'Control' is one of the basics of any Risk Management architecture. So, every bank needs to have complete control on Operational Risk Management through an external audit, preferably on annual basis. This will inspire more confidence in Regulatory Authorities in India. This article elaborates the concept.

Need for Annual External Audit of Operational Risk Management in Banks

—An Offshoot of Basel Accord II

For almost 200 years since the advent of Commercial Banking, the business of Banking was being primarily driven by Credit Risks on Counter parties. Then, the lendable resources were at the disposal for remunerative deployment. Not much attention was either needed or relevant in the area of operational risks. Such risks in their hidden form were taken for granted as an inseparable part of the business.

But then came the big change. June 2004 proved to be a watershed in the world of Banking business as Basel Accord II were published. Although the pronouncements in the Accord II were not mandatory in nature, it had a great impact. Operational Risk Management was born out of the Accord as the heir-apparent of Credit Risk and Market Risk Management in Banking.

What is operational risk management

Any Banking risk other than Credit Risk and Market Risk is the plain vanilla expression of operational Risk. Basel Accord II has, however, provided clear and concise definition as under:

SK Bagchi

"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 Strategies and Reputation Risk."

Segmental Approach

Operational Risk in Banking is, therefore, considered to be having three albeit interlinked segments:

1. People, Process and System-related risks including Legal Risk.
2. External Events related Risk.
3. Strategic & Reputational Risk

People, Process and System-related risks in Banking issues generally cover:

- Payment/settlement risk due to breakdown in process/reconciliation system.
- Incorrect processing of service charges/cost (other than interest matter)
- Inappropriate product selection/product complexity espe-

The author is a Member of the Institute. He can be reached at bagchi_sandip@rediffmail.com

cially in related segments.

- Lack of integration of various processes e.g. Deposit of cash by a customer of demand draft (D/D) and subsequent issue of D/D.
- Inadequate infrastructure for control of process/systems.
- Inadequate data information execution.
- Fraud by staff or by others.
- Mistakes/Errors not with any fraudulent motive.
- Workforce disruption e.g. strike/lockout.
- Loss of high skilled people e.g. head of Technology Services Department.
- Health and safety issues of staff.

External Event related risks are generally the following (which are not only applicable to Banking but to their lending areas as well):

- Act of God such as Flood, Earthquake, Volcano or any other natural calamities affecting business.
- Act of Miscreants such as Terrorist attacks or disruption or law & order problem.

Strategic and Reputational Risks may be broadly the following ones (which again are not restricted to Banking business only):

Adverse business decisions by the Top Management arising out of inadequate/ inappropriate appreciation of market/industry changes, etc. and/or ineffective implementation of Top Management decisions may be treated as Strategic Risk areas, which may affect a Bank's profit/capital.

Shrinkage of market share is, however, a symptom of Reputational Risk, which has the effect on Goodwill of a Bank (Converting Goodwill into Bad will?) and in turn may affect Bank's profit/capital. This category of risk may be the following:

- Negative public opinion about product/service or health and safety standards.
- It is often said that an Internet Bank is exposed to greater Reputational Risk than a traditional Bank as the customer may quickly quit a Bank if a negative opinion is formed.
- Adverse opinion by Regulatory Authority in regard to working of a Bank.
- Basel II Accord has not prescribed any special treatment for Strategic and Reputational Risk probably because of difficulties that may be associated in proper identification, measurement and monitoring such risk. Hence, such risks in banking would for the time being (till a probable Basel III comes up) continue to be managed as hitherto.

Operational Risks in Banking are of wide ranging area and often are mixed up with Credit Risk. Hence audit of Operational Risk may partly serve the purpose of audit of Credit Risk.

10 basic principles of management of Operational Risk

Basel Committee has identified following 10 principles for successful management of Operational Risk:

1. Board of Directors should be aware of major aspects of Operational Risk of the organisation as distinct risk category.
2. The Board of Directors should ensure that operational management framework of the organisation provides for effective and comprehensive internal audit.
3. Senior Management of the organisation should consistently implement approved operational management framework of the organisation.
4. In all material products, activities, processes and systems, operational risk contract should be identified and assessed.
5. Regular Monitoring System of Operational Risk profiles and material exposures to losses should be in place.
6. Policies, processes and procedures to control/mitigate Operational Risk should be evolved.
7. Contingency business plans should be evolved.
8. Regulatory Authorities should review periodically about organisation's approach to identify, assess, monitor and control/mitigate Operational Risk.
9. Regulatory Authorities may ensure that appropriate mechanisms are put in place to allow them to remain apprised of position of Operational Risk Management of the supervised organisations.
10. Adequate Public Disclosures to be made to enable market participants to assess organisation's approach to Operational Risk.

Convergence

The convergence of capital measurement and standards in operational banking is one of the focus areas these days.

One of the main purposes of

covering Operational Risk as a separate risk category is to provide added focus to such risk areas in Banking in order that any abrupt incident does not disturb the well being of a Bank.

Basel II Accord on Operational Risk management is a welcome move. This is all set to strengthen the business orientation and focus of Indian Banking.

Basel Accord II provides that to take care of Operational Risks Banks should maintain separate Capital base in addition to Capital requirement for Credit Risk and Market Risk (no separate capital requirement for Strategic and Reputational Risk). Such capital requirement may be measured and standards set in the following manner:

(1) Basic Indicator Approach

Under the system, capital required will be worked out as under:

(a) A fixed Percentage of Gross Annual Income will be the requirement.

(b) Gross Annual Income will be worked out on the basis of average of previous three years.

(c) Minimum 15% of such average annual income must be maintained

'Gross Income' for the above purpose consists of Net Interest Income plus Non-Interest Income. Extra-ordinary Income/Expenses is to be ignored.

OR

(2) Standardised Approach (SA)

Under the system capital requirement will be arrived at in the following manner

(a) Bank's activities are to be divided into –8-Business Lines e.g. Corporate Finance, Trading & Sales, Retail Banking, Commercial Banking, Payment & Settlement, Agency Services, Asset Management and Broking.

(b) Capital Charge for each business line is calculated by multiplying Gross Income by a factor assigned to a business line.

(c) Total Capital charge is calculated as –3- year average of simple summation across each business line in each year.

OR

(3) Advanced Measurement Approach

Subject to approval of Regulatory Authorities of each country the capital required will be worked out taking into account the risk measure generated by Bank's integrated Operational Risk measurement system using qualitative and quantitative criteria as laid down in the Accord.

As per RBI Press Reports, RBI is likely to ask Banks in India to adopt Basic Indicator Approach for the time being.

It is therefore clear that Banks will have to embrace the new requirement of Operational Risk management and thereby provide for regulatory capital adopting any of these options stated above.

Constraints in implementation

India is blessed with around 100 Commercial Banks (except Co-operative Banks and Foreign Bank branches operating in India). But implementing aforesaid wide-ranging but quite valuable guidelines in such a massive network may pose following constraints: -

- Wide variance in size and area of operation of Banks.
- Degree of varying sophistication of products & services.
- Risk Philosophy and Risk Appetite of banks is not always professionally conceived.

Availabilities of skilled manpower and usage of up to date technology are also not uniform.

Operating Instructing/Manual of Banks is not in all cases structural/ updated.

Role of RBI

Under Pillar: 2 of Basel Accord II, the Reserve Bank of India has to undertake periodical Review Process of Banks in India so as to ascertain in respect of Operational Risk Management:

- That the Bank has in place appropriate Operational Risk

management System.

- That appropriate Capital Charge Computed under any method of computation as above is maintained.

Need for External Annual Audit

- Operational Risks in Banking are of wide ranging area and often are mixed up with Credit Risk. Hence audit of Operational Risk may partly serve the purpose of audit of Credit Risk.
- What risk mitigants are in place i.e. fidelity insurance for staff if available, Bank's Property Insurance, etc.
- How frequently Bank's Manual Instructions are updated and whether guidelines are clear and disseminated to all levels in the Bank.
- What specific arrangements of staff skilling/re-skilling are made.
- What reward/punishment measures for intentional/deliberate mistakes/ frauds are in place and how effective they are.

While RBI may undertake periodical on site/ off site review process an External Audit System on an annual basis may well supplement their efforts. The functional role of such an external audit mechanism is expected to cover.

- Assessment of Top Management involvement in managing operational risk matters.
- Evaluation of intensity of each component in Operational Risk in a Bank.
- Whether technology for managing Operational Risk to be outsourced and if so to what extent.
- On the top of all whether Operational Risk Capital Change of any point of time is properly computed as per the guideline.

Conclusion

Basel II Accord on Operational Risk management is a welcome move. This will surely strengthen the business orientation and focus of Indian Banking. Furthermore since each Bank is likely to have a specific Operational Risk Policy it will provide a clear direction to operating staff and simultaneously enable Top Management to monitor and control the risk on an on going basis.

'Control' is one of the basics of any Risk Management architecture,an external audit, preferably on annual basis, should be put in place by each bank. ■

ANNOUNCEMENT

On-Line Placement Portal

www.placements-icai.org

The Committee for Members in Industry pleased to inform the Members and others concerned, the hosting of an on-line Placement Portal with domain name www. placements-icai.org. The Placement Portal caters to the employment needs of the following categories of Members/ Students:

1. Campus Interview Programme for Newly qualified Chartered Accountants
2. All Members and
3. Semi-qualified candidates

The **placements-icai.org** is a single window recruitment system for Corporates and CA firms interested in recruiting Chartered Accountants from the Institute's vast talent pool of more than 1,30,000 members. Both the candidate and the Corporates and CA firms can register themselves on-line. This new technology based opportunity is an unique endeavour of the ICAI and is the first such placement portal launched by a professional body in India.

The registration for the recruiting entities i.e. Corporates and CA firms desirous of recruiting Semi-Qualified candidates and Members is absolutely free upto 31st March 2005. However, the Corporates and CA firms shall be charged for participating in the campus Interviews as per the existing practice.

ANNOUNCEMENT

Non-receipt of ICAI journal

This is for the attention of members of the Institute who fail to receive *The Chartered Accountant* journal dispatched to them due to un-intimated change of address or postal problems.

The Membership numbers pertaining to all such cases are regularly hosted on ICAI website (www.icai.org) at the web link http://www.icai.org/members/s for information of the respective members. Please inform the respective regions immediately after you change your address so that we can subsequently update our mailing list and ensure timely and regular delivery of journals to you. Other queries and complaints in this regard can also be sent to journal@icai.org

— Journal Secretariat