

Effective risk identification is a crucial component of strong risk management, and yet ORX members often find that it is one of the most challenging elements of the operational risk framework.

By pooling industry expertise, we can more easily identify and understand top and emerging operational risks. To facilitate this, ORX conducted the 2017 Operational Risk Horizon project. The study provides our members with an external benchmark, helping them validate and challenge their internal assumptions of the operational risk environment.

Forty-four banks and insurers took part, submitting their current and emerging operational risks ranked according to importance. This study aggregates these risks, and explores how participants believe the landscape will change over the next few months and years.

Our findings are based on the analysis of 377 operational risks and 282 emerging risks. These were categorised to create two overall lists – a top operational risk list and a top emerging risk list. This ranking accounts for both the number of submissions and the ranking of each submission.

The full report, available to participants, contains analysis of the top 15 operational and emerging risks. This report is a short summary of the full report, and includes analysis of the top five operational and emerging risks.

A diverse portfolio of operational risks

Operational risk is a multi-faceted discipline and institutions face a diverse and changing set of threats, which is reflected across the 650+ risks submitted by members. The overall top risk lists contain both well-established risks such as fraud, and more recent developments such as those associated with digital disruption.

The diversity of submissions highlights the wide range of operational risks that institutions need to understand and manage. We have previously highlighted how, within some firms, operational risk is becoming the 'umbrella' function in an effort to provide a holistic view of the risk environment through a single framework (ORX & McKinsey&Company, 2017).

Overall risk profile set to increase

As the financial industry changes so does the nature of operational risk. Our Future of Operational Risk study (ORX & McKinsey&Company 2017) found that most institutions expect operational risk to become a more significant part of their overall institutional risk profile, primarily driven by the level of change across the financial industry. Our study reflects this – participants expect almost every risk category to increase in the next three years.

It comes as no surprise that technological change is driving much of this increase, especially for risks associated with IT infrastructure, cyber security and digitalisation. Equally, the persistent regulatory attention on culture and conduct in the financial services industry only looks likely to intensify. Ongoing legacy issues, as well as emerging areas of concern, see conduct as the highest ranked risk category in this study.

Changing concerns on the emerging risk horizon

Digital disruption and geopolitical uncertainty are ranked significantly higher in members' emerging risk lists compared to their current operational risk lists. Digital disruption was a major theme from our 2016 emerging risk inventory (ORX, 2016), and represents the biggest source of emerging risk in this study. In addition, recent political events on both sides of the Atlantic, and rising tensions in Asia and the Middle East, have contributed to geopolitical and macroeconomic risks remaining one of the top sources of emerging risk.

Operational Risk Horizon

Summary: March 2018

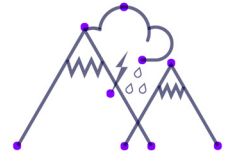


Figure 1. Top five operational risks ranked by weighted aggregated score. Right-hand column shows last year's rank by weighted aggregated score and direction change between the two years.

Conduct a top risk on the management agenda

It is perhaps unsurprising to see risks associated with conduct come out as the most significant industry concern this year. Conduct is an area of acute regulatory concern across multiple jurisdictions. Three quarters of participants identify at least one conduct issue among their top ten operational risks, with four fifths of these firms considering it in their top five.

Participants submitted a diverse range of conduct risk issues, reflecting the varied definitions we see across the industry. For more information on how institutions define conduct risk, please see our study, *Understanding Conduct Risk Practices* (ORX, 2017).

Information security risk profile remains elevated due to multiple drivers

The information security and cyber risk category narrowly lost the overall top rank to conduct risk. However, 84 per cent of participants include an IT security risk in their top ten operational risks. These risks are consistently ranked highly, with the highest median rank of any category.

According to submissions, IT security risks are elevated by two macro trends: the complexity of the digital landscape and the increasing reliance on systems and data in financial services firms. These trends have opened new threat channels and increased the potential for financial loss and reputational damage.

Theft and fraud still a pervasive risk

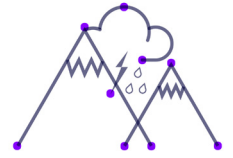
Theft and fraud maintains its rank as the third most significant operational risk category. While some respondents note that technological innovation can help to mitigate fraud, most submissions state that certain technologies have enabled increasingly complex and sophisticated fraud schemes to proliferate.

Continuing regulatory change driving compliance challenges

Regulatory compliance risks saw an overall increase from eighth to fifth place in the top operational risks, representing the largest annual increase of any category. The volume and complexity of new regulation brings substantial implementation costs, as well as the potential for penalties associated with non-compliance.

Operational Risk Horizon

Summary: March 2018



Overall operational risk profile set to increase

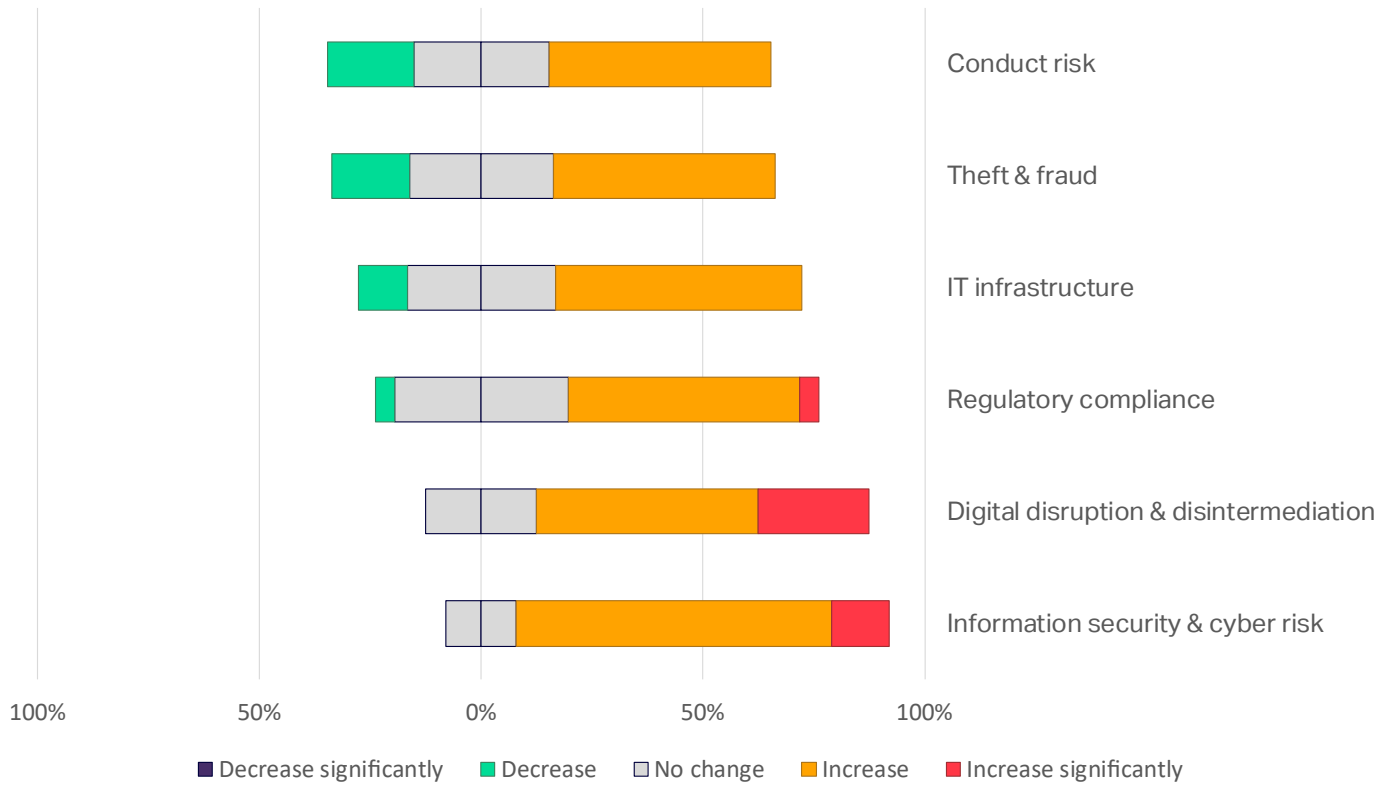


Figure 2. Divergent bar showing perceived change in risk profile over the next three years for each top 5 operational risk category. For each risk, participants were asked to indicate whether they expected the risk to 'increase significantly', 'increase', 'remain stable', 'decrease' or 'decrease significantly'.

Analysis of all 15 top operational risks shows that, on aggregate, almost every category is expected to increase over the next three years. In fact, within the top 15 operational risks, no single submission is considered to significantly decrease in this period.

Risks associated with digital disruption look set to increase more than almost any other category over the next three years, with a quarter of submissions stating that they are expected to 'increase significantly'. Unsurprisingly, risks associated with digital disruption also rank very highly on the emerging risk list.

Interestingly, only half of submitted conduct risks are judged to be increasing in the next three years, despite being ranked as the top overall operational risk category this year. Participants who indicate that these issues are likely to decrease suggest that considerable resources have been devoted to managing conduct issues in recent years, which is beginning to have a positive impact on the risk profile.

It is unsurprising that 84 per cent of submitted information security risks are expected to 'increase' or 'increase significantly'. The sophistication of cyber criminals, the interconnectedness and complexity of the digital landscape, and public intolerance of data breaches and service interruption are all cited as trends increasing this risk.

Operational Risk Horizon

Summary: March 2018

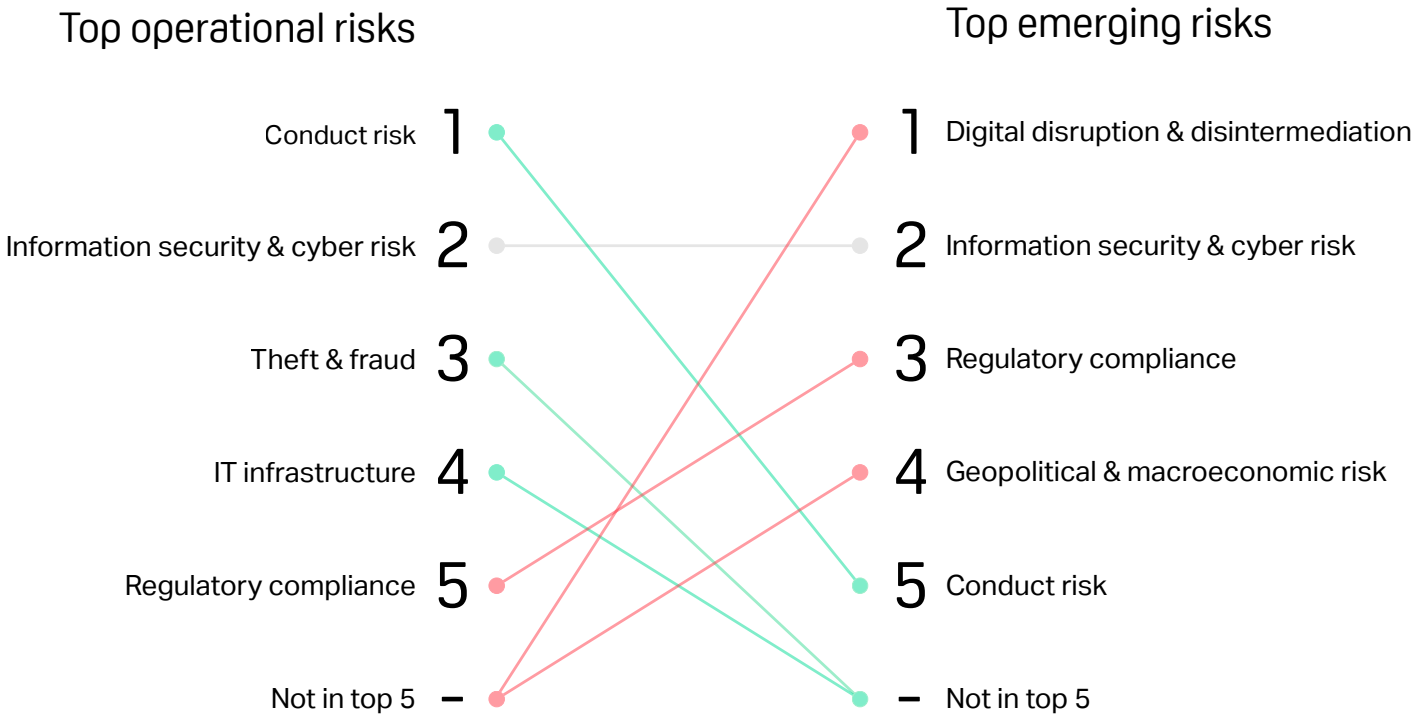
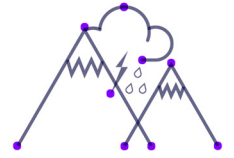
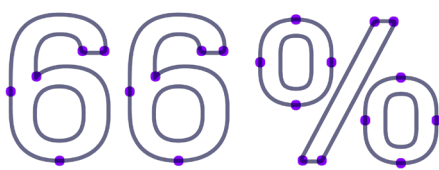


Figure 3. Top five operational risks by weighted aggregated score compared to top five emerging risks by weighted aggregated score.

New technology dominates emerging risks

Despite not entering the top 5 of the operational risk list, digital disruption is ranked the overall highest emerging risk category. This disparity suggests that there is considerable uncertainty about the impacts associated with fintech and digitalisation, as participants are yet to see the full effects of this change on the ground.

Participants note this disruption carries opportunity as well as unexpected risks. The need to quickly adopt new systems, adapt existing processes and introduce new products and services in aggressive timeframes can create new exposures and interdependencies that may not be fully understood.



of participants included digital disruption risks in their top 10 emerging risks

Information security also a major emerging risk

Information security and cyber risk is ranked second on both the current and emerging risk lists, showing that risks from hacking, data breaches and other cyber threats are expected to remain high.

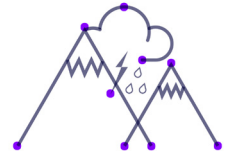
Responses highlight the ever-changing nature of the cyber security environment. Respondents noted the growing sophistication of cyberattacks, as well as the increase in non-financially motivated attacks.

Global uncertainty poses a significant challenge

Geopolitical and macroeconomic risks do not feature in the top five operational risks, but are ranked as the fourth most important emerging risk category. Chief concerns include the policy direction of the Trump administration and the uncertain consequences of Brexit, as well as ongoing tensions across Asia and the Middle East.

Operational Risk Horizon

Summary: March 2018



Top risks by region

There is remarkable consistency in the top risks across different regions. Conduct risk is the top ranking risk category in both Europe and Asia/Pacific, with respondents highlighting the risks associated with retail mis-selling and advice failures.

Both African and North American banks have information security as the top overall operational risk. North American respondents in particular note the growing sophistication of cyberattacks as they become a tool used by nation states to wage war.

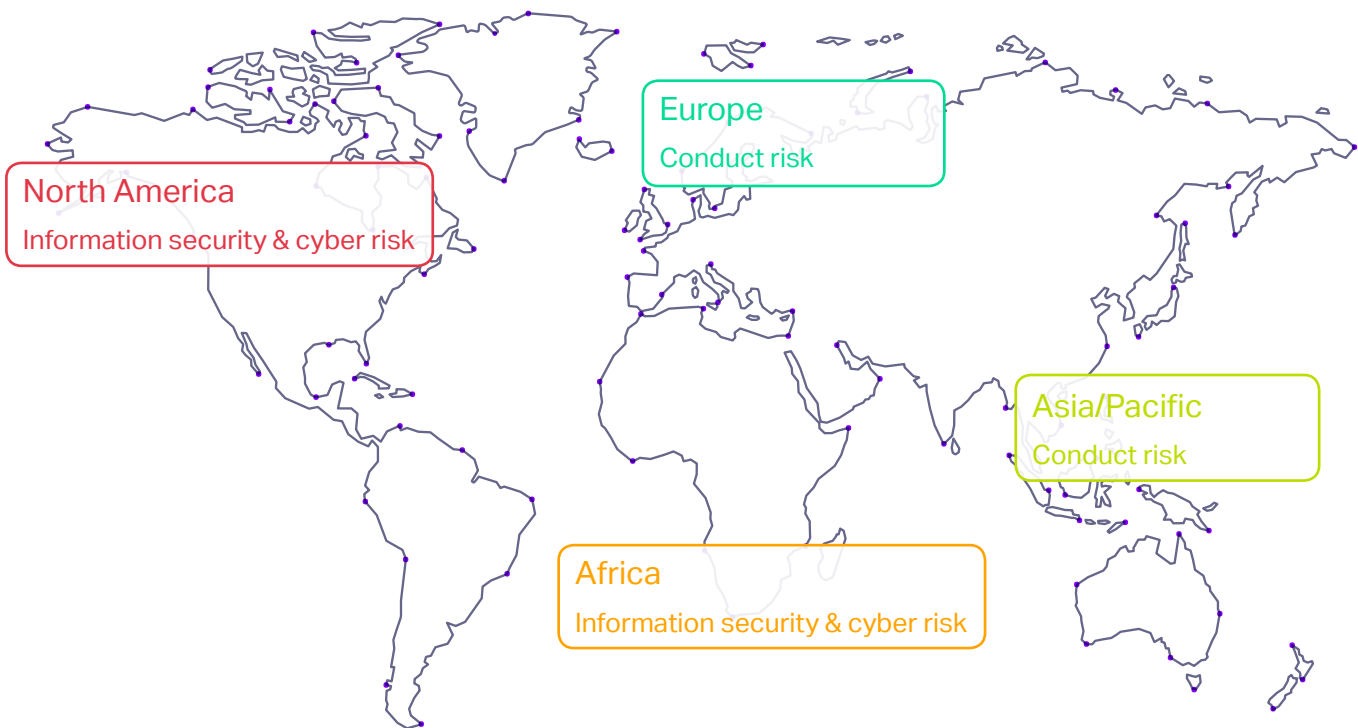


Figure 4. Map showing the top ranked operational risk category for each region by weighted aggregated score.

Risk descriptions

1. Conduct risk

Regulatory action and civil lawsuits resulting from unfair or illegal delivery of a product to customers, ranging from retail mis-selling to market abuse.

2. Information security and cyber risk

The threat of sophisticated cyber-attacks exploiting the sector's growing reliance on data and information technology.

3. Theft and fraud

Both internal and external theft and fraud carried out by individuals both known and unknown to the firm, with or without internal collusion.

4. IT infrastructure

Over-reliance on obsolete, underfunded or vulnerable technology infrastructure.

5. Regulatory compliance

Difficulty for institutions to meet multiple, complex and competing regulatory standards.

Operational Risk Horizon

Summary: March 2018



References

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Managing risk together

ORX believes many heads are better than one. We're here to bring the best minds of the international operational risk community together. By pooling our resources, sharing ideas, information and experiences, we can learn how best to manage, understand and measure operational risk and become less vulnerable to losses.

We work closely with over 90 member firms to develop a deeper understanding of the discipline and practical tools. We set the agenda, maintain industry standards, and garner fresh insights.

ORX is owned and controlled on an equal basis by its members.

For more information about ORX, visit our website at www.orx.org



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