ORIC INTERNATIONAL

Creating value from risk events

Leading practices in operational risk event reporting, analysis and investigation, learning and management

Leading practice study by Oliver Wyman on behalf of ORIC

OLIVER WYMAN

FOREWORD

ORIC is a consortium of organisations in the insurance sector with the common purpose of further advancing the management and measurement of operational risk.

One of our key aims is to share best practice in operational risk and, where appropriate, set leading practice for operational risk. We see our mission as serving our membership and creating a community where information and ideas can be shared.

In gathering and sharing information on risk events we also seek to provide practical tools and insights to drive improvement in risk management practices. It is therefore with great pleasure that I recommend this study to you on behalf of ORIC.

We hope this report will inspire you to further improve your own organisation's risk event capture, reporting and analysis. If you operate in the insurance related sectors and you share these values, why not join us on this journey?

Alex Hindson, Chairman, ORIC

IRM ENDORSEMENT

"The Institute of Risk Management is delighted to lend its endorsement to this worthwhile report on the importance of risk event reporting in creating a healthy risk management culture. Our own recent publication on Risk Culture identified the importance of risk disclosure and the effective reporting and escalation of risk events as fundamental tests of an organisation's ability to create a supportive culture. As the world's leading enterprise-wide risk management education institute we see this report as an important step in strengthening leading practice in the area of learning from risk events. Risk events should be seen as gifts to management and as an opportunity to improve. Survival of the organisation may in some cases depend on this important evolutionary skill."

Carolyn Williams, Head of Thought Leadership, Institute of Risk Management

IOR ENDORSEMENT

"The Institute of Operational Risk is pleased to endorse this helpful contribution to the issue of loss event reporting and causal analysis, which is critical to understanding operational risk exposure as well as being fundamental to instilling a learning culture and an environment of continuous improvement. We commend it as a practical guide to those involved in operational risk at all levels."

Simon Ashby, Chairman, Institute of Operational Risk

Organisations which place a strong focus on risk event reporting, analysis and learning actively reduce operational risk losses as well as outperform the market financially.

EXECUTIVE SUMMARY

Introduction

Operational risk events have resulted in huge losses and reputational damage across all industry sectors. For example, BP faces losses of $43bn as a result of the Macondo disaster; the banking industry has had to pay out tens of billions of pounds in fines and compensation as a result of LIBOR, money laundering, mis-selling and other risk events; and public sector organisations like the NHS have suffered massive reputational damage around patient safety operational risks.

The insurance sector also endures large losses each year from operational risk events, often associated with significant reputational damage. In addition to impacting the P&L directly, capital reserves must be set aside to cover these risk events, which can have a significant impact on corporate return on capital.

Organisations which place a strong focus on risk event reporting, analysis and learning actively reduce operational risk losses. Typically, they exhibit the following characteristics:

- An open culture where people see risk events as an opportunity to improve
- Undertaking analysis of risk events to understand the root causes and establish whether other areas of the organisation could have an exposure
- A disciplined approach to deciding on management actions required in response to a risk event and their implementation
- Continuous improvement of their control framework using learnings from internal and external risk events to reduce operational risk exposures.

When an organisation gets these things right, it tends to outperform the market financially.

Our study

28 ORIC members were interviewed to identify leading practice in risk event management, focusing on risk event capture reporting, analysis and learning. In addition, four companies from other sectors (oil and gas, utilities, aviation, and mining) were interviewed as comparators. From this, best practice approaches were identified and a maturity diagnostic developed to assist organisations in benchmarking and improving their performance. These approaches and the maturity diagnostic have broader applicability across other industries and sectors.

This document is not intended to prescribe particular methodologies. Each individual organisation will be faced with different scenarios, challenges and risks and those working within it will need to use their own judgement to identify appropriate practices.

Main findings

Our study focuses on the four main areas which organisations need to get right:

- Creating an open culture that encourages reporting
- Event investigation and analysis, including impact assessment
- Managing actions
- Learning and continuous improvement.

Creating an open culture that encourages reporting

Creating an open culture where people can speak openly about risk events is fundamental. An organisation that is aware of a loss event or near miss can find ways to create value by reducing the likelihood of reoccurrence and the event's impact.

Identified best practice for creating an open culture includes:

- Making the reporting process as simple and user-friendly as possible
- Ensuring people know what a risk event is, how and when to report it, and how to learn from it
- People feel valued and respected when reporting a risk event and understand the importance of this to their organisation.
- People share information on risk events openly, without fear of blame
- Communication of risk events is timely and efficient, particularly in high priority cases.

Leading practice organisations understand the significance of culture and the role of strong and supportive leadership, risk awareness, understanding and governance in promoting the reporting of risk events.

The crucial ingredient of success is visible leadership behaviour. Best practice organisations have strong, risk-aware leaders who actively champion the process, get involved in training their people, communicate the importance of risk to the business, actively follow up on actions, and recognise people for reporting. Such organisations invest in developing risk leadership skills and measuring leaders' performance in this area. Critically, these leaders avoid blaming those who report, or those who have made genuine mistakes, and place a high value on the opportunity to learn from risk events to drive value for their organisation.

Event investigation, analysis and impact assessment

Effective risk event analysis ensures the business fully understands the root cause(s) of that event to determine the most appropriate response. For major events, this will involve a formal investigation.

Identified best practice for risk event analysis includes:

- Setting clear thresholds that determine when an in-depth investigation of the root cause of a risk event is required
- Using recognised tools and techniques such as: 'The Five Whys'; Fishbone/Ishikawa diagram; and Bowtie analysis to analyse the root cause(s) of material risk events
- Using people with appropriate skills from the first and second (and, at times, third) line of defence to support root cause analysis
- Conducting balanced investigations that cover people, capabilities, culture and behaviours, processes and systems. It is easy to blame a system or human error for a risk event occurring, but it is critical to understand why someone made such a decision
- Evaluating the organisations response to a risk event to identify whether any lessons could be learned.

Accuracy in quantifying the direct and indirect impact of a risk event is important. The true cost (or potential cost), as well as non-financial impacts of a risk event, needs to be fully understood to ensure that mitigating actions are proportionate and to make an effective case for any required changes to the underlying control environment and/or insurances held.

Identified best practice in impact quantification includes:

- Providing staff with a guide that sets out direct and indirect impact types to enable more accurate quantification
- Back-testing of actual losses against the P&L.

Managing actions

The analysis of the causes of a risk event will lead to identification of a number of potential remedial actions. Action management covers the governance and implementation of agreed activities to recover from the risk event itself and to reduce the likelihood of re-occurrence. It is used to find the appropriate balance between potentially conflicting objectives and ensuring all significant actions are carried out, while avoiding the imposition of unnecessary bureaucracy.

Identified best practice in managing actions includes:

- Prioritising actions against a defined risk appetite
- Evidence-based monitoring of the progress of agreed actions
- Meaningful and clear key performance indicators
- Robust governance, including independent oversight
- Assessing the adequacy and effectiveness of actions taken.

Learning and continuous improvement

Organisations need to share relevant key information and learnings from risk events with the parts of the business that could have an exposure. Best practice is also to learn from external events, with a good example provided by the North Sea, where all oil and gas companies openly share details of all safety and environmental risk events, including near misses.

Within the insurance industry, qualitative narratives captured in the ORIC database could be more widely disseminated within members to appropriate first line staff. Through continuous improvement, group-wide operational risk exposures can be systematically reduced. Learning also helps create a culture of ‘chronic unease’. This is an organisational state where people are highly risk aware and continually assessing what might go wrong, as well as being prepared to challenge processes and leaders from an informed basis.

Identified best practice in learning and continuous improvement includes:

- Setting clear targets to reduce annual operational risk exposure
- Identifying relevant external risk events and using the qualitative and quantitative information to challenge the adequacy and effectiveness of internal controls and insurances held
- Sharing information and learnings from internal and external risk events with parts of the business that could have an exposure
- Prioritising and targeting learnings through appropriate engagement. The whole process of learning is most powerful when it is fully integrated into a robust organisation-wide continuous improvement culture.

Conclusions

Currently, there is a wide range of operational risk management practice across the insurance sector. Even organisations of similar scale and in the same area of business show markedly different levels of maturity around their approach to operational risk event reporting, analysis and learning.

Maturity Diagnostic

There is a real opportunity to reduce the cost of operational risk across the industry. To assist organisations in benchmarking and enhancing their own performance we have developed a maturity model. This identifies four levels of maturity:

- **Reactive:** organisations where operational risk events are seen as a cost of doing business, with little focus on effective risk management
- **Compliant:** organisations which focus on meeting rules and regulatory requirements

- **Proactive:** organisations where everyone owns risk and takes responsibility for improving its management
- **High reliability:** organisations where risk management is transparent and fully integrated into continuous improvement systems. Staff at all levels take full ownership of risk and feel free to challenge. The company learns from its own and external loss events and actively targets reductions in operational risk losses.

Moving from 'reactive'

We have identified three key levers for organisations which wish to improve from a reactive approach:

- **Build a compelling benefits case:** covering both financial and non-financial benefits
- **Gain leadership support:** create strong, visible, executive level sponsorship
- **Increase awareness and knowledge:** of operational risks, reporting processes, and the benefits of reporting, through a major engagement programme.

As leaders and staff focus on understanding the operational risks they face and the benefits of risk event reporting, organisations will quickly strengthen their operational risk management. Typically, organisations can expect to see a temporary increase in loss events as reporting improves.

Organisations should be wary of creating a systems and process based solution, although this may meet regulatory requirements. Without effective leadership and staff engagement, such systems-led transformations are notorious for not producing real benefits and for being unsustainable. Successful organisations have initially built simple tools and templates (such as electronic forms) rather than depending on off-the-shelf systems. Improvements to these basic tools can be made quickly and adapted to business requirements. In all but the smallest organisations, this information will then be captured on the corporate risk system.

Moving towards 'proactive' and 'high reliability'

Best practice in other sectors identifies four key areas:

- **Near miss reporting**

  A focus on reducing the incidence of near misses will reduce the number of loss events. Other sectors have demonstrated that addressing near misses will quickly deliver tangible results. Some insurance organisations reported that they treat small loss events as large near misses, but others report difficulties in achieving accurate near miss reporting.

- **Behaviours and culture**

  Best practice in other industries is to give the same weight to addressing behavioural failures as is given to system, control and process failures. Only by focusing on behaviours can organisations become mature. There was almost universal recognition from the insurance companies interviewed that behavioural issues lie at the heart of most loss events. Many report a developing focus on addressing culture.

- **Root cause analysis tools for analysis and investigations**

  Other industries use proven industry-wide approaches and tools, resulting in robust and consistent analysis and investigations which give management full confidence. This also facilitates the sharing of lessons across the sector. Most of these tools are suitable for use when investigating risk events and we have recommended three for adoption: Five Whys; Fishbone/Ishakawa; and Bowtie. Many of the organisations interviewed recognise that moving from a relatively ad hoc approach to investigations to a more systematic approach centred on proven tools is a quick win.

- **Become a learning organisation**

  World class operational risk managers supplement data from their risk event reporting process with data from other areas of the organisation and external risk events. There is an opportunity for many insurance companies to use more data from ORIC reporting across the sector to supplement internal learnings. Using external data helps businesses to create a culture of 'vulnerability and challenge' where all staff are actively conscious of potential risk events that may occur and proactively strengthen operational risk controls. In addition, best practice organisations use their learning actively to target year-on-year reductions in operational risk losses.

Maturity Diagnostic

	Reactive	Compliant	Proactive	High reliability
Open environment for reporting	• Only significant loss events are reported • Lack of leadership involvement • Inconsistent reporting processes • Fear of blame/ reprimand impedes reporting • People are unsure what to report and why • Reporting delegated to the 2nd line • Near misses not reported	• Coherent process for people to report loss events • Most events reported • Key people are risk aware • Key people understand how to report a risk event • Little focus on near miss reporting	• Everyone feels encouraged to report risk events • Simple standardised company-wide approach to reporting • Ownership of reporting at 1st line • Selected staff at 1st line of defence staff are focused on risk • Staff understand the need to report near misses. >50% are reported	• Single, simple approach to capture enterprise-wide risks • Everyone understands the current and potential risks they face • Everyone understands the need to report risk events and do so directly • Open, learning culture sees events as an opportunity to improve • Near misses actively reported in order to reduce frequency of loss events
Risk event analysis, investigation and impact assessment	• Focus on addressing recovery from loss events • Leadership seek to identify responsibility and blame • Root cause analysis (RCA) not conducted	• Root Cause Analysis (RCA) conducted for priority events • Focus on controls, processes and systems – not behaviours • Ad hoc and inconsistent approach to RCA - few standard tools • Little trained investigative capability	• Clear thresholds for Root Cause Analysis (RCA) • Standard, proven tools and approaches used to conduct RCA • Behavioural root causes always sought • Strong trained capability to conduct RCA • Top leadership reviews causes of major events	• Deep Root Cause Analysis (RCA) for key loss events and major near misses • Analysis identifies trends and causes from high volume minor events • All leaders are seen to engage in RCA • Focus on behaviours (why people acted that way) • Leadership, behavioural and cultural issues confronted • Quality assurance of investigations through peer and 3rd line review
Action management	• Actions for most loss events are not monitored or followed up • Follow-up for major events is on ad hoc basis	• Actions often derived so that they can be delivered rather than make a difference • Actions are managed, monitored and closed • Approach and tools for action management are not consistent across company	• Actions derived to make a difference • Actions are prioritised based on resources available and risk appetite • Actions clearly tracked and only closed on evidence • Top leadership review actions for major events	• Action management process integrated into company-wide continuous improvement approach • Actions may involve replacing existing controls that are not cost effective, not just adding additional controls
Learning and continuous improve-ment	• No systematic approach in place to learn from internal or external risk events • Learnings tend to be ad hoc and rely often on informal networks	• Changes to policies and procedures occur in response to significant internal risk events • Learnings not always shared across all relevant parts of the company • Review of major external loss events is not systematic	• Processes in place to prioritise and share learnings across the company from internal risk events • Learnings are derived from external risk events • Appropriate ORIC data shared with 1st line • Multiple channels used to engage staff in learnings • The 3rd line review learning effectiveness	• Learnings from loss events and near misses used to deliver year on year reductions in risk exposure • Rigorous approach optimise behaviours and controls based on learning from internal and external events • Proactive sharing and learning across the industry to reduce sector-wide operational and reputational risks

GLOSSARY

During the study, we noted there was some variance in the language used to describe elements of operational risk management. To assist with clarity, we have defined below some terms used in the report.

Analysis of event	The actions taken after a risk event to determine the root causes, assess the impact and identify potential remedial actions. Analyses can be focused on single events or groups of events to identify trends.
Chronic unease	A term used extensively in the asset intensive industries to describe an organisational state where people are highly risk aware and continually assessing what might go wrong.
Insurance sector	This includes insurance, reinsurance and asset management activities.
Investigation of event	To analyse the root cause/s of a major event, a formal investigation is often set-up. A dedicated multi-skilled team may be appointed to carry this out.
Risk event	An event that results in a loss event, fortuitous gain or near miss.
Loss event	An event that results in a financial and / or non-financial loss.
Near miss	An event that did not lead to a financial and / or non-financial loss, but had the potential to do so.

—ORIC

ORIC (Operational Risk Consortium Ltd) is the leading operational risk consortium for the (re)insurance and asset management sector globally.

Founded in 2005 to advance operational risk management and measurement, ORIC facilitates the anonymised and confidential exchange of operational risk data between member firms, providing a diverse, high quality pool of qualitative and quantitative information on relevant operational risk exposures.

As well as providing operational risk data, ORIC provides industry benchmarks, undertakes leading edge research, sets trusted standards for operational risk and provides a forum for members to exchange ideas and best practice.

ORIC has over 30 members with accelerating growth.

www.abioric.com/home.aspx

—About Oliver Wyman

Oliver Wyman is a global leader in management consulting. With offices in 50+ cities across 25 countries, Oliver Wyman combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation. The firm's 3,000 professionals help clients optimize their business, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is a wholly owned subsidiary of Marsh & McLennan Companies [NYSE: MMC], a global team of professional services companies offering clients advice and solutions in the areas of risk, strategy, and human capital. With over 53,000 employees worldwide and annual revenue exceeding $11 billion, Marsh & McLennan Companies is also the parent company of Marsh, a global leader in insurance broking and risk management; Guy Carpenter, a global leader in providing risk and reinsurance intermediary services; and Mercer, a global leader in talent, health, retirement, and investment consulting.

For more information, visit www.oliverwyman.com.
Follow Oliver Wyman on Twitter @ OliverWyman.