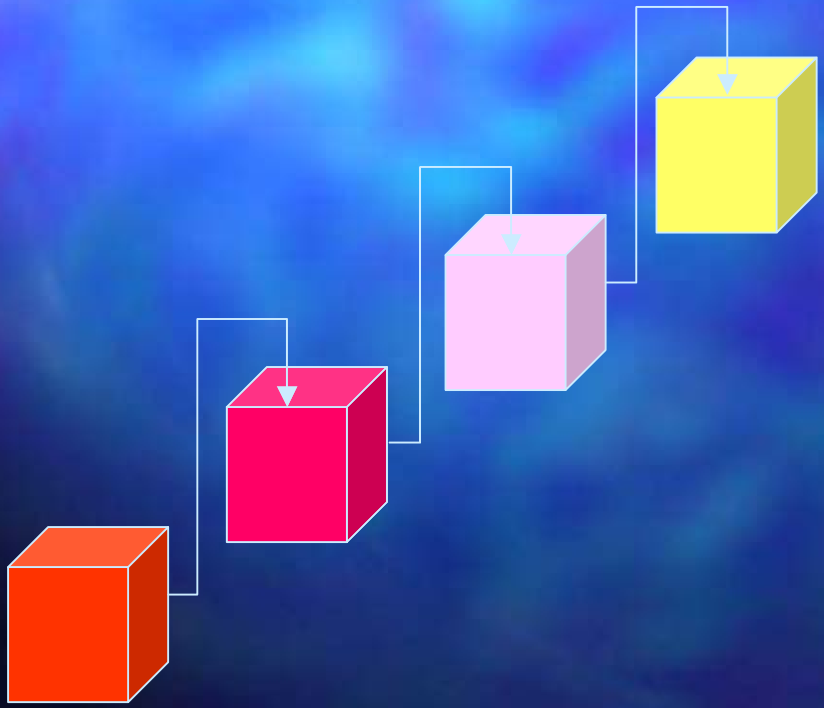
Tier 4
Risk Organisations



Adoption of a broader risk management perspective to review group level "hot spots" & support risk management in business units.

Organisations consider both the qualitative & quantitative risk factors.

The customisation of risk tools & strength of the entire risk management program relies heavily on the knowledge, judgment & effective span of influence of the Chief Risk Officer ('CRO')

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Tier 5
Risk Organisations

Risk management has fully evolve
from a Back Office function to a CE
concer

CEO believes risk manageme
should be embedded in every part
the organisation & actively promotes
sponsors the risk manageme
progran

Group Risk function designs & implements the framewo
within which risk should be identified, measured, controlle
& reported. Using decentralised risk managers, eac
business unit translates the group risk framework
processes to meet their specific need

Risk is viewed as an opportunity as well as a threa

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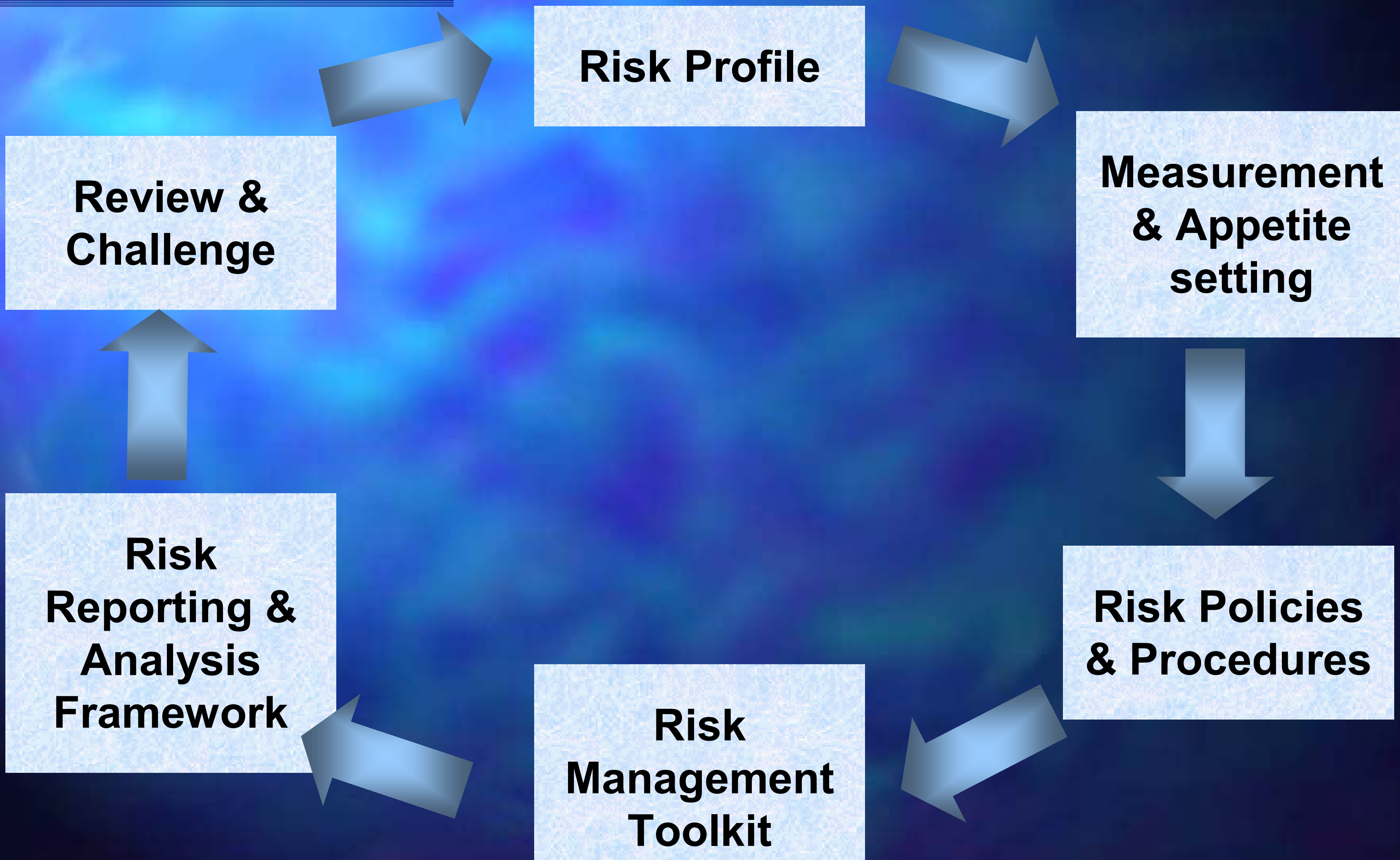
Tier 6
Risk Organisations

Converts its risk management capability into a competitive edge, for itself & its customers

Displays all the characteristics of a level 5 organisation, however integrates risk management into the very fabric of achieving the organisation's strategic goals by embedding risk management practices in the strategic decision making process

Organisations are typically top quartile performers and exhibit best in class governance and control capabilities supported by timely, reliable, accurate, complete and relevant risk information with high levels of external disclosure

The risk management process



Who does what?

Risk policy (Board of Directors)

Defines the risk management framework. Sets overall policies and limit structures

Risk management (Line Management)

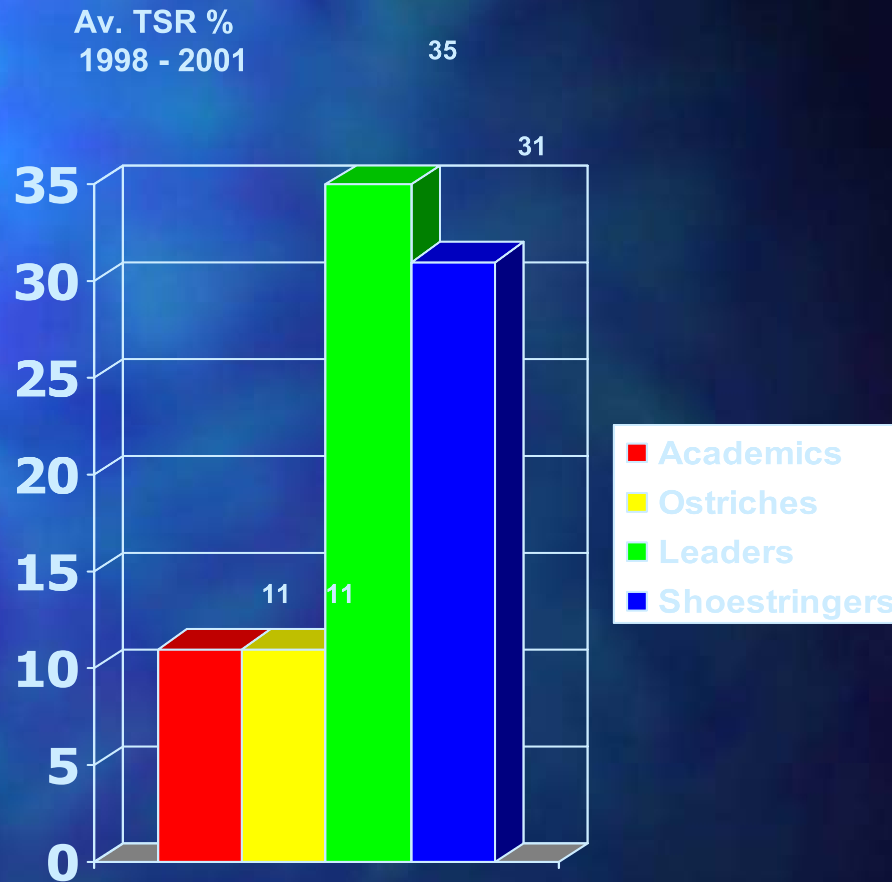
Assumes risk positions. Manages risk within established framework

Risk control (Risk Management / Control Units)

Monitors compliance with framework. Analyses risk profile. Reviews adequacy of framework and proposes enhancements

Effectiveness not sophistication drives value

- **Academics**
  Banks that have developed highly sophisticated risk models, but have failed to use the tools to support business decisions
- **Ostriches**
  Banks that have avoided risk management as an issue; they have relatively unsophisticated risk models for decision - making purposes
- **Leaders**
  Banks that have sophisticated risk models & are applying these models to make business decisions
- **Shoe stringers**
  Banks that have relatively unsophisticated models but are using these models effectively to make business decisions & have experienced significant improvement



Source : PA Consulting Global 'IRM' Survey 2001

Risk management - the MIS challenge

“Would you please elaborate on ‘then something bad happened’?”

Risk management - the MIS challenge

- Ultimate test of any risk management framework is quality of MIS
- MIS must be appropriate to risk footprint of business
- Senior management and shareholders must be able to rely on quality and integrity of risk data
- Risk organisation designs reports and assures their integrity

In conclusion

The question should not be

'How far should operational risk management go in Private banking?'

The real question is

'How good is risk management currently in Private banking, and how can it be improved?'