Panel session:
Best practices for operational risk management

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Panel objectives

- To provide an overview of the FCA’s current engagement approach for the review and assessment of firms’ approach to Operational Risk (OR) management
- To identify and comment on key areas of challenge to the development and embedding of effective OR management practices by FCA solo-regulated firms
- To explore regulatory and practitioner views of acceptable standards of practice for the oversight and management of operational risk by FCA solo-regulated firms

FCA operational risk approach

- Operational risk firm reviews:
  - Aim to minimise risks to consumers and the integrity of the financial markets arising from inadequate firm risk management arrangements
  - Proactive assessment of our most significant solo-regulated firms through our SREP / ICAAP review process. We also support (risk management related) supervisory deep dives of significant dual-regulated firms
  - Focused on firm's embedding of effective risk management practices, including the role of senior management and front-line business heads (e.g. to demonstrate effective ownership and management of risk)

FCA operational risk approach

- Operational Risk external stakeholder engagement:
  - On-going interaction with relevant industry expert groups, skilled persons, the PRA and other relevant regulatory bodies to discuss key OR issues and trends
  - Encourage industry-led initiatives to address common concerns and improve standards of practice in risk management

Current regulatory developments

We continue to be engaged in a number of EU/international policy initiatives for the treatment of operational risk, alongside our colleagues from the PRA and the Bank.

- EBA/ESMA Investment Firm Review:
  - Review is now underway to assess the appropriateness of the CRD IV prudential regime for investment firms
- Basel Pillar 1 Approach:
  - Current proposal to replace the Basic Indicator and Standardised Approaches with a Revised Standardised Approach (RSA)
- International:
  - A number of regulatory organisations (e.g. Basel, the FSB) are considering conduct issues and the potential interaction with the prudential framework

Governance and culture

Sound governance and culture are essential for the delivery of effective risk management. This includes:

- Appropriate design, embedding and performance appraisal of key roles and responsibilities across the Board, executive, (1st line) business, (2nd line) risk function and (3rd line) audit / assurance function
- Proactive Board and senior management oversight and consideration of all key risks - including operational risks and not limited to (reactive) issue management
- Demonstrable culture and tone from the top that embeds effective (risk management) challenge in all key decision-making processes, and supports the timely identification, escalation and management of material risks
- Decision-making supported by management information that is relevant, complete and timely, and that facilitates effective identification of key risks, issues and trends

Operational risk measurement

- Capital measurement – a risk management tool
  - Firms need to demonstrate that their capital measurement approach is adequately integrated and aligned to an effective risk management framework
  - OR capital assessments often need to incorporate both qualitative and quantitative elements. Qualitative elements are susceptible to bias while quantitative measures may create a false sense of accuracy.
    - Be aware of the limitations and supplement with conservatism where appropriate
- Internal challenge, Validation and Use Test
    - Appropriate level of documentation to permit effective independent validation of the statistical quality, calibration and use test of the model

Diversification benefits

As part of the Pillar 2 capital assessment process can firms recognise diversification benefits to reduce their capital requirements:

(i) for their operational risk exposures; and/or

(ii) between operational risk and other risk types, e.g. credit or market risk?

- We are aware that firms claim for the presence of diversification benefits for their operational risk profile, but our ability to recognise these for the purposes of regulatory capital requirements is very limited by the EBA's SREP guidelines.
- The Pillar 1 capital requirements represent an absolute minimum, so reduction by a firm of its Pillar 2 capital through diversification is not recognised in Pillar 1
- The EBA SREP guidelines do not allow firms to recognise inter-risk diversification (i.e. across different risk types)
- Firms must present satisfactory and compelling empirical evidence of diversification benefits between operational risk exposures where this is claimed under their ICAAP

Insurance as a capital mitigant

Can firms that do not meet the qualitative and quantitative standards for an approved Advanced Measurement Approach (AMA) use insurance as a mitigant for operational risk when determining their Pillar 2 capital requirements?

- For Pillar 1 regulatory capital purposes insurance is not recognised as an operational risk mitigant outside of its role in calculating Pillar 1 capital requirements for institutions with an approved AMA, i.e. we cannot recognise insurance as a mitigant for Pillar 1 capital requirements for non-AMA firms
- For firms that have an approved AMA model, the maximum possible Pillar 1 reduction from insurance and all other risk transfer mechanisms taken together is 20%. (Subject to meeting appropriate insurance recognition criteria and standards)
- If a non-AMA firm can demonstrate the efficacy of insurance as a mitigant for operational risk then it could be included in the ICAAP