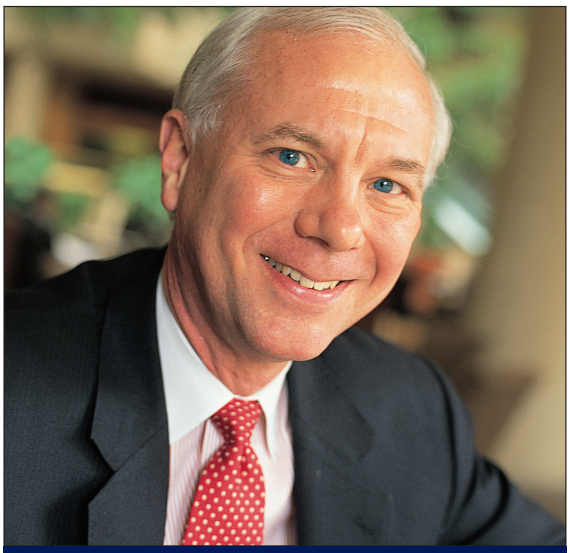
A difference in kind

Tracking key risk indicators is emerging as a central aspect of best practice for operational risk management. Defining these indicators and establishing benchmarks for them, however, is a complex task. David Rowe discusses an industry initiative that can help

Last month's column discussed the continuing need for eclectic risk indicators that cannot easily be aggregated into a single total risk figure. This is especially true in the area of operational risk management. Recent discussions of op risk tend to emphasise its differences from market and credit risk. In particular, the heterogeneous nature of op risk is forcing a qualitatively different approach to its measurement and control than is typical for the two more familiar categories of risk. At the heart of the emerging consensus is the important role of key risk indicators (KRIs) in an effective op risk management regime.



David Rowe is group executive vice-president for risk management at SunGard Trading and Risk Systems
Email: david.rowe@risk.sungard.com

Selection and interpretation

While the conceptual importance of KRIs is increasingly accepted, building a consensus on implementation details will be more difficult. Defining appropriate KRIs and validating the reliability of their relationship to potential losses is a daunting task. This is partly due to the immense range and variety of potential indicators. In addition, a given KRI may be reliably related to losses in one context and not another. Even at the more basic level of benchmarking and peer group comparison, KRIs cannot be developed in a vacuum by a single organisation without extended trial and error.

A constructive initiative

Recognising the difficulty of validating the effectiveness of KRIs, a very helpful initiative has been launched by the Risk Management Association (RMA). The project is called the KRI Framework Study[1] and is chaired by Charles Taylor, formerly of The Group of 30. Part one of the project has now been completed. It involved seven banks with varied geographical and business profiles. Part two is under way and appears to have approximately 50 banks participating.

One of the first goals of the project was to develop a KRI framework tailored to the banking industry in general and detailed enough to be relevant for individual banks of all types. To this end, the two-dimensional breakdown of Basel II based on risk category and business line has been supplemented by a third dimension called business function. In addition, the segments along the risk category and business line dimensions have been made more granular. In all, part one of the project arrived at a framework with 15 risks, 38 business lines and 45 business functions (or high-level processes).[2]

The intersection of any of these three dimensions represents a 'risk point'. Obviously few, if any, banks will be actively engaged in all the 25,000-plus risk points. But the idea was to make the framework fully comprehensive so that any one bank could extract those risk points of relevance to its own activities.

Having defined the risk framework, the next goal was to group the risk points in terms of low, medium or high contributions to total operational risk. These can, in turn, be aggregated along the marginal axes of the risk framework cube to arrive at an indication of their relative risk importance. This is a good starting point for defining where incremental process control resources are likely to yield the greatest risk reduction.

Another goal of the project is to define KRIs with sufficient detail and consistency that they can be benchmarked and directly compared across different institutions. This is particularly important since peer group comparison is one of the most valuable immediate benefits of this type of indicator. Without consistent definitions, it may still be useful to compare trends over time, but comparing absolute performance becomes almost meaningless. I suspect this development of consistent definitions of common KRIs will be one of the most immediate benefits of the project.

Continued flexibility is essential

If I have heard any reservations about this effort it is a fear that preliminary results may harden into fixed rules too quickly. Clearly, the process of establishing reliable links from eclectic KRIs to the probability of actual loss will be difficult and time-consuming. It will also be a process in which there are no final victories. On the one hand, these links are likely to differ across institutions based on their particular process characteristics. Even within institutions, however, the links will need to be reviewed and tested continuously.

The rapid pace of technological change that can be expected for the foreseeable future will induce associated organisational and operational changes. These, in turn, will alter the relative importance of different KRIs as effective predictors of process failures and financial losses.

It would be a mistake to expect this initiative to yield a sudden and dramatic improvement in our ability to model and predict potential operational losses. That said, the RMA's KRI framework project is an important and valuable initiative that will advance the practice of operational risk management. Any bank that is serious about improved process reliability and more disciplined execution should consider getting involved. ■

[1] *For more information on the RMA in general and the KRI study in particular, see* www.rmahq.org *and* www.KRIeX.org

[2] *See Taylor, Charles and Davies, Jonathan,* Getting Traction with KRIs: Laying the Groundwork, *The RMA Journal, November 2003, pages 58–62*