Internal Loss Data

- Setting up a comprehensive system and process for ensuring completeness
- Treatment of specific issues (recoveries, accounting losses, legal provisions, fixed assets write-offs, various dates)

Presentation by
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Head of Operational Risk, Axis Bank
Definition of Operational Risk

- Defined by some as Variance in net earnings not caused by credit and market risk.

But generally accepted definition and as defined by Basle or RBI is

- Risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.
Primary requirements for AMA approach

- Developing a Qualitative/Quantitative Framework on Operational Risk for the Bank.
- Developing a risk profile by identifying, classifying risks based on their frequency & severity and monitoring them over a period of time.
- Accumulating Loss Data (Business Unit-wise/Event-wise) across the Bank over a period of 5 years.
- Developing Key Risk Indicators from risks and loss data, collecting information on these KRI(s) at periodic intervals from all Units and escalating them to the Top Management based on the criticality of the issues.
Operational Risk Management Cycle

I. Business Planning & Objective Setting

Business Mission, Objectives & Strategies

Risk Appetite

Governance through RMC, ORMC and Sub-ORMC

Identify
Assess
Mitigate
Measure
Monitor
Report

Key risk indicators

- External Events
- Incident Reporting
- Internal Audit Reports
- Frauds
- Complaints
- COSMOS

- Risk Assessments
- Control Assessments

- Proactive Measures
  - PMC / CMC
  - Outsourcing Committee
  - IT Security Committee
  - Software Evaluation Committee

- Internal Loss Database
- External Loss Database
- Scenario
- Capital Calculation Modeling

- Internal Loss Database
- MIS
- Dashboard
Approaches for Operational Risk

Computation of Capital Requirements for Operational Risk Methods

- Basic Indicator Method
- Standardized Method
- Advanced Measurement Approach
  - Internal Measurement Approach
  - Loss Data Approach
  - Scorecard Approach
### OpRisk Approaches under Basel II

<table>
<thead>
<tr>
<th>APPROACH</th>
<th>GROSS INCOME</th>
<th>LOSS DATA Internal</th>
<th>LOSS DATA External</th>
<th>SELF-ASSESSMENT</th>
<th>KRI</th>
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<tr>
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Ops Risk Management Process
Process Allocation and Risk Loss indicator comparison
Internal Loss data

What is it?
Collection of Operational Losses (Financial/Non financial impacts including Penalties) in business processes and projects, structured by risk categories, such as technology, human resources, organization, external factor.

Why do we need it?
- To Analyze organizational weaknesses per product/Process, organizational unit and/or location
- To Analyze weaknesses in Outsourcing arrangements
- To identify and prioritize need for management action or attention
- To validate economic capital

How does it work?
- Identify loss booking procedures and accounts
- Identify responsible people
- Replace existing manual procedures with loss collection workflow
- Coordinate with Internal Audit, Insurance and Compliance
Risk Categorised Causal factors

**People**
- Attrition
- Adequacy
- Competency

**Process**
- Adhoc
- Granular Completeness

**System (IT Operations)**
- Enablements
- Validations
- Access Control (Login id/password compromise)

**External Events**
- Floods
- Earthquakes
- Riots/Vandalism
### Loss Matrix (8 X 7)

Operational Risk is broken down into event types as they cut across business lines.

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The internal business lines and events matrix for collection of loss data

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<td>Retail Liabilities, Investment Products &amp; Channels</td>
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<td>Rural &amp; Inclusive Banking</td>
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<td>Infrastructure</td>
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<td>Investment Banking</td>
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## Risk Event Types (RET)

<table>
<thead>
<tr>
<th>Risk Event Types</th>
<th>Examples of Risk Event Types</th>
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</thead>
<tbody>
<tr>
<td><strong>Internal Fraud</strong></td>
<td>Losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/discrimination events, which involves at least one internal party.</td>
</tr>
<tr>
<td><strong>External Fraud</strong></td>
<td>Losses due to acts of a type intended to defraud, misappropriate property or circumvent the law, by a third party.</td>
</tr>
<tr>
<td><strong>Employment Practices and Workplace Safety</strong></td>
<td>Losses arising from acts inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity/discrimination events.</td>
</tr>
<tr>
<td><strong>Clients, Products &amp; Business Practices</strong></td>
<td>Losses arising from an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature or design of a product.</td>
</tr>
<tr>
<td><strong>Damage to Physical Assets</strong></td>
<td>Losses arising from loss or damage to physical assets from natural disaster or other events.</td>
</tr>
<tr>
<td><strong>Business Disruption and systems failures</strong></td>
<td>Losses arising from disruption of business or system failures.</td>
</tr>
<tr>
<td><strong>Execution, Delivery &amp; Process Management</strong></td>
<td>Losses from failed transactions processing or process management, from relations with trade counterparties and vendors.</td>
</tr>
</tbody>
</table>
### Classification / Categorization of Risk

The table below enables the participants to classify the risk.

<table>
<thead>
<tr>
<th>Impact</th>
<th>Frequency</th>
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<tbody>
<tr>
<td>Very High</td>
<td>Very High</td>
</tr>
<tr>
<td>(Devastating/Catastrophic)</td>
<td>(Almost Certain)</td>
</tr>
<tr>
<td>High</td>
<td>High</td>
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<tr>
<td>(Substantial/ Major)</td>
<td>(Likely)</td>
</tr>
<tr>
<td>Medium</td>
<td>Medium</td>
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<tr>
<td>(Tolerable/ Moderate)</td>
<td>(Moderate)</td>
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<tr>
<td>Low</td>
<td>Low</td>
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<tr>
<td>(Negligible/ Minor)</td>
<td>(Unlikely)</td>
</tr>
<tr>
<td>Very Low</td>
<td>Very Low</td>
</tr>
<tr>
<td>(No Impact/ Insignificant)</td>
<td>(Rare)</td>
</tr>
</tbody>
</table>
## Risk Matrix

**Categories:**
- A - Acceptable;
- M - Manageable;
- U - Unmanageable

<table>
<thead>
<tr>
<th></th>
<th>Rare (Very Low)</th>
<th>Unlikely (Low)</th>
<th>Moderate (Medium)</th>
<th>Likely (High)</th>
<th>Almost Certain (Very high)</th>
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<tr>
<td><strong>Catastrophic</strong></td>
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<tr>
<td><strong>Substantial</strong></td>
<td>M</td>
<td>M</td>
<td>M</td>
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<tr>
<td><strong>Moderate</strong></td>
<td>A</td>
<td>M</td>
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<td><strong>Negligible</strong></td>
<td>A</td>
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<td>M</td>
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<tr>
<td><strong>No Impact</strong></td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>A</td>
</tr>
</tbody>
</table>
Coverage of Operational Risk Policy

Nature of Events –
- Single event and non repetitive
- Multiple events and repetitive
- Multiple event types affected
- Multiple refunds to clients (known failure points)
- Multiple Business Lines

Exclusions –
- Opportunity costs
- Lost future business
- Events involving reputational damage
- Events causing gains

Effect Types –
- Legal Liability
- Regulatory action
- Loss or damage to assets
- Restitution
- Loss of recourse
- Write Down

Contd ..
Coverage of Operational Risk Policy

**Business Lines –**
- More than 1 Business Line impacted
- Buying a new Business Line(s)
- Merger / Demerger of Business Line(s)

**Overlaps –**
- Credit
- Market
- Strategic

**Ops Risk Boundaries**
- Fixed Assets
  - Replacement Cost
  - Market Value
  - Book Value
- Pending Losses
  - Legal Cases
  - Damage to Physical Assets
Coverage of Operational Risk Policy

- Timing Losses
- Date
  - Occurrence
  - Accounting
  - Detection
- Recoveries
  - Direct
  - Insurance (Indirect)
Some major losses being witnessed by the Bank Industry

- Unauthorised debits to customer accounts
- Unauthorised debits to transit/office accounts
- Misappropriation of collections-asset accounts; unauthorised collections by agents/staff
- Fake cheques/forged cheques-collection/payment
- Mortgage frauds-various types-fictitious docs, fabricated financials, valuation frauds, forged/fake sale deeds, release of mortgage security (intentionally), multiple sale deeds, fraudulent sale of mortgaged property
- Chargeback losses
- Cross sales of third party products-mis-selling
- Phising/skimming attacks
- Data entry errors
- Cash/cheques lost in transit or stolen
- IPO-recon/delay/errors
- Purchase/sale of stocks
- Limit breaches,
- Fake LCs
- Fake guarantees
- Double/error in remittances
- ATM frauds-atm carried away, drilled open, reconciliation issues (switch, GL and physical cash), cash stolen by employees of service providers, cash un-reconciled in vault of service providers, cash limit breaches in atm cassettes, stolen
- POS/Internet frauds-fraud merchants/usage of counterfeit cards (data security)-collusion between staff and merchant,
General Causal Examples

- Misuse of system inadequacies includes absence of validation checks, gaps in system interface, mis-operation by systems.
- Lack of due diligence.
- Eagerness to achieve the tight targets
- Heavy attrition - sales staff
- Lack of domain knowledge
- Rapid changes in the existing products/ roll out of new products without the necessary system enablements/ lack of product knowledge
- Misuse of powers by superiors to coerce juniors to execute unauthorised txns
- Process inadequacies
- Inadequacies in segregation of duties - operations, collections, sales and credit reporting to same head.
- Lack of due diligence in asset/ individual / property verification
- Facilitating business by diluting controls due to business complexity.
- Rapid change in usage of technology/ channels.
- Business disruption
- Data leakage
- Gaps in recon
- Absence of real time limit monitoring tool.
- Gaps in account sourcing
- Gaps in data quality/ de duping process.
- Monitoring of chargebacks, merchant blacklisting/ delisting, payment gateway security in terms of data security
- Information flow and security
Thank You