



# Operational Risk

*B Banerji*

*It is likely that the unlikely will happen.*

**—Aristotle**

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# Agenda

*Interplay and overlap of risks*

*What is Operational Risk*

*Dimensions of Operational Risk*

*Frauds – a significant component of OR*

*Trends in reported frauds*

*Some interesting examples*

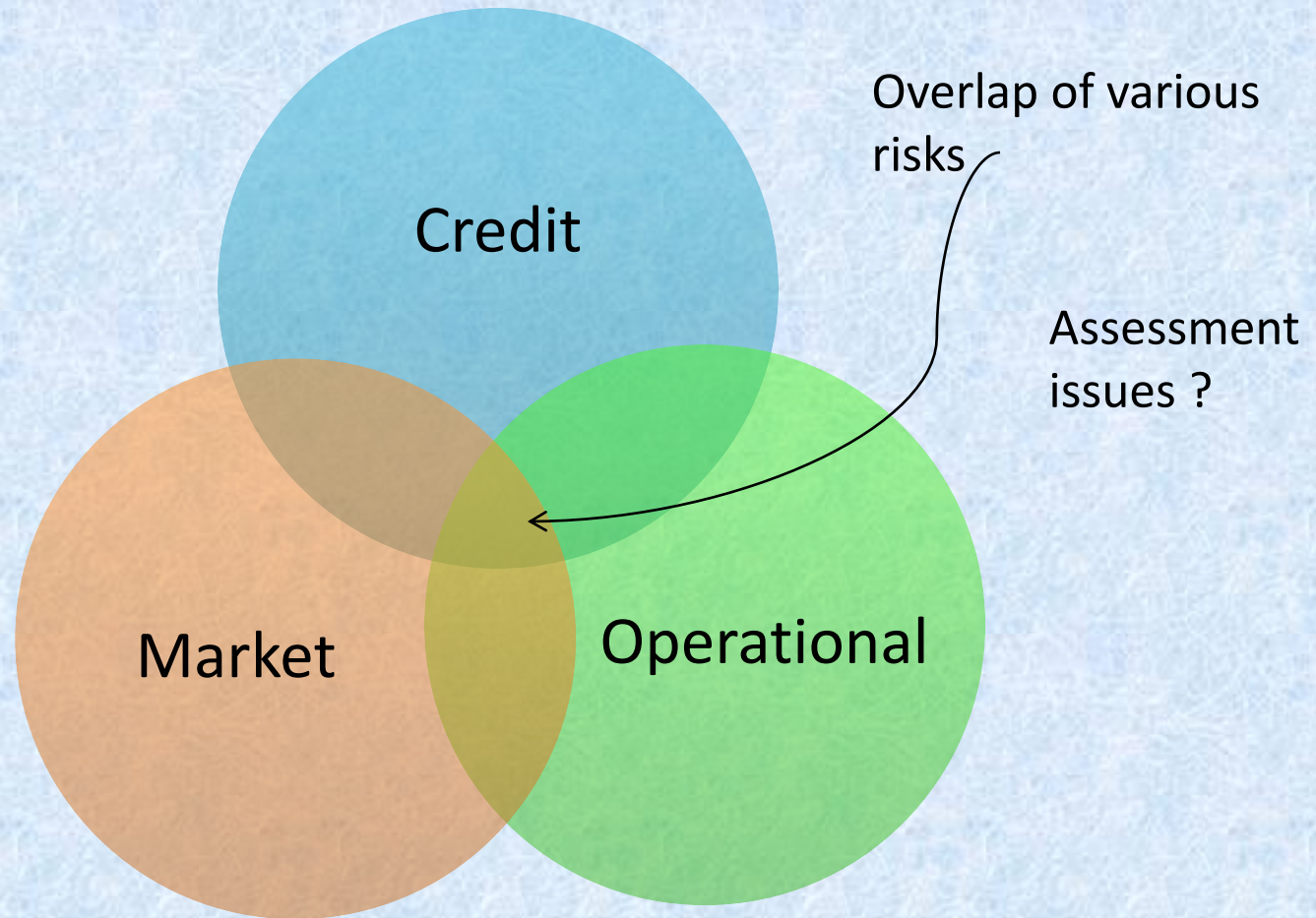
*Lessons drawn from the cases*

*Internal control*

*Monitoring at the Board level*

*Measure of Operational Risk – the Basel prescriptions*

# Interplay and overlap of major risks

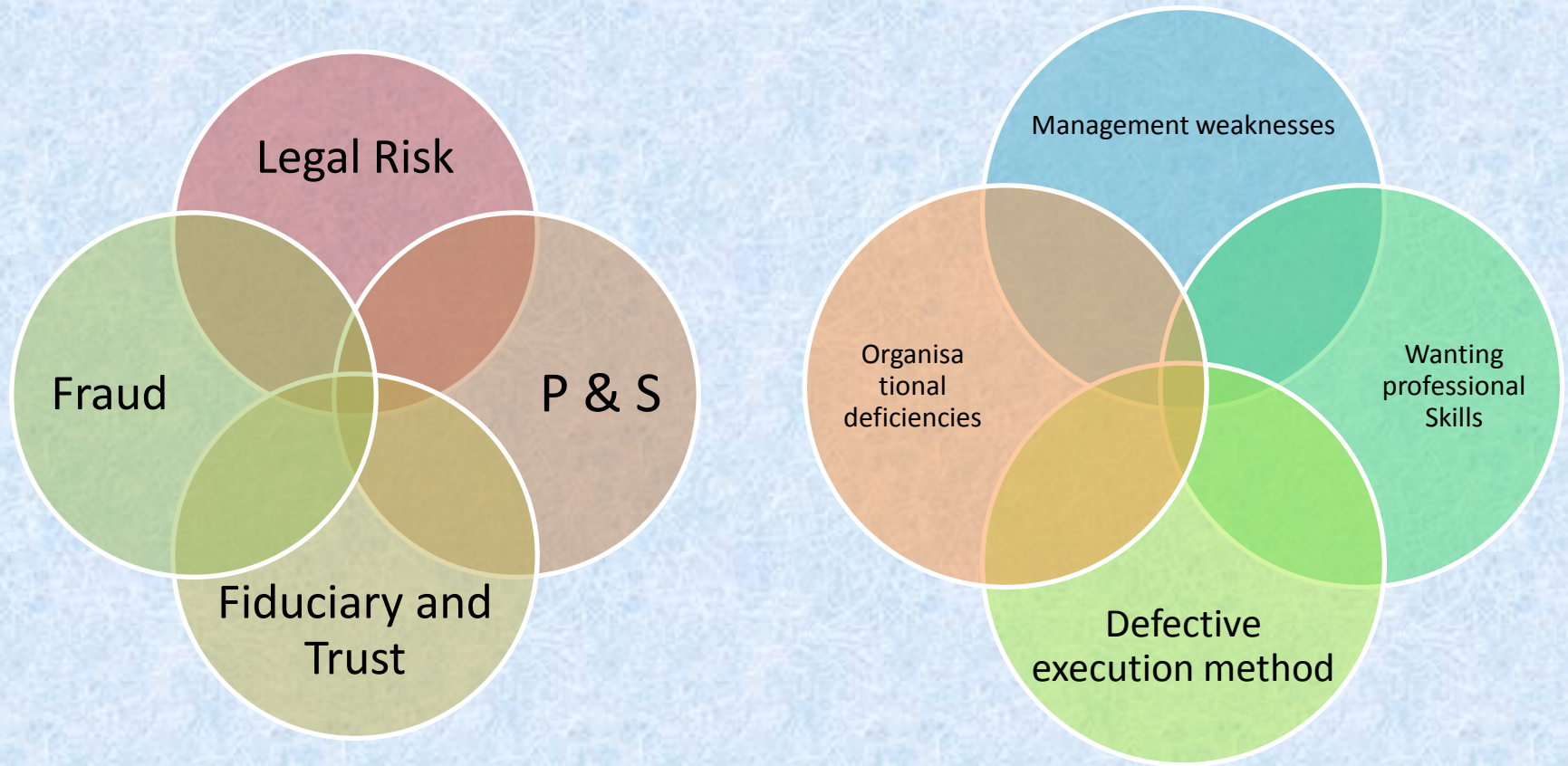


# What is Operational Risk

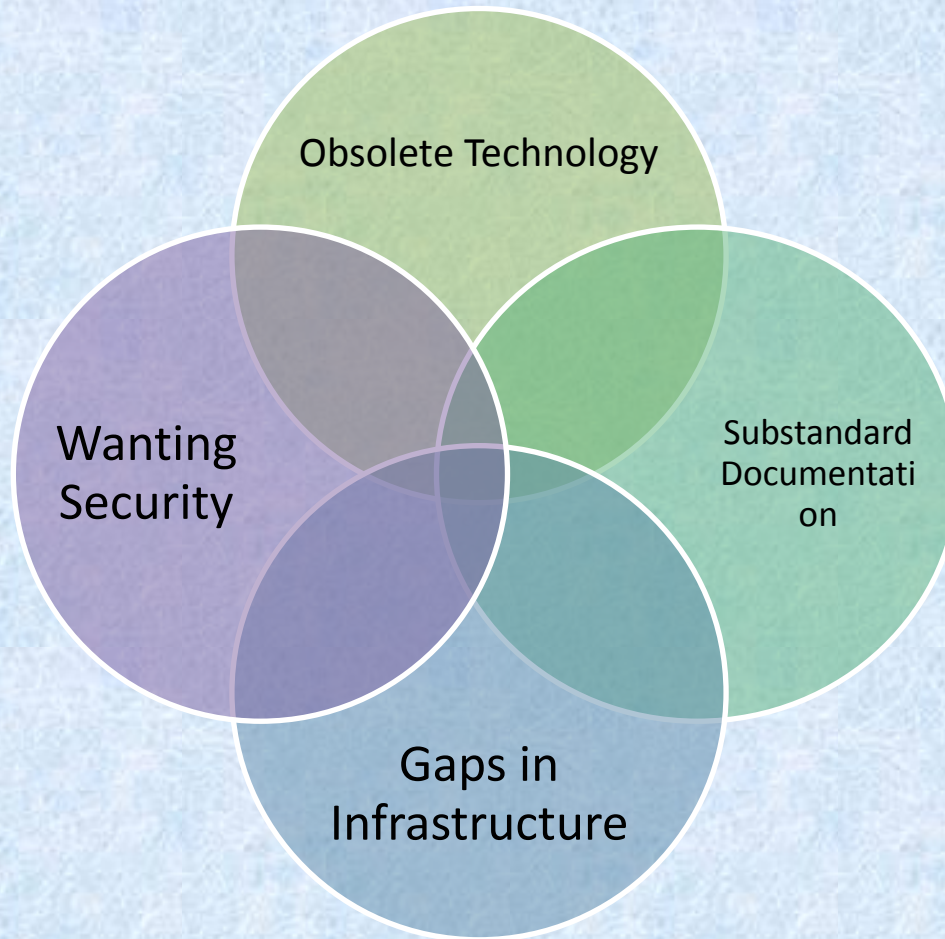
- **O R defined as the risk of monetary losses resulting from**  
inadequate or failed internal processes, people and systems or from external events.



# Dimensions of Operational Risk present in every organisation



# The third – now the most important- IT - Oriented



# Operational Risk

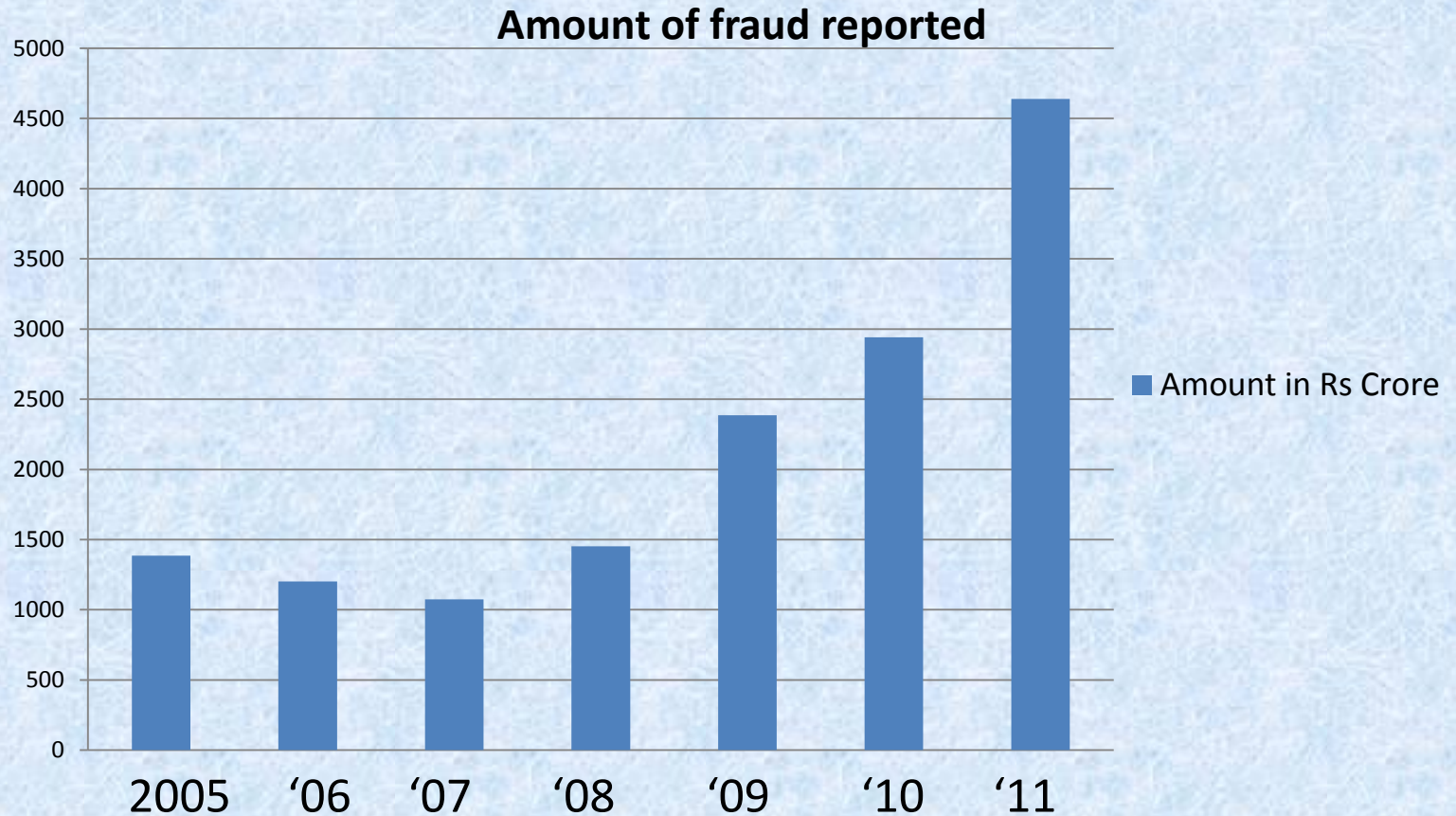


## Reasons for Fraud:

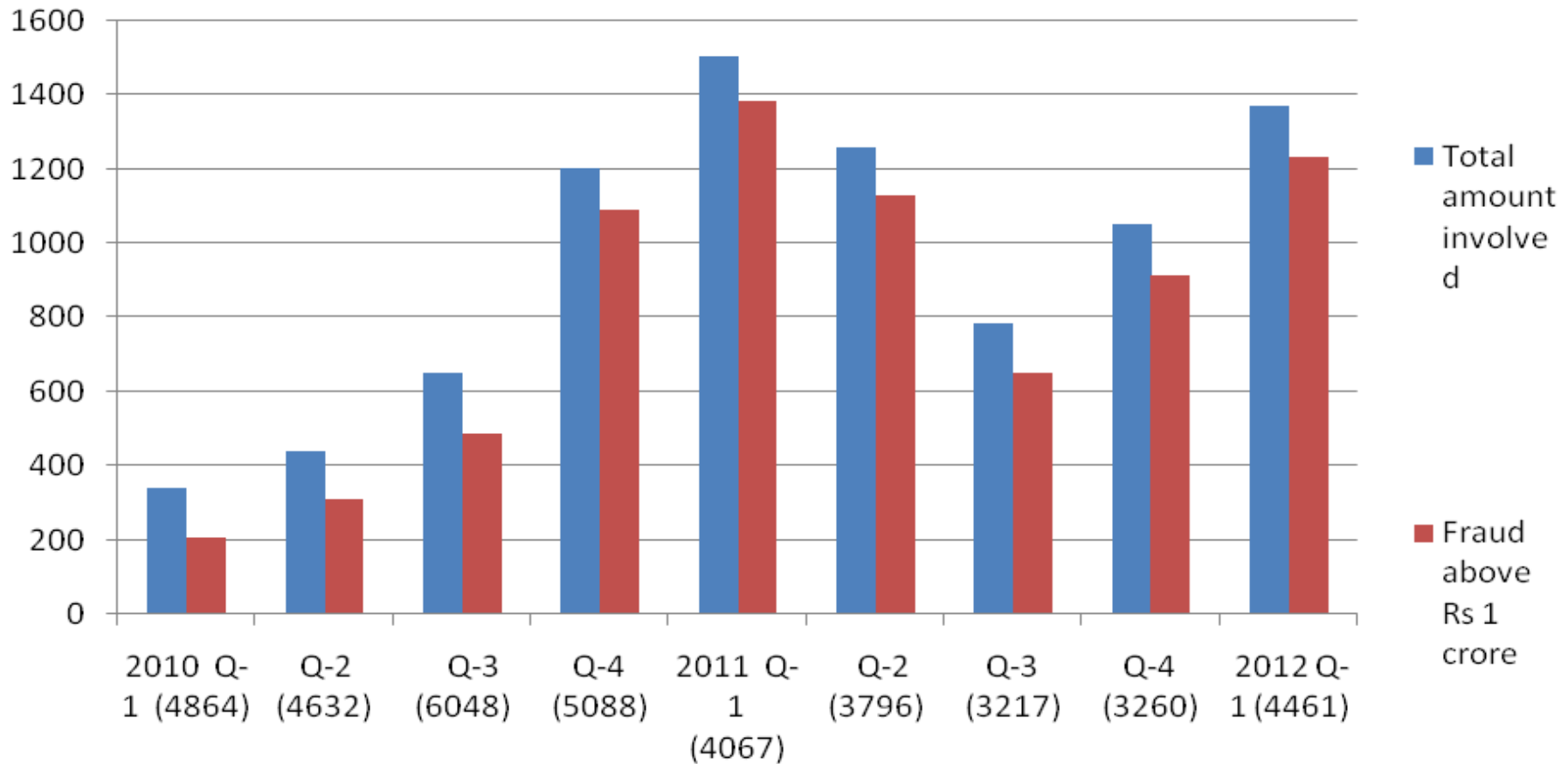
- Lack of Internal Controls
- Non observance of KYC norms
- Collusion of borrower & employee
- Weak IT security
- Forged/ Fake documents
- Misappropriation and diversion
- Phishing
- Kite flying
- Impersonation
- Faulty legal opinion



# Trend in reported frauds



# Trend in reported frauds



# 1 man, 30 clones, a credit card racket

Pradeep Gupta, TNN | Sep 29, 2012, 03.43AM IST

- **THANE:** The police have busted a credit card cloning racket and arrested three people, among whom one has 30 bank accounts. While the police found the figure to be staggering, what surprised them more was that the accused, Mansoor Wadkar (36), opened these by using 30 names and photographs of himself in as many forms of disguise. An officer from the Police Station said all disguise were done professionally, "as we see in the movies".



# LC devolvement due to fraud

- L/C limit from 7 banks. L/C opened in favour of an intermediary for import of metal scrap. MCB of some banks not informed that it was for intermediary/ merchant trading.
- The contract for the export leg is usually backed by a tripartite contract entered into between M/s FRG Ltd, PYT Metals and the buyer. Goods are sold and payments are remitted promptly
- As per the contract, FRG was to receive advance payment for shipment from the buyers before the due dates under the import LCs. The original bills of lading were to be dispatched to PYT Metals/the buyers only after that.
- Contracts covered under the export leg was reneged by the buyers even though there was a back to back contract by the importing firm.
- devolvement of L/Cs to the extent of around USD 250 million.
- the fraud was detected when MC Metal (notify party) insisted on taking the cargo at lower than contracted rate on grounds of inferior quality of cargo
- Later revealed that the importing company and the buyer co. had common directors



# Fraud thru System suspense account

- A certain branch (A) of a bank informed the HO that the representatives of M/s ABC was seeking confirmation of certain BGs amounting to Rs. 25.00 crore purportedly issued by another branch (B) favouring M/s ABC.
- The BGs were purportedly issued on behalf of certain other companies.
- The Regional Office of the bank conducted verification of various accounts of the branch B and found that certain accounts in which TODs were being allowed by the branch for longer durations, were immediately closed by the branch after the enquiry by the RO.
- The A branch also found certain irregularities in high value transactions in two of their clients' accounts which originated from B branch account.
- The branch suspected a link of an earlier fraud perpetrated on it in "*system suspense account*" with that of transactions the branch had with B branch. The R O, therefore, verified certain suspicious accounts at B branch which revealed serious irregularities as under:



# System suspense account -2

- The branch had opened six current accounts without adhering to KYC norms.
- The branch had granted frequent unauthorised ODs beyond the discretionary powers of manager.
- The credits to these accounts were raised thru high value instruments without actual presentation of cheques in high value outward clearing account. Cheques were also not traceable at the branch.
- It had been found that on fifty-three occasions high value credits to the tune of Rs.38.83 crore had been given by debit to “**Outward Clearing Suspense Account - High Value**”, without sending the instruments to clearing house. These transactions had been posted in Core Banking Solution system as if the instruments were presented in normal course of clearing with RBI.
- The branch Manager could not clarify the non-availability of cheques at the branch
- Irregularities such as issue of LCs and BGs beyond the delegated powers , not entering the details in the system and BGs not secured by security/ cash margins.
- The fraud was result of complicity of branch staff with customers / outsiders.
- It was also revealed that a circular flow of funds moving back to the presenter of the instrument through the branch B/ branches of other banks to avail of daylight float



# Fraud in multiple banks – group of accounts

- A group of companies with common promoters availed facilities from seven different banks aggregating Rs 220 crore.
- The directors of the firms got huge amounts sanctioned with promise of infusing matching capital contribution (initial capital Rs 1 -5 lakhs)
- Submitted false CA certificate and also committed cheating and forgery by submitting fabricated/fake title deeds.
- Further, the visit to the factory sites of the borrowers revealed that no such factories/units were in existence at the addresses mentioned by the companies.
- Falsely claimed large value orders - loans for export of jewelry based on large orders available with the concerned companies but no banks tried to find the genuineness of such orders
- A bank sanctioned/ enhanced/ re-structured the loans to the group companies even when the accounts were showing irregularities with the same bank/other banks



# Bank Guarantee (SBLC) Fraud

- Firm involved in Project Development, undertaking project works involving process plants, industrial and engineering products, energy, environment and infrastructural projects in several countries.
- Acting as a sub-contractor / aggregator - awarded contract by the 'principals', for providing materials, manpower and other services to enable execution of contracts.
- The guarantees (SBLC) issued by bank were for the purpose of guaranteeing the performance of the firm in the matter of providing engineering drawings, etc to the principals.
- As per contract terms, the firm was entitled to receive mobilization advance against SBLC issued by members in the consortium of 25 banks.
- SBLCs were issued through intermediary overseas banks.
- Though the contract period is for 2 to 3 years normally, guarantees were issued by overseas banks for a period of 6 months and were rolled over on a regular basis.



# Bank Guarantee (SBLC) Fraud -2

- Aggregator entered into contractual arrangement with the company and in turn it mobilised manpower through the Vendor/Sub-contractor
- The company faced liquidity crunch to meet day to day expenses due to delay in payments by overseas clients for work undertaken.
- The foreign banks which had earlier confirmed the BGs issued by the Indian banks refused to renew their FBGs. The company was not able to arrange alternate foreign intermediary Banks. This resulted in invocation of the FBGs.
- Total assessed Bank Guarantee limit of Rs.2650 crores of the consortium of 25 banks .
- The SBLC limits were covered to the extent of Rs.1650 crores under ECGC-EPG Guarantee. However, the claim made by the bank were rejected citing violation of FEMA, Fraud.



# Multi-layer Marketing firms

- Many small depositors paying cash against promise of high returns
- Agents collecting money against post dated cheques
- Large number of cheque leaves issued to these companies by bank branches.
- Transfer of money from Balasore and other branches of banks in Orissa to Kanpur, Lucknow, New Delhi and Mumbai using core banking
- High volumes of cheques on certain days in local clearing house
- The accounts were frozen before the cheques could bounce due to insufficient balance.
- Prize Chits and Money Circulation Schemes (Banning) Act, 1978 invoked.
- The companies went to court for unfreezing of account.



# Kite Flying Operation

- Two branches had been allowing excess drawings in two accounts against “uncleared effects” . These were being adjusted during the same month so as to avoid these accounts from being shown as overdrawn.
- NCC, City X on noticing a high percentage of returns in respect of two entities suspected kite flying operations
- High value cheques presented in local clearing instead of high value clearing since the effects were cleared on third day only.
- A large number of cross transactions were permitted by the branches.
- Instrument paid by the branch by debiting Extension Counter Adjustment Account instead of debiting the respective accounts. Reversed after three months causing loss of income.
- Raised fictitious entries in the system to camouflage the effects of returned cheques in the accounts by overriding the system and creating uncleared effects of the cheques lodged on a day to day basis.

Total loss to the bank Rs 25 core



# Case Study – Learnings

- KYC is crucial - has bank-wide ramifications
- Oversight on review / renewal and factual reporting a must
- Exception report of concurrent audit/ inspection to be submitted to the Board in time
- Exceptional roll over of BGs/ LCs – control required
- Random check for documentation/ security in case of large advances - must
- Sudden spurt in deposit/ advance / NPA/ Banking activity
- Reconciliation delays/ arrears, High amount of cheque bouncing/ exceptional activities in branches regions as part of exception reporting
- External environmental factors like global slowdown/ change in govt policies affect accounts/ risk ↑



# Types of Control break-downs

- Lack of Control Culture
- Inadequate recognition and assessment of the risk of certain banking activities
- Absence/failure of key control structures
- Inadequate communication
- Inadequate / ineffective audit/monitoring



# Framework for the evaluation of internal control systems - BCBS

- A system of **effective internal controls** is a critical component of bank management and a foundation for the safe and sound operation of banking organisations
- Such a system can also help to ensure that the bank will **comply with laws and regulations** as well as **policies, plans, internal rules and procedures**, and decrease the risk of unexpected losses or damage to the **bank's reputation**.

The factors for assessing potential risks include:

- (i) Staff related factors such as productivity, expertise, turnover
- (ii) Extent of activity outsourced
- (iii) Process clarity, complexity, changes
- (iv) IT Indices
- (v) Audit Scores
- (vi) Expected changes or spurts in volumes



# Problems in Ops Risk Control

- Staff untrained/ lack focus
- Lack of clear directives, (incomplete understanding within organisation)
- Four factors to be dealt with:
  - People don't know what is targeted
  - People don't understand how to control Op risk
  - They don't want to do it in a rigorous way- touch other people's sensitivities
  - They don't like to be controlled in what they are doing
- **Problems which are external** to the organisation:
- Flood, earthquake, hurricane
- Hacker/ power failure/ communication failure
- Govt policies/ environmental laws/ *Force majeure*

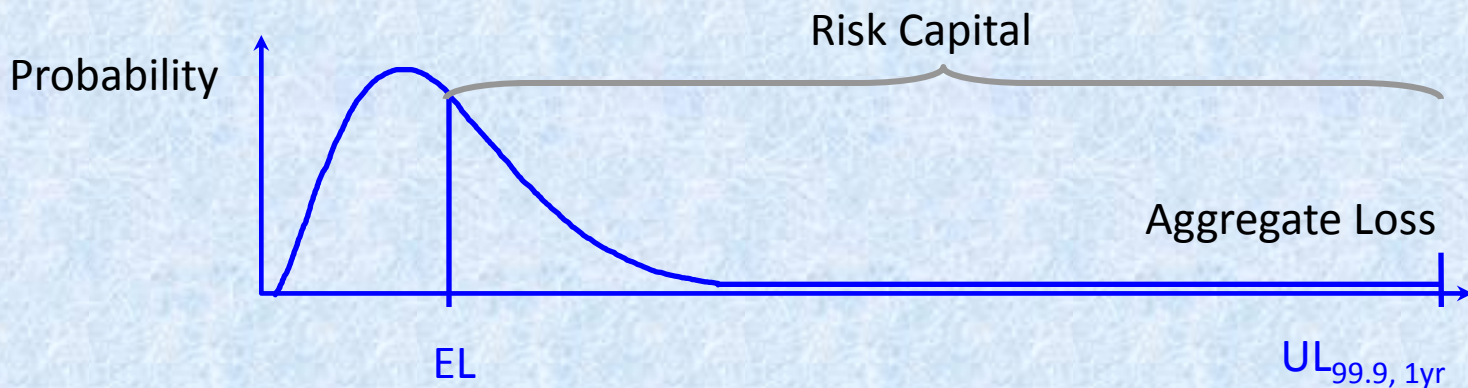


# Analytical Process



# Loss Distribution and Management Tools

- What does the shape of a loss distribution really look like?



- Where in the curve can we apply the most effective management tools?



# Board level monitoring of Operational Risk

- Check effectiveness of the bank's risk management process
- Overall control environment
- The bank's methods for monitoring and reporting its operational risk including data on operational losses and other indicators of potential operational risk through:

## **Calendar of reviews – feedback system to the Board**

- Compliance Reporting: on an exception basis
- Slippage and Recovery of NPAs
- Compromise proposals / bad debts written off
- Review of top 100 borrowal accounts of below Rs.5 crore in each category of NPA
- Position of house-keeping
- Inspection reports of poorly rated branches
- KYC/ AML reporting
- The timeliness and effectiveness of resolution
- The effectiveness of the bank's operational risk mitigation efforts, such as the use of insurance
- Bank's disaster recovery and business continuity plans



# Guidance Note

Issued vide DBOD.No.BP.BC.39/21.04.118/2004- 05 on October 14, 2005

- Organizational set up and culture
- Policy Requirement
- **Identify**- Define the risk tolerance level, break it down to appropriate sub-limits and prescribe reporting levels and breach of limits.
- Indicate the process to be adopted for immediate corrective action.
- **Monitor**-Management information systems
  - Operational Risk Loss events
- **Mitigate**- For all material operational risks that have been identified, the bank should decide whether to use appropriate procedures to control and/or mitigate the risks, or bear the risks.



# Measures of Operational Risk

- **Operational risk management** is about managing the exposure to the frequency and severity of expected as well as unexpected losses.
- Under Basic Indicator approach, Capital charge is measured as:

$$KBIA = [ \sum (GI_{1...n} \times \alpha) ]/n$$

Under Standardised Approach, bank's activities are mapped into eight business lines,

<b>Business Line</b>	<b>Beta</b>
Corporate Finance	18
Trading and Sales	18
Retail Banking	12
Commercial Banking	15
Payment & Settlement	18
Agency services	15
Asset Management	12
Retail Brokerage	12

- Then Gross income (average for 3 years) of each business line is multiplied with the Beta factor.

# Advanced Measurement Approach

AMA is based on an estimate of operational risk derived from a bank's internal risk measurement system

- Measuring operational risk requires banks to estimate the Probability of Loss Event (PLE) and potential size of the loss i.e. likelihood and impact.
- Common Elements Required – Qualitative and Quantitative key requirements- Internal data, External data, Scenario Analysis , Business Environment/ Internal control Factor, Risk Mitigation- correlation
- Challenges – Data, efficiency, regulatory burden, Home-Host issue (part use - different approaches, significant banking subsidiary – to calculate standalone capital or incorporate diversification benefit, etc.)
- Scarcity of data in the tail (frequency-severity distribution); Fat tails, Expected loss (EL) and unexpected loss (UL).

**THANK YOU!**

