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2016 - Irish Chapter Event No. 2

The Virtual Meets the Intangible

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Agenda for Todays meeting

Thursday, 21st April 2016	
7:30 to 7:45	**Registration**
07:45 to 07:50	Enda Twomey – Head of Irish Chapter - Welcome and Opening remarks
07.50 to 08:15	Tony Moroney – Managing Director – Berkley Research Group: "Cybersecurity Preparedness Benchmarking Study"
08:15 to 08:45	Enda Twomey "Exploring Risk Culture " following by Panel Discussion
08:45 to 09:00	Ronan Scully – Head of Analytics and Reporting – AIB – " Introduction to the Standardised Measurement Approach"
09:00	End

Who and What is the IOR

- Not for profit association of operational risk practitioners
- Established in 2003
- Central Council with Local activities driven by local Chapters

See

https://www.ior-institute.org/about-us

Priorities of Irish Chapter 2016

- Irish Local Committee* to continue formal establishment of Irish Chapter
- Grow membership of the Irish Chapter
- Create network of Op Risk Professionals
- Host four events in 2016 – See Irish Chapter Topics Survey
- Leverage off other IOR Local Chapter network activities
- Be recognised as thought leaders in Op Risk

*** (Enda Twomey, AIB, Enda Collins, GE Capital, Tony Moroney, BRG, Alan Stewart, Pioneer Investments and Ronan Scully, AIB)**

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Topic 1

Tony Moroney

Cybersecurity Preparedness Benchmarking Study

Topic 2

Enda Twomey

"Exploring Risk Culture "

"If things were simple, word would have gotten around" Derrida

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Why is Risk Culture important – let's recall

- Excessive Risk Taking leading to Financial Crises

*"Notwithstanding this febrile environment, some of the banks have been the principal authors of their own demise**. The culture within parts of British banking has increasingly been one of risk taking leading to the meltdown that we have witnessed.** Bankers have made an astonishing mess of the financial system. However, this was a failure not only within 39 individual banks but also of the supervisory system designed to protect the public from systemic risk."*

House of Commons Treasury Committee - Banking Crisis: dealing with the failure of the UK Banks

- Followed by Conduct Risk Failures – Incentives Culture and Cost of PPI

The consensus has emerged that an absence of an appropriate risk culture was at the heart of the financial crises and conduct risk failures

So what is Risk Culture and how is it formed?

What is meant by Culture?

"that complex whole which includes knowledge, belief, art, morals, law, custom and any other capabilities and habits acquired by man (sic) as a member of society." E.B. Tylor

Cambridge English Dictionary states that culture is, *"the way of life, especially the general customs and beliefs, of a particular group of people at a particular time."*

What is meant by Organisational Culture?

"The way we do things around here" (M Bower 1966 - The Will to Manage: Corporate Success Through Programmed Management)

"A pattern of shared basic assumptions learned by a group as it solved its problems… which has worked well enough to be considered valid and, therefore, taught to new members as the correct way to perceive, think and feel in relation to those problems" (E Schein 1992 - Organisational Culture and Leadership)

So what is Risk Culture and how is it formed?

Risk culture can be seen as a subset of the overall culture of the organisation

There are numerous definitions for example

> "… *the norms of behaviour for individuals and groups within an organisation* ***that determine the collective ability*** *to identify and understand, openly discuss and act on the organisations current and future risk….* FSB 2013

> "*the* ***values, beliefs, knowledge and understanding*** *about risk shared by a group of people* ***with a common purpose****, in particular the employees of an organisation or of teams or groups within an organisation*" IRM 2012

Excessive risk taking is regarded as a demonstration of inappropriate risk culture however excessive risk control can also be detrimental to the achievement of ones objectives and **what is the appropriate risk culture is very much context dependent.**

Risk culture is a dynamic social process and not just about individual aptitudes and behaviours and heavily influenced by both external and Internal factors.

So what is Risk Culture and how is it formed?

Potential Drivers of Risk Culture - External Factors

- Economic Conditions – the appropriate balance between risk control and risk taking activities should be (!) heavily influenced by the economic cycle.
- Competition – an argument can be made that excessive competition leads to excessive risk taking.
- Technology – the speed and intensity of events can be exacerbated by technological developments
- Stakeholders – Meeting stakeholder's expectation can influence risk culture
- Incentives regulation – the way incentives are regulated can impact on risk culture

So what is Risk Culture and how is it formed?

Potential Drivers of Risk Culture - Internal Factors

- Three Lines of Defence - how well articulated are roles and how well embedded are they in practise
- Risk Appetite Frameworks - how effective are they in practise
- Risk Management Function - the status of the risk management function and employment of centralised versus decentralised model
- Recent Risk History - the frequency and severity of recent risk events
- Nature of formal and informal organisations - how well are the formal risk governance structures operating and what is the power and influence of the informal networks within the organisation
- Incentive Structures - excessive incentive structures can undermine risk culture through excessive risk taking

Views of the Regulators

Financial Stability Board

The Financial Stability Board has issued guidance to supervisors as what they should be looking at when examining risk culture in financial institutions.

A. Foundational Elements of a Sound Risk Culture

- Risk Governance – Focus on roles and responsibilities of the Board and the stature, resources, authority and independence of the Risk, Compliance and Internal Audit Functions
- Risk Appetite – Focus on key elements of Risk Appetite Frameworks and how they are linked to strategy, business model and plan.
- Compensation – Focus on Performance Reviews which take into account risks assumed in carrying out activities

B. Indicators of a sound Risk Culture

1. Tone from the Top

The Board & Senior Executives are crucial in signalling the risk culture and ensuring that the appropriate risk culture permeates through the Institution. It also recognised that middle management are crucial in ensuring that the appropriate Risk Culture is transmitted. These are manifested in “Tone from the Top” and “Tune from the Middle” and indicators of a correct tone from the top are:

- Leading by example;
- Assessing espoused values;
- Ensuring common understanding and awareness of risk; and
- Learning from past experiences.

Views of the Regulators

Financial Stability Board

2. Accountability

A clear delineation of responsibilities in relation to the management of risks across all employees is crucial so as to ensure that everyone understand their accountabilities and indicators of accountabilities are:

- Ownership of risk;
- Escalation process; and
- Clear consequences**.**

3. Effective Communication and Challenge

A culture of transparency and open dialogue throughout the organisation is essential in order to promote a sound Risk Culture to fully utilise the skills of its people and indicators of effective communication and challenge are:

- openness to alternate views; and
- Stature of the control functions.

4. Incentives

Sound risk taking within the organisation is valued and enforced and indictors are:

- Nature of remuneration and performance;
- Succession Planning; and
- Talent development

Views of the Regulators

Central Bank of Ireland

The CBI set out its views in a discussion document entitled Risk Appetite in 2014 – http://www.centralbank.ie/regulation/poldocs/dispapers/Documents/Risk%20Appetite%20Paper.pdf

The CBI supports the FSB definition of risk culture and believes that a strong risk culture is one where

- The board, management and employees have a clear understanding of the risks that should be accepted and those which should minimised or avoided
- There should be no confusion as to where limits and tolerances lie
- Communication is encouraged in respect of how risks are measured and accumulated
- The culture is enforced through behaviours from management and directors and through incentives and sanctions
- Risk management is the responsibility of each individual in the organisation with any actions in response to identified risks being timely, appropriate and proportionate
- Clear definition of the roles and responsibilities in respect of risk management along with enhanced communication and training in respect of risk issues are also regarded as an important contributors to a strong risk culture.

High Level Topics to Consider

- What is the true nature of Risk Culture
- Complex versus Complicated
- What are the appropriate mechanisms for intervention
- Link with Organisational Cultural Change and Conduct Risk Management

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Suggestions on further Research

Risk Culture

- Ashby / Palermo / Power (2013)

“Risk Culture in Financial Organisations”

- Sheehy and Griffith (2015)

“Risk Governance, Structures, Culture and Behaviour: A View from the Inside”

Complexity and Leadership

- Snowden and Boone (2007)

“A Leaders Framework for Decision Making”

- Keith Grint (2005)

“Wicked Problems and Clumsy Solutions: the Role of Leadership”

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Risk Culture

Discussion

Topic 3

Standardised Measurement Approach

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Brief introduction to the Basel Committee Consultation on the Standardised Measurement Approach

Ronan Scully

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Standardised Measurement Approach

- What is proposed and why?
- How will the proposals be assessed?
- Some of the challenges posed?
- Take-away thoughts

What is proposed and why?

What:

- Replacement of existing AMA, TSA & BIA approaches under Basel II
- Combination of Business Indicators as a proxy for the Operational Risk profile
- Scaling factor reflecting 10 years historic loss experience

Why:

- *A recent review of the measures related to banks' operational risk modelling practices and capital outcomes revealed that the Committee's expectations failed to materialise. Supervisory experience with the AMA has been mixed. (Basel Committee)*
- *Pillar 1 Standardised approaches for operational risk use gross income as a measure of risk. This is not risk sensitive. During the recent economic downturn, incomes dropped but operational risk exposures, in many cases, remained the same or increased. (Prudential Regulatory Authority)*

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How will the proposal be assessed?

- Quantitative Impact Survey (Basel III QIS) currently being conducted.
- Gross historic losses over the last 10 years.
- Loss history based on adjusted gross loss view rather than point in time.
- Recoveries not included.

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Some of the challenges posed?

- No allowance for risk mitigation (e.g. Insurance for AMA Banks)
- Operational risk pricing within products is ignored.
- Observation period of 10 years will see many ’tail losses’ excluded in the future
- Lack of clarity of interaction between SMA and ICAAP including management add-ons under Pillar 2
- Non-inclusion of Scenario Analysis (either as a risk management or as a capital assessment tool)
- Adjusted loss based view reducing impact of losses that arise over time.

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Take-away thoughts

There are positive facets in the proposal:

- Levels the playing field in a simplified and uniform way.
- Allows comparability of level of capital between Banks.
- Brings clarity to the scope of operational risk losses.

However:

- Likely increase in regulatory capital.
- Challenges in explaining capital increases v. substantial improvements being made in embedding better control frameworks.

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Questions and Comments

If you wish to provide your views to IOR on proposals mail to ronan.j.scully@aib.ie or IrishChapter@ior-institute.org

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Thanks and Next event..

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