Hyderabad Chapter

State Bank Staff College

Round Table
BIS Consultative Document on Sound Practices for the Management and Supervision of Operational Risk (December 2010)

27th January 2011

Mrs Renu Challu, Managing Director, State Bank of Hyderabad and Chairperson, PRMIA-Hyderabad delivering inaugural address. Sharing the dias is Mrs. Mahapara Ali, Chief General Manager and Head, STU Corporate Centre, State Bank of India, Hyderabad.

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PRMIA-SBSC, HYDERABAD (INDIA) ROUND TABLE ON
BIS Consultative Documents on Sound Practices for the Management and Supervision of Operational Risk and the Supervisory Guidelines for the Advanced Measurement Approaches (December 2010)

Inaugural Address:

(i) Addressing the Round Table, Renu Challu, Managing Director, State Bank of Hyderabad, a leading associate of the State Bank of India, the country's biggest public sector bank, said that the Indian Banking Diaspora moved briskly during the last two decades and quickly caught up with the technological advancements in the sector. It seamlessly integrated with the global counterparts avoiding at the same time the associated risks, thanks to an alert regulator and conservative investment culture. Steady and sustained growth of the Indian economy at 8-9 percent during the last five years, carries the prospect of a double-digit growth of 10 percent and over in the coming few decades. The banking industry has grown at a compounded annual growth rate (CAGR) of 20% over the last decade. It has grown by a factor of five times. Total deposits have grown by 4.8 times, assets by 6.6 times, interest income by 9.5 times and net worth by 4.5 times. Employee strength registered only 5% growth. The ratio of total deposits-to-GDP , which stood at 44% in 2000, has now climbed to 74%. However, the credit-to-GDP ratio presents an opposite picture, and India, at 55%, lags many countries whose banks lend more than the size of their economies. We also have to catch up with the world's best-run banks in the area of cost management — at anywhere between 37% and 66%, our cost-income ratio is no match for international benchmarks of 30-35 %. A financial inclusion effort vigorously under way is likely to escalate the individual clientele base to 400million – larger than the size of population of some of the developed economies, in the next five years. It is this growth picture that is as much a cause for challenge as for opportunity, is the source genre for escalating operational risk in the financial system, she said.

(ii) The mini-mart or the boutique approach of banks and the anxiety of regulators to prove that they are doing their bit to avert the type of crisis and the contagion that engulfed the entire world, particularly since 2007, are enough reasons for the detailed debate on the approaches that the Basel Committee of International Settlements outlined for Banks on Operational Risks; one on the Sound Practices of Management and Supervision and the other for Banks following Advanced Management Approaches. The Reserve Bank of India had set April 2013 for full migration to Basel II in order that there would be preparedness to get into the Basel III approaches. It is any body's guess that the Basel III timeline of 2019 would

see the content of it in tact by that date. The long enough period may, who knows in these days of uncertainties and sovereign debt trappings, shift the paradigm of banking by that time. Preparedness always keeps the system healthy.

(iii) PRMIA, Hyderabad Chapter took the initiative to organize the Roundtable on the Consultative Document of BIS to give expression to collective thinking on the subject and four AMA Banks, academia both in banking and finance, and consulting firms joined the discussions.

Introduction:

(iv) It is but proper to recall what the Governor, Reserve Bank of India said at the BANCON 2011 regarding Basel III. "The building blocks of Basel III are by now quite well known: higher and better quality capital; an internationally harmonized leverage ratio to constrain excessive risk taking; capital buffers which would be built up in good times so that they can be drawn down in times of stress; minimum global liquidity standards; and stronger standards for supervision, public disclosure and risk management."[1] He expressed confidence that even as per the existing achievement levels, the more stringent capital requirements would be easily met by the Indian Banks:

Parameter	Basel III Requirement	Under Basel II Actual Value for Indian Banks	Under Basel III Actual Value for Indian Banks
Capital to risk weighted assets ratio (CRAR)	10.5%	14.4%	11.7%
Of which			
a. Tier I capital	8.5%	10.0%	9.0%
b. Common equity	7.0%	8.5%	7.4%

(v) But what needs recognition is that the Indian Financial System has fallen into the advanced regulatory regime in tune with the global ordain just a decade back. The data collection and transmission are in their nescient stage. People on the job are learning the art and science of data

[1] D.Subba Rao, Governor, Reserve Bank of India, Mumbai: Inaugural Address at BANCON 2010 published in the RBI Monthly Bulletin January 2011, page 1

management. Operational Risk component in the capital calculations under Basel II constitute no more than 5% of the total capital allocations.

(vi) **Operational Risk Defined**:

It is here that the group recalled the definition of Operational Risk: "**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]

(vii) "The Basel II Framework requires banks to develop an *operational risk management framework*.

(viii) The ORMF consists of a bank's:

risk organisational and governance structure;

policies, procedures and processes;

systems used by a bank in identifying, measuring, monitoring, controlling and mitigating operational risk; and

(ix) *operational risk measurement system*."[3]

(x) There is a broad consensus that the financial risk has been commoditized and risk modeling took a quirk turn at the hands of engineers who created esoteric products endangering the financial ethics.

(xi) The Issues:

The issues that were discussed at the Roundtable have been framed basing on the Basel Consultative Document and the underlying principles. They are as follows:

(i) Opinion on observed loss incidents across the eight Business Lines vis-à-vis proposed principles and practices.

(ii) Bearing in mind that operational data is still unavailable to the desired degree, what would be the appropriate timelines for implementation of AMA approach for operational risk measurement?

(iii) Where does the bank stand with respect to implementation of OR management practices as specified in Basel II and covering the following areas?

a. Governance
b. Risk management environment
c. Role of disclosure

(iv) Importance of supervisors in audit of operational processes, analysis of impact of audit findings, closure of audit findings and etc.

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[2] BCBS Consultative Document on Supervision and Management of Operational Risk in Banks, December2010

[3] BCBS Consultative Document on Supervisory Guidelines on Operational Risk Management under AMA, December 2010

(v) Risk education measures undertaken at the bank. Do they require additional investments?

(vi) Reporting & monitoring structure in place at the institution.

(vii) Is it proper to treat the Commercial Banks, Investment Banks and Insurance Companies with the same brush?

(viii) Business resilience and continuity plans, if any, at the institution
   a. What is the extent of coverage of these plans?
   b. Lead time for the business to be back up & running in full scale?
   c. How often are these plans tested?

(ix) With regards to implementation of the proposed framework,
   a. What would be the additional capital requirements? And would they get into the Basel III capital calculations comfortably?
   b. What would be the costs incurred by the bank upon implementing the proposed framework?

(x) Will the proposed principles and practices lead to regulatory capture?

(xi) Any other suggestions/recommendations for improvement of OR management over and above those proposed in the Basel document.

(xii) The recent crisis that shook the world formed the basis for the discussions. 'There is a clear recognition of the inadequacies of the regulatory approach based on the assumption of self-contained, well functioning markets which ignored the risks these markets passed on to the banking system. …Increased recourse to 'originate and distribute' model of asset creation and increased reliance on wholesale, market funding of balance sheets were two most evident signs of this shifting paradigm and which also contributed significantly to the intensification of the global crisis.' [4] The Group discussions centered round the embedded operational risks that lay around this syndrome.

Part II

<u>Structural Aspects of Indian Banking</u>

1. Indian Banking Structure unlike in the West, Europe and Middle East is uneven though well regulated. The Structure consists of public sector banks that constitute around 80 percent of the total banking system; the old private sector banks; the new generation private sector banks; the foreign banks; the cooperative urban banks (UCBs) under the regulation of the Reserve Bank of India(RBI) most of which

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[4] Shyamala Gopinath, Dy Governor, Reserve Bank of India: Inaugural address at the 12th FIMMDA-PDAI Annual Conference, Udaipur, January 8, 2011

are yet to join the overall payment and settlement systems set up by the Regulator; the Regional Rural Banks, the few Local Area Banks and the Rural Cooperative Banks, supervised by the National Bank for Agriculture and Rural Development (NABARD) fully owned by the Central Government and regulated by the RBI. Cooperative Banking system occupies nearly 15percent of the Indian Banking System but still to catch up with technology and leaves ample scope for systemic risk affecting the rest of Indian Banking.

2. Higher global minimum capital standards for banks from the BIS have come off as a response to the US sub-prime crisis that caused lenders to write off $1.8 trillion. Banks need to maintain minimum regulatory capital at 8% of the risk-weighted assets as per the existing Basel II norms. Out of this, not less than 50% should be Tier 1 capital. The New Basel III regulations have been established to prepare banks to absorb unexpected losses and to reduce the likelihood of another financial crisis. Banks will have to keep conservation buffers and countercyclical buffers. The first will ensure that banks maintain a capital buffer that can be used to absorb losses during periods of financial and economic stress. The second is not applicable to all the countries all the times. Countercyclical buffers will only be required when excessive credit growth could potentially lead to systemic risks.

If we exclude the countercyclical buffer, mandatory minimum regulatory capital would be 10.5% of risk-weighted assets. Out of this, not less than 8.5% would be Tier 1 capital, out of which not less than 7% would be core equity capital. This 7% includes a 2.5% capital conservation buffer. In a crisis, a bank will be allowed to let its capital ratio drop temporarily to as low as 4.5%, but then the bank will be limited from paying bonuses and dividends to shareholders until it has rebuilt this ratio to 7%. There is also an extra 2.5% countercyclical buffer that will allow regulators to raise the capital requirement to 9.5% during boom times in order to slow down lending. It is expected that central banks' macro policies will work better under the Basel III regime. It is this background to capital framework that made the Governor, RBI to exude confidence in the capability of the Indian Banking system mentioned in the Introduction in Part I of this paper. However, when disaggregated and looked at the complexity of the Indian financial structure there are concerns that the Roundtable discussed in great detail.

In the present very challenging business environment, the renewed attention on operational risk is timely. But the implementations of the recently finalized Basel III rules require considerable investment within a relatively short amount of time in systems including IT and human resources.

Banks unwilling to accept the lower returns on equity, or ROE, that result from higher capital requirements may fuel a new bubble by chasing high returns in commodities or emerging markets. Regulators, while focusing their restraints on banks, may drive risk-taking into unregulated funds that may pose danger to the system. A Study by NIBM to assess the concentration risk in six public sector banks finds that the mid-sized public sector banks' portfolios are more vulnerable in economic downturns in

comparison to large-sized banks.[5]

Opinion of Delegates

3. In the light of the new principles laid out in the BIS document, a broad consensus emerged that the definition of operational risk would require fine-tuning. In order that the loss events are properly assigned to operational risks, frauds that occur in retail and commercial banking, penalties paid out, legal costs and system disruptions would require clearer understanding and disaggregating. Business Development Department and Risk Management Department are today compartmentalized with no clear objective being driven from the top and insulated from each other. The board and senior management, on their part, even in the Indian context, must play an important role so as to bring all business and risk management functions to work supportively to work towards a common goal of improving operational processes and increasing shareholder value.

4. It is important to segregate the business and operational risks and these should be part of the Principles that the BIS puts forward. It is also important that the document spell out an illustration of operational risk structure.

5. The broad consensus was for keeping the Risk Management Department directly responsible to the Risk Management Committee of the Board instead of to the CEO. Usually, the CEO is biased to business development that contributes to growth of business and profit and it is not unlikely that the Risk Management Department may have some adverse comments either on new products or distribution lines or on new processes that do not go well with the former. This conflict can be avoided when the line responsibility is segregated. Granted, the responsibilities to manage risks on a day-to-day basis belong to the various risk owners (the various businesses, operational and support units). But the coordinating role and the driver of various risk management activities and programmes rest with the Risk Management Department. Thus, this department has to play the lead role in definitely designing and making sure that the organizational risk management framework is not only relevant and best practice but must work effectively for the organization.

6. The role of the Board of Directors under Principle (5) is too demanding and should be restricted in scope. The expectations from non-executive directors to go into the detail required to ensure the firm is managing "operational risks associated with new strategies, products, activities, or systems, including changes in risk profiles and priorities" is a bit too far in scope and may not be practical especially in Public Sector Banks. This task is much more suited to the role of senior executives. This in itself could be a potential source of significant operational risks for the industry. Operational risk governance structures vary widely across banks, with some structures working for some but not for others.

[5] Arindam Badopadhyay, 'For Bad Times' The Financial Express (Print Edition) 16 Oct 2010, p.9

Hence, individual banks should be allowed to decide on the governance structures.(*Principle 5 is prescriptive*)

7. The cost of system disruption understood as the price at which the system can be restored has to be part of the OR framework. In the context of the audit of risk management commencing just recently in the Indian Banking system, clarity on boundary issues would add value to the effort. It has still to be appreciated that the Operational Risk is not a residual risk after accounting for the credit and market risks but counts for a significant portion of hidden risk in the organization and has to be provided for much more than that is being done now. Presently a maximum of 5 percent constitute the risk weight component for operational risk in the leading public sector bank. Its adequacy leaves much room for scaling up. In fact, the State Bank's most recent announcement that every employee and official of the Bank has to necessarily avail a minimum of continuous ten-day holiday during the year is a step in the direction of reducing operational risk. Instances were not found wanting when the staff who did not avail either casual or ordinary or even sick leave, left a trail of fraudulent transactions putting the institution to severe loss.

8. There has been lack of information on business lines. Majority of the public sector banks in India have material business in around five of the eight business lines recognized by BIS. Modeling is difficult because human behaviour cannot fit into a trend analysis. Availability and reliability of loss event data in these business lines deserves lot of attention and much needed action, for, a branch that has not reported any loss data cannot be construed as functioning excellently. On the other hand, steps need to be taken to use data analytics as a tool for proactive risk management. For example, time lag in availability of important reports must be reduced significantly for the management to take appropriate risk mitigation measures.

9. While OR in its original framework has not considered reputation risk as part of it, the later has cast its impact. There should be a way to measure the reputation risk as part of operation risk itself instead of giving separate treatment.

10. Although there has been considerable penetration and use of information technology in the last decade, many delegates felt that there is a need to change perception of audit particularly because it is still the transactional audit that takes place instead of process audit. Probability of loss arising from failed processes is mostly not captured. Closure of Audit Reports continues to happen mechanically and there is no trail of audit compliance. Audit of IT System requires a lot of improvement.

11. In a country like India that has a huge customer base, audit department should have adequate and appropriate staff with the required training and education on Risk. To this end, the board of directors and senior management must provide oversight. The

guidelines require that banks should identify, consider and incorporate operational costs and risks of operational loss in “internal pricing, performance measurement, and new product approval process for all significant business lines” in order to align the “risk taking incentives of individual business lines with the operational risk exposures their activities create for the bank as a whole.” While involving the operational risk functions may pose limited problem for internal pricing and new product approval, at least for AMA banks, incorporation into performance measurement may pose a challenge. In our opinion, the cost involved would not be worth the result.

12. The approach to DISCLOSURE should be beyond compliance template and should be typically illustrated in the document.

13. The much-needed financial resources both on the budget and tactical side, support from the top management and the board are not substantive. They are mere rhetoric, and the needed commitment and support are just on semblance – more to please the regulator that their Banks have such programmes or risk management commitments. The role of Directors of the Board is of paramount importance. It is also important the Directors also receive training in risk management nuances. Accountability of the Board gains more currency than now in the context of the reforms in the financial sector and also the directions that the Financial Stability Board gives to the financial institutions in future.

14. The cost of implementation of the OR new framework – particularly in regard to data collection and data analytics is considered onerous and such costs cannot be passed on to the customers as is done in the areas of credit risk and market risk. The Central Bank could consider treating such cost differently and provide enough cushions for competitiveness. The Central Banks should incentivise banks which adopt data collection and data analytics tools for mitigating Operational Risk or capturing near misses by way of Tax benefits or other subventions.

15. Coming to data on OR, while the Banks like the State Bank of India capture even the near-misses data and has a well defined reporting and monitoring structure, process deficiencies, operational deficiencies, functioning of international switch, etc. need further refinement and integration.

16. There was mixed reaction with respect to the treatment of Commercial Banks, Investment Banks and Insurance Companies with the same brush.

    16.1. Those who opined in the affirmative thought that a new model has emerged for banks. It still requires cross-selling skills and a more holistic treatment of customers, but it doesn't call for the awkward fusing of disparate interests in commercial banking, insurance, asset management, financial planning and other businesses that typically demand some degree of scale to thrive. "The traditional universal bank concept had been extended

into businesses that [banks] didn't need to be in," says Terry Moore, managing director of the North America banking practice at the consulting firm Accenture. "Now they've gotten more focused on a core set of businesses that provide diversity but don't cause them to get too far out there." Since they are in the market for risk, proper pricing is important and collateral risks can be captured when the assessment is done on the same canvas.

16.2 Those who thought otherwise believed that the type of risk differs across these banking businesses and hence Basel guidelines cannot treat them in the same way.

17. Most banks have been reviewing the business continuity and recovery plans once in every quarter and are also put to stress testing as needed. Disaster Recovery Management is mostly found to be adequate.
18. As regards the timelines, the broad consensus has been that the Banks in India would be requiring time until 31st March 2014 to be in preparedness for the AMA when alone it would be possible to secure high integrity data for the past 20 quarters under all data requirements.
19. Indian Banks’ Association (IBA) has initiated Loss Data Consortium – Compilation of Operational Risk Loss Data Exchange (CORDEX) and is in its formative stages now and the Central Bank may itself take two years to validate the system. A public sector bank said that it has been following a scorecard approach. All the delegates mentioned that there is no clarity on relevant date – date of occurrence and date of provisioning; and it is difficult to capture the near-misses data. There were no two opinions on monitoring the leverage ratio of banks much better than other parameters of regulation and regulatory capital adequacy.
20. Most banks represented were with the feeling that there were inadequate budgets for risk management training. A working or corporate environment that is not conducive to risk management instantly, may be unwittingly, is setting up a welcome arch for Operational Risk. Awareness of risks among all employees, senior management and board is cardinal to the success of an effective risk management journey. It is recognized that risk management is after all a journey and not a destination. Risk management and risk concerns must be embedded in the organization’s corporate and working culture. Such operating culture enables every one to have risk appetite to the degree required for healthy business development and to think of every operation, activity, process, transaction and documentation with risk ‘first’ in mind. This mindset would distance the common errors, omissions, defects and faults to be non-existent or minimal.
21. In the context of the Basel approach outlined in the document, it is necessary that the architecture of risk management department itself need undergo change along with imparting additional skills required. It is important to separate out the management and supervision functions while building the new architecture, the Roundtable concluded.
22. It is not unlikely that the Bank crises as has occurred in the past, if were to repeat,

could escalate into sovereign crises when the governments concerned indulge in bailing out the too-big-to-fail banks. What counts as core capital may influence the Indian banking sector's competitiveness significantly. Broadly, these reforms will require banks to hold better quality capital and to carry more liquid assets.

LIST OF PARTICIPANTS IN THE ROUNDTABLE:

S.No	Name and Designation	Bank/Institution
1.	Mrs. Renu Challu, Managing Director and Chairperson, PRMIA, Hyderabad Chapter	State Bank of Hyderabad Hyderabad
2.	Mrs. Mahapara Ali, Chief General Manager and Head,STU Corporate Center	State Bank of India, Corporate Center, Mumbai
3.	Mrs. Usha Nair, General Manager And Principal, State Bank Staff College	State Bank of India
4.	Mrs Sudha Ravi, General Manager, Operational Risk Management, Corporate Centre	State Bank of India, Corporate Office, Mumbai
5.	Mr.M.C. Jacob, General Manager and Chief Risk Officer	State Bank of Hyderabad, Head Office, Hyderabad
6.	Mr. A.K. Basu, General Manager (Technology) and Chief Risk Officer	State Bank of Mysore, Head OfficeBangalore
7.	Mr. B.V. Upahyaye, Dy.General Manager, Risk Management	Bank of India, Head Office, Mumbai
8.	Dr. B. S. R Rao, Formerly RBI Chairprofessor, Gokhale Institute of Politics and Economics, Professor of Economics	Member, Steering Committee, PRMIA, Hyderabad

9.	**Dr.R.R. Pujari, Managing Director**	**TRINITY Infraventures Ltd., Hyderabad and** **Member, Steering Committee, PRMIA, Hyderabad**
10	**Mr. A.V. Ajay Babu, Branch Head**	**Axis Bank Ltd., Hyderabad**
11	**Mr. G. Venkatanarayanan, Dy.General Manager, Integrated Risk Management Department**	**State Bank of Hyderabad, Head Office, Hyderabad**
12	**Mr T.V.Rao, Financial Advisor and Visiting Professor, Former CEO, State Bank of Mauritius Ltd**	**Jawaharlal Nehru Technology University, Hyderabad**
13	**Mr. R.Ganesh, Dy.General Manager and Vice Principal**	**State Bank Staff College, Hyderabad**
14.	**Mr. D.S. Rawat, Dy. General Manager and Senior Faculty**	**State Bank Staff College, Hyderabad**
15	**Mr. S.B. Roy, Dy. General Manager and Senior Faculty**	**State Bank Staff College, Hyderabad**
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17	**Mr. M.R. Das, Economist**	**State Bank Staff College, Hyderabad**
18	**Dr. M. R. Laxman, Associate Professor, Money, Banking, & Corporate Finance**	**Administrative Staff College of India, Hyderabad**
19	**Mr. Venuturupalle N. Rao, Risk Consultant and Dy. Regional Director, PRMIA, Hyderabad**	**HSBC Ltd., Hyderabad**
20	**Dr. B. Yerram Raju, Director, Development & Research Services (Pvt), Ltd., Hyderabad, and Moderator, Roundtable**	**Regional Director, PRMIA, Hyderabad**
21	**Mrs. Reena Rath** Chief Manager (ORM)	**State Bank of Hyderabad, Head Office, Hyderabad**

22	**Mrs. Shailaja Gajjala, Asst Professor, Commerce and Management**	**Osmania University, Hyderabad**
23	**Mr. P. Avinash, Senior Analyst, Credit Rating**	**ICRA Limited, Chennai**