

Financial Services Authority

Building a framework for operational risk management: the FSA's observations

Feedback on industry practice as we prepare
to implement CP142

July 2003

About this newsletter

This newsletter provides a summary of FSA Policy Statement 142_2

This paper is particularly relevant for all firms covered by PRU 6.1 (banks, other deposit takers, insurers and most investment firms).

- You can download the complete Policy Statement from the PS142_2 Resource Page – see details below

Alternatively, to order hard copies of the Policy Statement:

- Copies are available at £10 each
- Phone our helpline on **0845 608 2372**, quoting reference PS142_2
- Please allow five working days for delivery

Useful links

CP142: Resource Page

<http://www.fsa.gov.uk/pubs/cp/142/>

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Executive summary

In July 2002, we published Consultation Paper 142: Operational risk systems and controls (CP142). It contained draft guidance on operational risk (OR) systems and controls for both **SYSC** (one of our high level sourcebooks, entitled *Senior Management Arrangements Systems and Controls*) and **PRU** (our forthcoming *Integrated Prudential Sourcebook*). Following consultation, we issued a Policy Statement in March 2003. In that paper, we stated that we did not propose to make any significant amendments to the draft text and were planning to publish our near-final Handbook text later this year. This is likely to take effect in September 2004, as part of the first phase of the implementation of the Integrated Prudential Sourcebook.

Over the last year, we have reviewed how the management of OR is evolving in firms, to enhance our knowledge of industry practice. As part of this review, we held discussions with 22 firms actively developing risk management systems for OR, on how they were developing the governance structures and the tools used to identify, assess and monitor OR. We call these the OR Framework.

This second Policy Statement outlines the main findings of our review, which confirmed our view that our proposed **PRU 6.1** policy on risk management systems for OR meets our statutory objectives. We also report on the progress and issues faced by the industry in developing and implementing risk management systems for OR. This paper, and the OR Framework it describes, does not make proposals for regulatory capital requirements for OR. It is for information only and is not 'guidance' as defined in section 157 of the Financial Services and Markets Act 2000.

Who should read this paper?

This paper will be of particular interest to managers responsible for developing and implementing OR systems and controls in firms.

Main findings of our review

As a discipline, OR remains at an early stage of development compared with other areas of risk management. While there are many areas that still require attention, firms have made significant progress in developing practices to manage OR. In part, this is driven by an increased emphasis on senior management accountability and regulatory focus. We noted increasing similarities between the OR methods and tools used by firms, and the emerging practices are consistent with our draft **PRU 6.1** guidance.

Firms we visited said that the evolving OR Frameworks were helping them better control and mitigate underlying risks. However, they acknowledged that, in most cases, it was too early to assess the full benefit to their business. We noted some common messages from the more advanced firms on the challenges involved:

- **Senior management commitment to OR management.** Senior management had been involved in considering what OR meant to their firm and had incorporated OR into their overall governance and risk management effort. Their role in setting internal expectations, allocating resources, and monitoring progress against objectives was essential to setting up a successful OR Framework.
- **OR management integrated into business activities.** Firms had made more progress where they had considered their requirements at the outset. Those making most progress had considered how a particular approach would enhance their business and risk management objectives rather than solely how it would meet our policy requirements.
- **OR Framework development based on experience.** Most firms were taking an evolutionary approach to developing a framework, using their own and industry experience as well as regulatory statements to inform their direction. Firms had started by adapting existing control and risk management frameworks, going on to add new tools and processes specific to OR. Although consultants could advise on good practice and assist in implementation work, internal effort and management time was considered crucial if the framework was to be effective.
- **Nominated resource for OR management.** A centralised and independent OR function helped to provide challenge and coordination of effort, enhancing the quality of information given to senior management. This was not always appropriate for some smaller firms, where another function, such as Internal Audit provided coordination. So, considering their full range of resources, including people in various functions, existing processes and systems, allowed firms to make better use of limited resource.

Some firms have taken a 'wait and see' approach because of a lack of knowledge over what good practice might constitute, as well as the uncertainties over regulatory requirements. However, implementing a sound effective approach that delivers business benefit takes considerable time and effort. Chapter 3 and Annex 1 detail some of the activities firms are undertaking and the areas that still need to be resolved before CP142 is implemented in September 2004.

Consumers

This Policy Statement will be of some interest to retail consumers, because our guidance on operational risk systems and controls is designed to promote our consumer protection objective.

This Policy Statement reports on the progress and issues encountered by the industry with the implementation of risk management systems for Operational Risk consistent with the proposed policy in PRU 6.1 of Consultation Paper 142 Operational Risk Systems and Controls.

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