WHITE PAPER

CUTTING RISKS, CUTTING LOSSES

Abstract

This paper examines operational conduct risk and its drivers from a financial services perspective, and presents a potential risk management framework that can comprehensively address the extant challenges.

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Risk and its costly implications

With the pace of technology — and consequently, societal — evolution throwing several challenges at the business world, managing risk today has become a worrisome exercise. This is more so in the case of financial services, because the nature of the business involves largescale fund transactions and the reputational and cost implications of any operational risk events can be quite significant.

In one of most discussed Wall Street Journal headline articles of 2020, regulators were preparing to reprimand an American bank for failing to improve its risk systems. Their lack of robust risk systems was highlighted by a 'clerical error' that resulted in the bank making an accidental payment of $900 million to a client's lenders, a mistake some pegged as the 'worst Wall Street bungle' in a long time.

On investigating, the bank discovered that an employee within its loan operations function simply did not select the right option in the system to avoid incorrect payment. However, the costly mistake has even accelerated plans for the hitherto successful CEO's early retirement.

Understanding the drivers

Today no financial institution wants to take a chance with operational errors which can damage reputations, demand financial reparations whether regulatory or non-regulatory, and cause the loss of potential and existing clients. Yet, the question remains. Are these institutions in any position to significantly rectify their operational errors?

Certainly, the answer is a resounding no, firstly because of their sore lack of any comprehensive risk management framework or any continuous efforts towards developing one, in the context of a rapidly changing world. Second, operational risk is generally categorised as only one risk type among several other risk types. However, the fact is that with operational risk arising out of the business value chain —which is comprised of multiple business operations — ideally it should be placed at the heart of any risk framework.

There is significant evidence to prove that the majority of financial misconduct incidents originate out of operations, whether it be rogue trade scandals, LIBOR rigging, or incorrect payments. And it is also clear from history that these operational risks lead to reputational risk, market risk, credit risk, liquidity risk and legal risk. The below illustration depicts these cascading effects, as well some drivers, of operational errors.

Drivers

- System capabilities
- Incorrect data entry
- Ignoring set procedures
- Lack of knowledge (process and risk related)
- Lack of controls in the process
- Absence of duties of segregation
- Lack of quality check mechanism
- Workload imbalances (high transactions/volumes/staff spread across time zones)
- No/less knowledge management (updates

Regulatory perspectives

After the financial crisis of 2008, financial market regulators introduced various guidelines exclusively for financial institutions to enable stable and sustainable markets. As one of these regulatory efforts, the FCA (the UK's Financial Conduct Authority), published its Risk Outlook 2013 which strongly recommended that financial institutions set up mechanisms to identify risks and implement all possible risk mitigation tools. FCA's Risk Outlook 2013 did not define exactly what conduct risk is, it being difficult to define universally. It did however outline the high-level drivers of conduct risk as below:

Drivers	Description
Inherent factors Information Asymmetries Biases & Heuristics Inadequate Financial Capability	A range of inherent drivers of conduct risk that interact to produce poor choices and outcomes in financial markets. These drivers are a combination of supply-side market failures (e.g. information problems) and demand-side weaknesses (e.g. biases), which are often exacerbated by low financial capability among consumers.
Structures and behaviours Conflicts of Interest Culture & Incentives Ineffective Competition	Structures, processes and management (including culture and incentives) that have been designed into and become embedded in the financial sector, allowing firms to profit from systematic consumer shortcomings and from market failures.
Environmental factors Economic & Market Trends Technological Developments Regulatory & Policy Changes	Long-running and current economic, regulatory and technological trends and changes that affect the inherent factors, structures and behaviours detailed above, and which are important drivers of firm and consumer decisions.

[1] https://www.fca.org.uk/publication/business-plans/fca-risk-outlook-2013.pdf

FCA's Risk Outlook 2013 also outlines the regulatory body's overall objectives in managing risk and ensuring that financial markets function well:

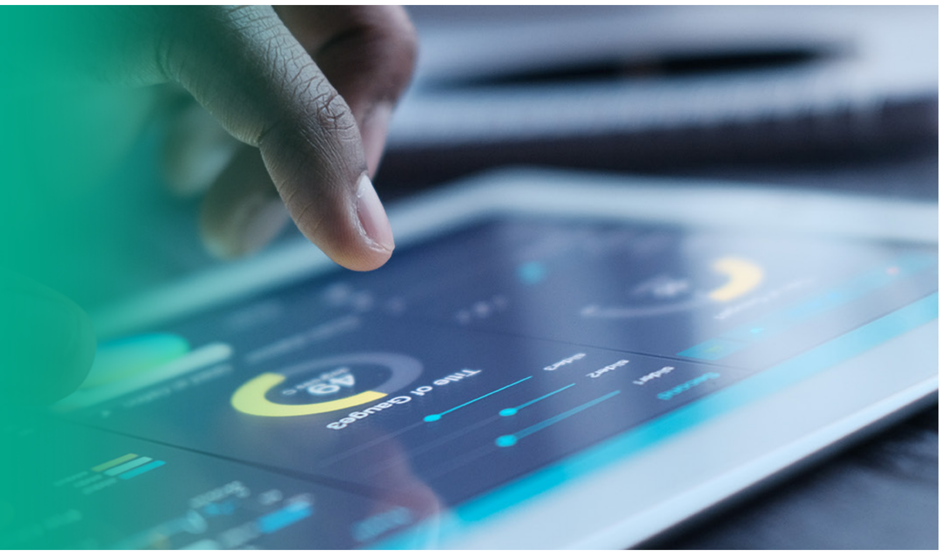
- Consumers get financial services and products that meet their needs from firms they can trust
- Markets and financial systems are sound, stable and resilient with transparent pricing information
- Firms compete effectively, with the interests of their customers and the integrity of markets at the heart of how they run their business

Other regulators including the U.S. Securities and Exchange Commission (SEC) have also endorsed the FCA's recommendations on conduct risk. However the real challenge that remains is about how to monitor individual firm's risk levels or control mechanisms.

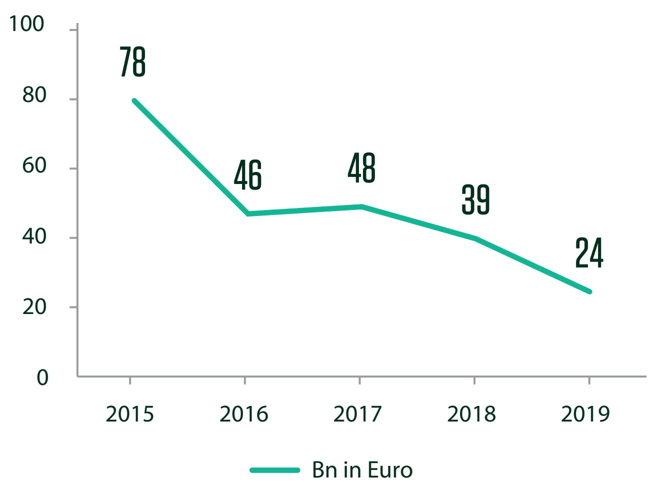
Thus today, it remains each individual organization's responsibility to adapt and work towards best mitigating possible untoward scenarios such as markets crashes leading to them having to close their doors permanently, sell their portfolios to peers, or pay huge penalties. However, regulators continue to watch the conduct of every financial institution and penalise accordingly for time being.

Challenges galore

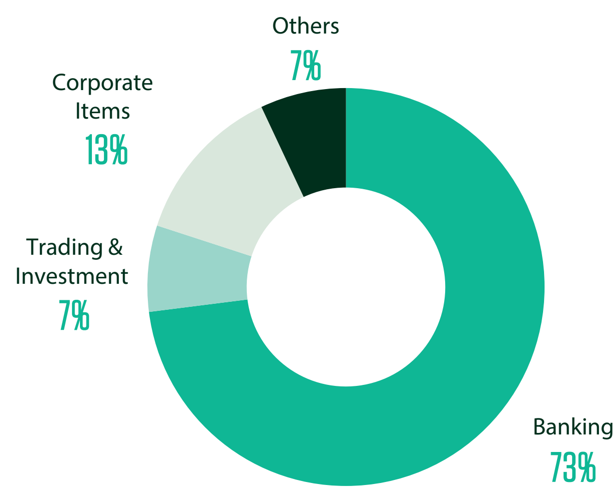
Surprisingly, the latest research continues to show enormous operational losses. The staggering numbers underline the many risks that surround financial institutions due to increasing customer needs, the width and depth of product and service offerings, as well as evolving technology and regulations.



Operational Risk Loss
2019-100 Participants



Proportion of Events Reported by Business Type



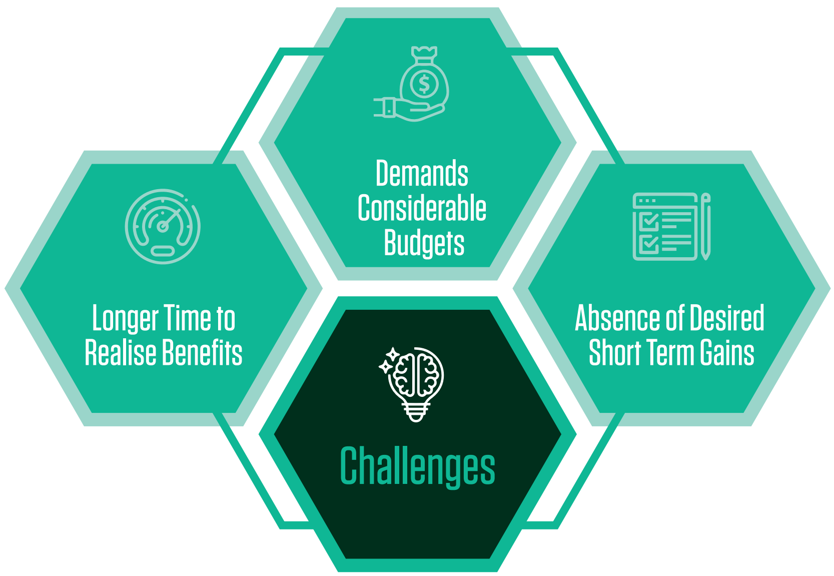
Source: Annual Banking Loss Report [2]

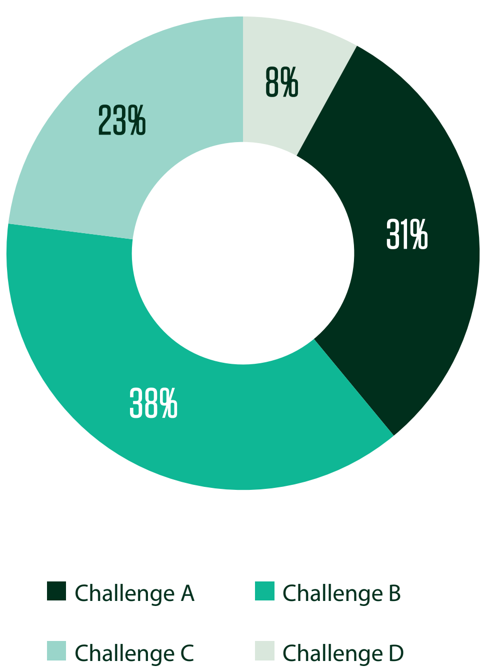
[2] Annual banking loss report

So the question arises as to why financial institutions continue to pay for operational losses. The simple answer is that implementing and managing a risk management framework is a challenging task for financial institutions.

Most of their scarce time resources are spent on their core business – offering new products to meet ever changing customer needs, dealing with competition and other challenges, and adopting new technologies. Further, apart from the shortage of time, managing risk also demands considerable budgets. With ever-shrinking profit margins and the way forward looking even tougher due the COVID-19 induced uncertainties, firms will continue to struggle with adopting effective and efficient operational risk management frameworks.

The graphics below depict challenges organizations face with adopting, implementing, and monitoring operational risk management mechanisms, as well as practitioner perspectives on the nature of these challenges.





What real challenges do practitioners can foresee in the coming years that may prevent them from achieving their key priorities?

- **Challenge A:** Still battling with insufficient buy-in into the importance of operational risk management (31%)
- **Challenge B:** Firms having more urgent and immediate priorities – whether strategic including business model viability, geopolitical, technological or compliance related (38%)
- **Challenge C:** Fatigue due to too much change overall, with operational risk also knocking on the door competing for time and attention (23%)
- **Challenge D:** As well as change in risk / operational risk leadership at the top of the house resulting in shift in direction and priorities (8%)

Source: Ops Risk Challenges [3]

[3] https://www.linkedin.com/pulse/operational-risk-priorities-challenges-2020-elena-pykhova

Imagining a comprehensive framework

A proper understanding of conduct risk and its role within operations, ought to be sufficient motivation to develop a comprehensive solution to tackle the extant challenges. i.e. an actionable risk management framework. Such a framework should deliver both short and long-term gains converting expenditure into rational investment(s).

Outlined below is one such framework developed through a wealth of experience in managing risk and delivering unique value propositions for several financial services firms.

The framework is powered by both people and technology, and its key components involve identifying and assessing operational risks, measuring and prioritising them, and actionizing steps to mitigate and monitor. The framework accomplishes this through the following key elements:

- **Maturity assessment:** Plug and play, maturity assessment tools not only benchmarks but also shows risks and issues at each process step, with very little customization required to identify the risks associated with each processes
- **Impact assessment:** A hybrid impact assessment tool is designed by considering SIPOC (suppliers, inputs, process, outputs, and customers) approach to derive the risk scores along with potential loss scores
- **Technology and people:** A discovery platform offers critical business metrics based on empirical data, protects sensitive information, provides an automation blue print and MIS, and is complemented by our subject matter experts.
- **Task management and reporting:** The framework allows for monitoring team/individual task progress, missed timelines and completed tasks, and sends email notifications about pending tasks to task owners/processors. The system also has the capability to extract reports/dashboards to display real time task statuses and provide audit trails for all tasks.

Cutting the losses

To deal with the complex and sometimes entrenched challenges of the financial services world, organizations will need to strategically address root causes of operational errors and deploy adequate mitigation measures using robust frameworks. These efforts will prove themselves crucial protection against the evolving risks that the future holds.

About Author

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Sourav is a Senior Principal with Infosys BPM's Digital Transformation Services, responsible for Financial Services & Insurance – Digital solution design and service delivery. An IBM-certified design thinking practitioner, he advises organizations on their operations strategy, assists them in improving profitability and efficiency of business processes, and helps in executing business transformation through calibration of operating model and technology.

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