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It's Time for Banks to Reassess the Role of Their Operational Risk Departments

The introduction of the Standardized Measurement Approach (SMA) by the Basel Committee in December 2017 marks an inflection point in the evolution of operational risk within financial institutions. This new regulatory framework replaces existing approaches with a single, standardized approach. Despite the criticism leveled against the SMA, its introduction is an opportunity for the industry to redefine the role of the operational risk department as a true risk partner to the rest of the organization, a change from its primary function today of calculating regulatory capital.

Banks, of course, have long been aware of operational risk. However, it was only in 2004, when the Basel II Accord created capital requirements for operational risks, that it was formally established as a risk discipline. The extraordinary losses suffered by banks in the 2008 financial crisis further highlighted the importance of operational risk and the need to better manage it.

Since the introduction of Basel II, banks have amassed large amounts of data but have generally limited its use to the refinement of regulatory capital models, which provide few insights into the root causes of risk and the resulting effectiveness of mitigation strategies. Operational risk management and operational risk quantification have grown in parallel, but have existed as fairly separate worlds. The opportunity offered by the SMA, which releases operational risk quantification teams from their regulatory capital duties, is to redeploy these teams to help financial institutions better understand and manage their risks.

Becoming a True Risk Management Discipline

In late 2017, the Basel Committee on Banking Supervision clarified banks' future minimum capital requirements for operational risk, which take effect in January 2022. The committee endorsed the SMA as the regulatory standard, replacing all three existing approaches — the standardized approach, alternative approach, and advanced measure approach — for banks to measure operational risk capital. While the impact of the SMA on banks' capital levels will vary by jurisdiction and by institution, it will yield a much clearer and consistent organizational impact. The large teams that banks have put together over the past 15 years to calculate regulatory capital will need to be redeployed.

Many industry observers initially predicted that the SMA would result in the death of operational risk management, but it seems that these fears have been exaggerated. Banks see the continued value of the function as a strong second line of defense. Fully leveraging the benefits of these redeployed quantitative capabilities to provide risk mitigation and oversight of operational risk will require investment, but the benefits have the potential to far outweigh the costs.

The data and expertise that banks have accumulated will allow operational risk departments to take on a broader, more strategic role — providing risk mitigation akin to their

sister departments, credit and market risk. In this way, operational risk departments will be positioned to provide greater value to revenue-producing divisions by advising on activities that drive operational risk capital.

An area that stands to additionally benefit from this evolution is the optimization of insurance purchasing. Doing so, however, requires aligning two areas of the bank that have been traditionally walled off from each other: operational risk and insurance. The irony is that a significant number of risks for which banks purchase insurance today are operational, yet the very department that quantifies and understands that risk is typically left out of insurance procurement decisions. As a result, insurance is often purchased in a vacuum, without leveraging the operational risk department's expertise and valuable insights about the bank's actual risk appetite and profile.

One way for operational risk and insurance departments to start breaking down the silos between them is for individuals responsible for purchasing insurance to sit in on operational risk governance committee meetings or scenario analyses, even if only as observers. Doing so can enable insurance buyers to develop a better understanding of banks' risk tolerance profiles so that insurance programs can be structured accordingly.

Capital Modeling Opportunities

Under the SMA, operational risk capital will be calculated based on a business indicator component and a loss component, known as the internal loss multiplier (ILM). The use of the ILM, however, is at the discretion of each participating nation's bank supervisors. It is not yet clear on what basis this decision will be made.

The significance of the ILM, from an insurance perspective, is that it is the mechanism under the new Basel rules by which financial institutions can use insurance to reduce internal loss data points. Conversely, a decision by regulators in a given geography to preclude the ILM mechanism will eliminate insurance as an operational risk mitigation strategy.

Regardless of regulators' determination, banks should begin planning for the impact of the ILM's application. Banks can take some relatively low-cost steps now, even if they believe it's unlikely that their regulator will apply the ILM. For example, they can negotiate with insurers to secure broader terms and coverages and lower attachment points to increase loss recoveries.

On the other hand, if banks believe their regulator is likely to apply the ILM, other — albeit costlier — options may be available, such as purchasing new, bespoke insurance products that would be tailored to maximize the SMA benefit and aimed primarily at financing expected operational risk losses. Compared to simply tweaking existing coverage, buying this new insurance would provide a more significant benefit when the SMA takes effect.

Seizing the Moment

Now is the time for banks to rethink operational risk — it's no longer solely about responding to regulators. Operational risk departments should assist in establishing risk tolerances and appetites and inform risk mitigation and transfer strategies. And insurance procurement should be brought more in line with banks' operational risk tolerances and modeling.

At this juncture, the question financial institutions need to ask themselves is whether they are going to seize this moment to invest more deeply in improving operational risk management or simply succumb to the short-term cost savings temptation.

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