

The first gentle steps

Penny Cagan* analyses how a risk manager can achieve real success in establishing an operational risk culture

Please allow me to issue a warning before we begin: with the exception of a brief initial mention, this article will attempt to discuss operational risk without mentioning the Bank for International Settlements (BIS), capital calculations, or 'lambda'. These are important components of a fully realised operational risk programme, but they are not 'the programme', or for the benefit of the quants among us, they are variables rather than the equation itself. Since they have received a great deal of attention recently, I thought it was time to discuss other matters.

Lining up the variables during the early phases of establishing an operational risk programme is like placing a cluster of numbers randomly on a sheet of paper without any context – they simply do not add up to anything meaningful. Unfortunately, there are many people who appear to believe that the calculations alone will protect their organisations from looming and potentially damaging operational risks.

However, the numbers do not always add up with this approach. The first step

in establishing an operational risk programme should be a careful examination of an organisation's risk culture. Discussing "cultural" issues, of course, is less quantifiable than numbers, but there are some common sense measures for assessing the state of such a culture and for instilling it within the organisation that we can discuss.

This is the early groundbreaking work that an effective risk manager will need to do to prepare the organisation for the adoption of measures later on – including internal data collection efforts and the calculation of capital for each business unit. Otherwise, the person assigned to establishing an operational risk programme – whether an operational risk manager, auditor, internal examiner or finance officer – could be faced with the dreadful prospect of becoming 'marginalised' into a number crunching or regulatory function. Real success is achieved instead when these activities are integrated into every part of the organisation. They need to be accepted and signed off by the board of directors and every business unit manager in order to be ultimately successful.

The reality of establishing an operational risk culture involves consideration of what it means to engage in an internal selling job. This basically follows standard sales methodology: the person in charge of operational risk will need to cover all the 'bases' if he or she wants to avoid blockages later on that could derail a programme. The best way to get a quick start in this regard is to achieve sign-off from the board of directors (according to corporate governance best principles), ceo, cfo and chief risk officer. This will probably require the scheduling of appointments with these people, and a presentation of why the establishment of an operational risk programme is vitally important to the health of an organisation. It helps to provide case studies (an example of which can be found in appendix A) that provide drama and 'hit senior managers in the gut' with the seriousness of operational risk transgressions. If the initial cultural buy-in can be attained at this level, it will be much easier later on to sell the programme to the business unit managers (who will have their own biases and concerns and are certainly capable of derailing a programme).

In fact, it is possible to partially quantify cultural matters using such case studies. For instance, when the Zurich Financial Services' FIRST (financial institutions risk scenario trends) database of operational risk loss events is consulted it is possible to find many instances of organisations that have pushed a 'profits above all else' mentality among its workforce. This concentration on aggressive returns can lead to major operational risk-related incidents that will ultimately cost a firm more than if it followed a more straight and narrow path, and valued profits that are attainable without being so aggressive so as to encourage employees to take unreasonable risks. This approach is often seen in aggressive financial services selling cultures, such as the one that arose within Prudential Securities in the 1980s (see Appendix B), or American Express in the 1990s (see Appendix A). Both firms encouraged aggressive returns on the part of their investment professionals, which led to unwarranted risks, and ultimately losses that cost the respective firms a great deal of hard cash and resulted in reputational damage. Ultimately, the reputational issues are what can devastate a firm's market share and business model.

A loss history of these reputational and cultural-type events can be collected and analysed either through an external database or individual research. It is then possible to examine both the quantifiable loss history of losses, fines, write-offs, loss of access to markets, loss of market-share, drop in share price, and other issues that are less quantifiable such as reputation. This record of events provides a powerful story to a board of directors or senior managers who are considering strategic issues (see Appendix C).

When a download is completed in the FIRST database of cases that involve 'excessive risks' as a contributory factor (rather than a primary factor or event trigger) of the top five events, the quantifiable loss amount ranges from \$4,400m to \$1,008m. Of these top five events, two of the entities found themselves insolvent, one is severely diminished in terms of its business reach, one is struggling to maintain its market share, and one eventually emerged after a long struggle to rescue its reputation with a new business model.

Although contributory factors such as 'excessive risks' do not necessarily trigger an event, they certainly add to its severity. For instance, in the case of Barings, the primary factor or event trigger might have been unauthorised trading, but the contributory factors – including lack of dual controls, lack of supervision and management's inability to respond to a mandate – certainly contributed to the severity and likelihood of the event. In cases where the trigger might be market or model risk, such as with Long-Term Capital Management, there are contributory factors – such as failure to test models, excessive risk taking – that need to be addressed from an operational perspective. Of course, this will drive the quants who need to create clear boundaries between types of events for purposes of capital calculation crazy, but that does not mean that these issues should be ignored from the perspective of instilling an operational risk culture within an organisation.

Once acceptance (or near-acceptance) is established at as high a level as possible within an organisation, it is important to establish a way of communicating throughout the organisation the tenets of such a programme. This may include the distribution of a memo from a senior

executive with a list of operational risk best practices attached. One interesting method for drawing up this list is to either interview senior business managers on an individual basis concerning "what keeps them up at night" or to bring them all together for a brainstorming session (although this is a difficult task to attain in many organisations where there is a history of the business units operating in silos).

The very act of interviewing senior executives about the establishment of an organisation's best principles, or even better, bringing them together, will start affecting the cultural environment almost immediately. One starting point for drafting this document might be the principals established by the BIS in its December 2001 report, *Sound Practices for the Management and Supervision of Operational Risk*. (The full text of the report can be found at the following website: www.bis.org). Some may counter that these sort of memos are never read and are consequently ineffective. However, the important issue to remember is that they come from senior management, and a small but significant change in culture was affected by their attention to its creation.

At this point in the game, the most crucial issue is one of communication. One method of attaining this is to draft on a monthly basis an operational risk newsletter that discusses recent losses and events that have hit other organisations (see Appendix D for an example of this). These events can be identified by the use of an external loss database or with assistance from an in-house research team. Newsletters are an easy and cost-effective method for disseminating information throughout an organisation, and for starting to effect cultural change. A monthly review of key operational risk issues, with a discussion of operational issues that have emerged in other organisations, is a good way to open the dialogue on operational risk. It provides senior managers and others with the occasion to inquire if such events could happen within their own walls, and the dissemination of a newsletter is an approach that does not engage in finger pointing within the organisation. It also provides a valuable forum for establishing the importance of operational risk issues, and the best way to sell anything is to create a sense of urgency.



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The first steps in creating risk awareness within a firm are often best directed toward senior management. Cultural issues are almost always first bred in the senior echelons of a corporation and filter down in unexpected ways to influence behaviour among the rank and file. For instance, in the examples of Prudential Securities and American Express, there was pressure from above to earn aggressive double-digit profits that were significantly above industry norms. This type of pressure will in turn lead to behaviour on the floor of an organisation that is not in the best interest of a company and its customers and shareholders in the long term. Although there are rogue traders in every organisation (or rather, the possibility of rogue behaviours), they are often kept under wraps by a culture that emphasises an intelligent approach to risk.

Initial steps

Once senior management is on board it is much easier to start disseminating risk principles and best practices within the organisation. A good first step is to work closely with a business manager who appears particularly friendly during the initial out-reach process. This is a way of moving on to the next step in the process: tracking and identifying losses. This usually involves the adoption of risk indicators to track ongoing internal losses, and the deployment of some sort of data collection system. This is also where a risk manager or other person responsible for operational risk will get snagged. He or she may have done their homework, evaluated the offerings from vendors and determined the best system for the organisation, but unless the cultural landscape has been primed for this step, it will be a difficult process to push ahead with requiring each business unit

to contribute data. It would make more sense to enlist a single business unit (with a risk friendly manager) as a test site, and to use a newsletter or other communication vehicle to build from there.

Otherwise, there is a risk of appearing to jam down the throats of busy business managers the task of collecting data for their units. They will at best under these circumstances offer 'grudging compliance' and perhaps assign the most junior team member to the task of guiding the process. However, if effort is undertaken by entering agreements with one friendly business unit after another, a nice flow will enter the process that will prove to be more effective in the long run.

Gently does it

It all comes down to taking first steps first, and to approaching the process from an attitude of 'gentleness' rather than 'aggression' or 'arrogance'. It also means doing your homework, and determining which approach is best for your organisation. It might be that you favour a quantitative approach but the talent or faith in such an approach does not exist within your organisation, and a softer, more qualitative approach is the best one to pursue in the beginning.

There are risk managers who come on strongly at first and receive a lot of publicity from their innovative and 'scientific' approaches. Two years later, however, their initial efforts have fizzled out and they have moved on. It is better to first do your homework, cover your bases, know your organisation and build internal senior level support for your endeavours, before you take your first gentle steps.

Yes, the regulators are knocking at your doors – particularly if you are a commercial banking organisation – and yes, you will have to do something about the darn capital requirements, and it might be part of your job to make sure your organisation stands in good stead in this regard. However, if you also work to instil an operational risk culture within your organisation, all later efforts at establishing processes and installing systems will be met with a great deal less resistance than if you ignore these important first and gentle steps. □

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Appendix A: American Express CDO Case

Zurich IC Squared FIRST Operational Risk Database
Loss Event Report for Loss Event 2922
Event Description

On 18 August 2001, in a process-related risk case, and a few days ahead of the release of its mid-year earnings, American Express warned the markets that it intended to take a \$826m write-down to cover its problematic high-yield bond portfolio. This followed a similar write-down of \$182m for the first quarter of 2001. The revelation concerning the quality of American Express' junk bond and collateralised debt portfolios startled investors and analysts who had assumed that the earlier write-off was the extent of the firm's troubles. The company's stock price dropped 32% between 1 January 2001 and 17 August 2001 and the market is currently sceptical that the company has come totally clean in terms of its bad holdings. Analysts are concerned that American Express is currently experiencing a serious credibility problem. The company's stock will most likely not recover until the markets believe that its losses have been stymied, or if (as is rumoured) it becomes a takeover candidate and its price is driven up as a result of merger speculation.

According to Kenneth Chenault, American Express ceo, the company did not fully understand the depth of its bond-related troubles after it announced the smaller first quarter write-down. The investments that are the primary source of pain are structured loan trusts and other types of structured investments that American Express added to its high-yield portfolio in 1997 and 1998. According to Chenault, the risks inherent in increasing the firm's holdings of structured products were not fully comprehended and the firm failed to adequately balance 'risk and reward'. Many of the underlying securities in the structured products were investment grade debt instruments, and the firm incorrectly believed it had a relatively balanced and safe portfolio. American Express' investment team, however, did not account for steadily increasing default rates and the volatility of the junk bond component of its holdings. As the US economy has slowed, bond default rates have steadily increased and are expected to do so through to the end of 2002. Part of the write-down expense is attributed to American Express' current mission to swap out the volatile securities with more stable and less risky ones. American Express had estimated that its collateralised debt obligation (CDO)/junk bond portfolio was worth \$1.4 billion at the end of the first quarter of 2001. By the end of the second quarter of 2001, the same portfolio was estimated to be worth \$370m. The losses were expected to continue if the firm had not taken steps to cut back on its investments in high-yielding and risky bonds.

The company's problems can be partially traced back to 1997 when its Minneapolis-based Financial Advisors unit was under pressure to increase its profit margins. The management of the company at the time requested that the financial unit increase its return-on-equity growth target to an unusually aggressive level of 20%. This allegedly led to the decision to increase the firm's junk bond holdings to 12% (while the industry average was around 7%) from its previous level of 8%. This move increased the overall riskiness of the firm's own trading portfolio. A few months later the firm's head of high-yield investments decided to take on additional risk and started buying CDOs. American Express, with the blessing of the firm's chief investment officer, entered into approximately 60 CDO-related transactions. This allowed the firm to achieve higher than average returns on its investments, and to diffuse its risk through the multi-tiered approach of a CDO structure. Analysts have also expressed fear that with default rates continuing to head upwards and the US economy slowing, other CDO portfolios will also be registering losses.

What is clear from this case is that even sophisticated financial firms, such as American Express, do not fully understand the risks inherent in the complicated tranche structures of CDOs. These firms may be at risk of falsely believing that their investments are only as volatile as the safest portion of the structured instruments – the investment grade securities – rather than the lowest rated securities – or the junk debt.

Appendix B: Prudential Securities Mis-selling Case

Zurich IC Squared FIRST Operational Risk Database
Loss Event Report for Loss Event 2922
Event Description

Prudential Securities found itself burdened with a serious relationship and reputational risk situation when it settled charges of securities fraud with US state and federal regulators in 1994. The settlement stemmed from charges that had emerged the previous year, and ultimately cost the parent entity, Prudential Insurance, \$1.4 billion in related costs. The incident stemmed from charges of improper management practices, sales misrepresentation, and an executive management structure that promoted profits above all else. It also damaged the sterling reputation of an insurance company that had managed to survive for over 100 years without serious scandal.

The insurance concern acquired Bache Securities in 1981 and renamed the down-at-heel brokerage firm Prudential-Bache Securities. (The name was later changed to Prudential Securities.) Within a few years of the acquisition, the ceo, George Ball, managed to reinvigorate the securities subsidiary with increased sales incentives and a heightened competitive pitch. Prudential's Direct Investment Group marketed and encouraged its army of brokers to sell limited partnerships in real estate, oil and gas from 1981-1990. An unusual incentive structure had been established: if the brokers sold more than \$25,000 of limited partnerships, they would share in half the profits. This aggressive incentive structure encouraged Prudential's brokers to sell limited partnerships without regard to whether they were appropriate for the client.

The partnerships carried a great deal of risk and were tied to wavering energy and real estate market conditions, and yet were sold to elderly clients who had limited time to recover during a market downturn. To make matters worse, changes under the 1986 Tax Reform Act wiped out tax incentives associated with limited partnerships. A public relations nightmare was created when the media ran stories of older investors who had lost everything they owned. In October 1993, Prudential Securities settled civil charges with the SEC, the National Association of Securities Dealers and 48 state securities regulations. Prudential initially paid out \$371m under the pact, which included a \$330m settlement fund for investors and a \$4m fine. In 1995 the firm pleaded guilty to securities fraud and was placed on three-year probation. The settlement also allowed investors who did not participate in the earlier class-action suit to press charges, and opened the firm to future additional losses. The firm ultimately added another \$300m to the \$300m restitution fund that was put into place. The securities scandal led to a change in how retail brokers are compensated and the adoption of incentives tied to assets under management rather than sales in the major brokerage firms.

Appendix D: Sample Operational Risk Newsletter

(from FIRST newsletter, January, 2002)

This has been a difficult year for many of us, with regretfully a lot of new operational risk-related content emerging each month for the FIRST loss database. It is human nature to find the 'good' in acts of evil, to sit back and assure oneself that no matter what happens there are lessons to be learned, and acts of kindness to be grateful for. Although this has certainly been the case in New York and elsewhere after 11 September, it feels trite to reduce the horror many of us have experienced to a few 'lessons learned'.

However, the case involving Cantor Fitzgerald – the firm that was most impacted by the tragedy of 11 September – does offer a remarkable example of how the human spirit can prevail in the face of disastrous circumstances (see event No.3236). Cantor's response, despite losing the majority of its New York staff, was remarkable. The firm had developed and properly maintained a state-of-the-art computer system that ran at just 10% of capacity, and all transactions were mirrored at back-up locations. What is even more remarkable, for a variety of reasons that are discussed in the FIRST database's case study, Cantor reinvented itself and its business model practically overnight, and has moved toward an online model. For a discussion of how the events impacted another firm that suffered significant loss of life – Keefe Bruyette & Woods – refer to event No. 3231.

Appendix C: Sample Download from Zurich IC Squared FIRST Database:

Top five cases involving "undertaking excessive risks"

Organisation	Amount	Currency	End Occurrence	Event Triggers
Long Term Capital Management	4400,000,000	US\$	09/23/1998	Model risk
Enron	2200,000,000	US\$	10/17/2001	New business risk
Orange County	1600,000,000	US\$	12/06/1994	Market Fluctuations
Prudential Insurance Co (Prudential Securities – Prudential-Bache)	1400,000,000	US\$	1990	Sales misrepresentation
American Express Company	1008,000,000	US\$	2001	Bankruptcy/ Credit risk