Please note that the comments expressed herein are solely my personal views

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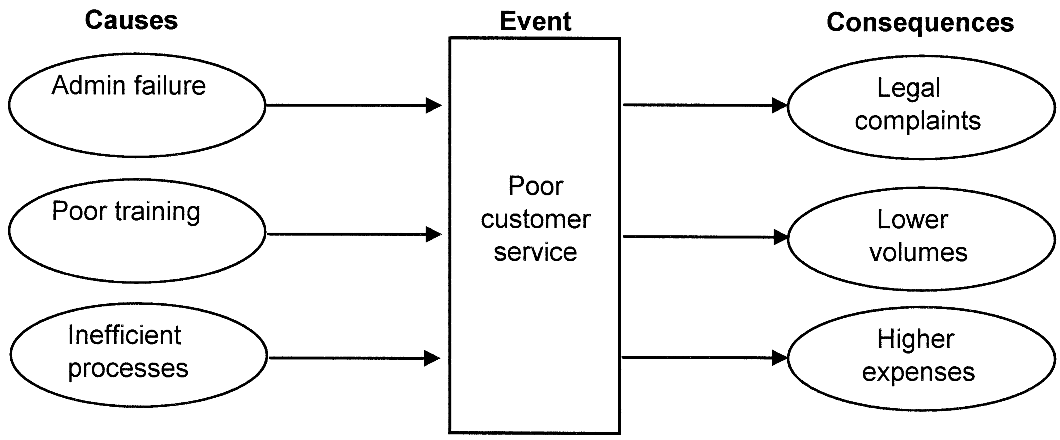
Your Ref: Comment letter on Consultative Document
- Sound Practices for the Management and Supervision of Operational Risk

Dear Sir.

Thank you for giving us the opportunity to comment on your consultative document on Sound Practices for the Management and Supervision of Operational Risk. I will first make some general comments, and then discuss some more detailed points.

Overview

Operational risk is notoriously difficult to identify and quantify, let alone to model, monitor and manage. Furthermore, poor control of operational risk allows other types of risk, such as market risk or credit risk, to be excessive. It is important that institutions understand fully the consequences and potential losses arising from operational risk events. From this, the appropriate risk management response should deal effectively with the root causes rather than with the consequences. The following diagram illustrates the distinction between causes, events and consequences:



Consider a poor customer service event, such as a serious processing error. One consequence might be an increase in legal complaints, leading to reputational damage, falling sales volumes and higher expenses. An investigation into the complaints reveals that the root causes of this error were people-related, for example poor training, and partly system-related.

The customer

The definition of operational risk on page 3 is complete.[1] However, I note that the consultative document does not refer to customers at all. Selling practices are a considerable source of operational risk, relating to poor processes, poor sales training, legal risk concerning sales contracts and misselling risk to name but a few issues. I would suggest that selling and interaction with customers of all kinds should also be more explicitly covered in your proposed principles, as I view these as major components of operational risk, rather than anything else.

Gross and net risk assessment

An institution would normally assess the net or residual operational risk, which is net of any controls in place to mitigate the risk. However, the institution should also consider the operational risk before any controls and risk mitigations. Such a gross operational risk assessment is useful, as operational risk losses are affected by both the extent of the gross risk and the effectiveness of the controls and risk mitigations in place. A gross and net operational risk assessment would help the institution to understand potential operational risk losses if controls and mitigations were ineffective, and also to help prioritise control assurance work.

Agency risk

Agency risk is another distinct risk within operational risk. This is the risk that one party appointed to act on behalf of another will, instead, act on its own behalf. In banks, a key agency risk occurs if bonus systems create perverse incentives for traders to take on excessive risk. This specific point is considered elsewhere[2], but I would suggest that more effort be spent considering this type of risk generally.

More comments on the consultative document

Para 39 (f). Agreed. It can be very useful to reverse scenario test and stress potential operational risk losses. This would help an institution to identify operational risk failures which

[1] Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.
[2] See Range of Methodologies for Risk and Performance Alignment of Remuneration, BCBS, 2010, and my comment letter thereon.

could cause large losses, and then the institution would be able to modify operational settings, controls and risk mitigations in order to reduce their potential impacts.

Principle 7. Also paras 25, 28 (c), 40, 53. As a minimum, new products should be approved by the CRO, and also potentially the CFO, on the solo basis and at group level.

Para 50 (e). Agreed. I would recommend that an institution should regularly carry out a movement analysis of risk measures and performance, and an analysis of variance thereon.

Para 56. Agreed. Risk transfer should not be seen as a substitute for a sound operational risk management system and practice.

Yours faithfully

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