



**Operational Risk  
Corporate Governance Expert Group**

**The “Use Test”**

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Industry Representatives	Andrew Blackmore	Nationwide	
	Helen Banks	APCIMS	
	James Elder	CSFB	
	David Haberfield	DRKW	
	Simon Hills	BBA	
	Garth Hinton	Citigroup	
	Jonathan Howitt	Man Group	
	Vejen Stoilov	Deutsche Bank	
	Ralph Nash	AXA	
FSA Participants	Anna-Karin Saxena	(Facilitator)	
	Daniel Selby		
	Andrew Sheen		

## **Introduction**

The EU's Capital Requirements Directive (CRD) contains the following reference to the "Use Test":

- TSA - The operational risk assessment system must be closely integrated into the risk management process of the credit institution. Its output must be an integral part of the process of monitoring and controlling the credit institution's operational risk profile. (Annex X, Part 2, Section 4, Paragraph 17b).
- AMA – The credit institution's internal operational risk measurement system shall be closely integrated into its day-to-day risk management process. (Annex X, Part 3, Section 1.1, Paragraph 3).

These requirements (colloquially referred to as the "use test") aim to ensure that the operational risk assessment or measurement system is not just implemented to determine the regulatory capital requirements but are actually embedded in the risk management practices of the firm (ie used in practice).

However, the types of behaviours or processes that would ensure these requirements are achieved are not defined. This paper provides an industry perspective on what may be considered appropriate use. The requirements of the TSA and AMA are considered separately as the nature of the use requirements will differ.

As the TSA and AMA will be applied to firms of varying size and complexity, the scale and scope of implementation of the OpRisk management process should be proportional to the size and complexity of the organisation, eg the OpRisk management framework for a small building society using the TSA would be different to a large global bank using the same approach.

### **Review of the nature of Operational Risk compared to other risk types**

In assessing the appropriate way in which an OpRisk measurement framework should be utilised within an OpRisk management framework, it is worth assessing the nature of OpRisk and comparing to the measurement and management of market risk.

Due to the ability to accurately measure the relative risk on market risk positions, and the rapidly changing and quantifiable size of the positions and hence the risk, a measurement and management framework utilising frequently calculated numbers, a framework of limits and the direct linking of the risk measure and risk management (eg closing down positions in the event of limit excess) is appropriate.

OpRisk however is very different. The nature of OpRisk is such that the direct linkage of measurement to management is difficult. This is partly due to the inherent difficulties in assessing the OpRisk positions that a firm faces and how to measure these, but also because the risk profile of a firm does not change quickly, nor can changes to this profile be identified over a short time frame. OpRisk management practices rely on a whole host of techniques from supervision to the use of KRIs, and place less reliance on any risk or capital numbers than in the market or credit risk disciplines.

Therefore the manner in which OpRisk measurement methodologies play in the management of OpRisk need to be very different to those of market risk or credit risk.

### **The “use test” for the TSA**

Due to the methodology to determine the TSA capital requirements, it is not appropriate for the capital requirement of the TSA to be integrated into the risk management processes of the firm. This is because the only way to manage a TSA derived OpRisk capital number is to reduce the Gross Income Indicator or to convert the business line into one with a lower beta factor.

The key “use test” requirement for the TSA is the risk *assessment* systems are integrated in the risk management processes of the firm. This would most likely include: the process to identify risks; monitoring and reviewing OpRisk losses, review of appropriate Key Risk Indicators, and establishing a suitable corporate governance framework for OpRisk.

The FSA have not proposed any high-level principles for that “use test” for TSA banks. The Sound Practices paper outlines some requirements of the “use test” that would be applicable for TSA banks, so additional guidance is probably not required.

### **The “use test” for the AMA**

## *Interpretation of the CRD requirements*

As stated above, the CRD requires “the credit institution’s internal operational risk measurement system shall be closely integrated into its day-to-day risk management process”. Whilst the industry agrees that the measurement system should be integrated within the OpRisk management process, we would recommend a broad interpretation of the terms “closely” and “day-to-day” in this context.

It should be recognised that a firm’s operational risk profile is not dynamic or prone to rapid fluctuations (especially compared to market risk which can change quickly due to both external events and internal trading strategies). It is however expected that some of the inputs used in the AMA model (e.g. KRIs, loss information) will be used by a firm in the “day-to-day” OpRisk management processes, but the use of the capital number on a “day-to-day” basis is not appropriate. Indeed, reiteration of capital models are only likely to occur on a quarterly frequency at a maximum. It should be demonstrable that the capital model employed, and resultant capital allocations, incentivise proper management behaviour e.g. remediation of weakness which have resulted in higher capital allocations. Therefore the term “day-to-day” needs to be broadly interpreted in this context.

Furthermore, the FSA have recently indicated that they would expect at a minimum the calculation of the OpRisk capital number on at least a quarterly basis. This quarterly requirement could be difficult for methodologies that rely on significant amounts of subjective review and expert judgement, both from a practical perspective, but also because identifying changes in slowly changing risk profiles is difficult over a short time period.

Also, for other more quantitative methodologies, any changes highlighted by the model may be more due to the sample error of the arrival time of internal losses, rather than any underlying changes in the risk profile of the firm, thereby potentially suggesting a level of false precision in the model.

It should be noted that many firms might utilise an internal Economic Capital measure for internal allocation and therefore the mechanism to incentivise management behaviour rather than the use of the AMA measure. This is appropriate to ensure that the OpRisk allocation to management is consistent with the allocation of other risk types within an organisation, and for OpRisk to link into existing performance measures such as Return on Economic Capital.

The allocation (and hence “use”) of internal capital measure rather than at the direct use of the AMA measure should not preclude the passing of the use test, as long as the methodologies used to derive the Economic capital and AMA measures are consistent, and have similar reactions to the model inputs and risk profile. In many institutions, the AMA and Economic capital measures would not be identical (eg may use different confidence levels, different criteria for recognition of insurance), but would be largely similar.

References to the risk measurement system in this paper should be interpreted to refer to either the AMA or the internal Economic Capital measure for OpRisk depending on which mechanism is used within each firm.

### *Review of the FSA’s proposed high-level principles*

In addition to the language contained in the CRD, in CP05/3 the FSA expresses a preference to communicate expectations on the “use test” through high-level principles rather than detailed guidance. This paper supports the view that high-level principles are preferable.

As the FSA has already drafted four high-level principles on the use test, these are reviewed below, along with industry comments. This paper will also consider whether any additional principles are required. There has been some discussion with the regulatory community regarding the inclusion of examples in regulatory documents to assist the industry in knowing how the 4 broad principles could be demonstrated. The industry cautions the use of examples in this situation as these examples may not be appropriate for the institution and may be considered by some regulators as requirements. Regulators should consider how banks address the four principles on a case-by-case basis.

#### **“The purpose and use of the risk measurement system is not limited to determining regulatory capital.”**

The concept that the risk measurement system is not just used to determine a capital number but should be incorporated within the management framework is generally accepted by the industry.

**“The risk measurement system should continually evolve as the institution develops experience of risk management techniques and solutions.”**

The risk measurement system should naturally evolve, improving the “risk sensitivity” of the framework. With increased experience of using the models and monitoring the inputs, methodology enhancement will become evident, and changes implemented where appropriate. However, it is not the expectation that institutions “continually” evolve their methodology for the sake of it. It can be argued that if management are to use the model effectively, a level of stability is necessary in order to allow period on period comparisons to be made and for management acceptance of the model to be gained. Therefore methodology change should only be made where considered appropriate and it is recommended that the word “continually” in the above principle be removed.

**“The operational risk framework brings together the measurement and management of operational risk within an organisation.”**

The use of the four data elements required for the AMA ensures that the information used in the management of Operational Risk is incorporated in the measurement model and results. This ensures that the two frameworks consider similar and consistent information that assists in ensuring that the operational risk capital measures reflect the actual risk profile of the firm.

One area of caution is in the direct linkage of the OpRisk capital measures to OpRisk management decision-making. As referred to in the first principle, the use of OpRisk models to explicitly drive decision-making may be an issue due to the lack of experience of the use of the models compared to existing management decision-making using more qualitative information. Therefore there should not be a requirement to explicitly show how the output of the measurement models drive decision-making other than the changes should provide directionally incentives for proper management behaviour. At best, firms may use the output from a measurement model as one of the inputs into management decision-making in conjunction with other more qualitative inputs.

**“The use of an operational risk measurement system should provide tangible benefits to the organisation.”**

Whilst firms would not dispute that the measurement system should provide benefits to the firm quantifying the level of OpRisk that the firm faces, the use of word “tangible” seems inappropriate in this principle.

The demonstration that the measurement system provides tangible benefits would suggest that physical or definable benefits could be seen (eg a physical object, or monetary value). Any benefits derived may not be actually visible or determinable, but the benefit may be discernable as an additional piece of information for management to use in the management of the business and risk profile and to incentives business managers. None of these will be able to be demonstrated in a tangible manner. Therefore the word “tangible” should be removed from this sentence.

## **Demonstrating compliance with the Use Test requirements**

The sections above have discussed industry comments and concerns regarding the interpretation of the use test requirements and high-level principles.

In demonstrating compliance with the use test requirements, the FSA should strive to satisfy themselves that there is some linkage between the measurement and management frameworks, although the nature and extent of these linkages would be dependent on the size or nature of the institution, the AMA methodology being used by the institution, and the OpRisk management of the firm.

In many institutions, this linkage may be demonstrated by the incorporation of business control factors (e.g. audit scores, risk assessments etc) into the capital model. This will reward management behaviour that mitigates control risk and “penalises” behaviour that erodes the control environment.

## **Conclusions**

Caution needs to be applied in the regulatory interpretation of the use test requirements to ensure that regulatory expectation on the use of the measurement models and the extent to which they can be used to manage the business is not too high.

The FSA's preference to provide high-level principles to assist in the interpretation of the CRD requirements, on what constitutes the use test, is supported by the industry. Generally the industry is comfortable with the four principles outlined in CP05/3 subject to the drafting changes suggested above.

However, the interpretation of these principles and how regulators expect firms to demonstrate that they meet these principles needs to be considered carefully. Due to some inherent limitations over the accuracy and responsiveness of the measurement of OpRisk (especially when compared to market risk measurement), the ability of the risk management system to drive management decision-making is limited. Also, new measurement methodologies should not necessarily be prioritised above good old-fashioned management decision-making and traditional inputs into this process. To do so could actually increase operational risks as decisions may be made on inappropriate information.