Preventing the Operational Risk of Commercial Banks Based on Internal Control

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Abstract— This article starts with the relationship between of internal control and operational risk, then narrating the " the operational risk events of X, Y commercial banks in Harbin in the last three years " situation, described the operational risk of the two branches in detail, focusing on analyzing the causes of operational risk of two branches from the perspective of internal control, through the point to area, reflecting the common problems to explore a good policy to prevent and resolve the operational risk of commercial bank in China from the perspective of internal control, and ultimately establish a management system to manage the operational risk of Chinese commercial banks, effectively reducing the operational risk of commercial bank occur frequently in China.

Keywords— operational risk, internal control, risk events

I. THE RELATIONSHIP BETWEEN OF INTERNAL CONTROL AND OPERATIONAL RISK

Operational risk's endogeneity decide the inevitable relation between internal control and effectively managing operational risk . A comprehensive, scientific, effective internal control system is the main way which commercial banks manage operational risk.

A. Understanding of Internal Control is the Basis of Forming Philosophy and Culture of Operational Risk Management

In 2003 the Basel Committee issued the "Sound Practices for the Management and Supervision of Operational Risk " indicate that": " Banking institutions within the framework " is the basis of operational risk management." This reflects close connection between the operational risk and the internal control, and only understand the internal control system, can we truly understand the operational risk, the formation of philosophy and culture about operational risk management.

B. Operational Risk is the Risk which is Mainly Due to Imperfect Internal Control System

The current banking institutions facing operational risk is operational errors risk which is mainly caused by internal factors. That is, banking institutions operational risk mainly caused by the "internal processes, people, imperfect system and mistakes" , the bank's internal processes, people and system Improvement all belong to the scope of internal control system's construction, which If the errors appear, must be the result of the internal control system which is not perfect.

C. Strengthening the Internal Control System's Construction is the Bank's Main Way of Operational Risk Management

Basel Committee considered: capital constraint is not the best way to control operational risk, rigorous internal control mechanism is the first line of defense with which deal operational risk. For the external factors of the operational risk, commercial bank have no choice but to adopt risk mitigation measures such as insurance because the bank does not control external events. However, operational risk which is caused by internal factors is controllable, through strengthening the internal control system's construction, improving the bank's business processes, personnel arrangements and accounting systems, and strengthening enforcement, commercial bank can avoid internal errors and irregular operation to a considerable extent, thereby preventing operational risk.

II. THE CIRCUMSTANCES OF OPERATIONAL RISK OF X, Y, TWO COMMERCIAL BANK INSTITUTIONS IN HARBIN IN THE LAST THREE YEARS

A. The Circumstances of the Operational Risk Events of X Branch

According to the information documented from X branch, the branch accumulatively took place 171 operational risk events in the last three years (2006.12-2009.12), the direct economic losses reach up to ¥460 thousand, of which as a significant operational risk events had 12 pieces, the largest single loss was ¥280 thousand. The distribution of 171 pieces operational risk events: (1) the prone point of deposits and counter service had 41 pieces in total. There were 19 piece because of opening, changing and cancelling account, Verifying Seal system and managing seal cards, 14 large pieces were caused by large certificates of deposit issued and large deposits paid , important blank Certificate of management was 8; (2) accounting business prone points was 14 in total . The important accounting positions was 5, authorizing was 4, reconciliation was 5; (3) credit prone points was 38. Three examinations of loans was 18, credit management was 14, others was 6; (4) treasury prone point was 15. Transferred and transfer out of funds added up seven, Positions grouped took place 4, others was 4; (5) Intermediate business point reached up to 42. Included that bank cards and
credit, settlement and others was 8; (6) information systems prone to point added up 32. Included that the management of network systems was 12, the user and password management was 7, data information management was 4, the virus was 5 and the others had four.

B. The Circumstances of the Operational Risk Events of Y Branch

According to checking, bulletin and year-end assessment of the Y branch the last three years, we set up five levels: very good, good, ordinary, poor, very poor, on which based eight under the jurisdiction of the Y branch whose strengths and weaknesses of internal control, and Classified eight sub-branches according to five levels. Meanwhile, we list operational risk event data of the sub-branches the last three years (2006.12 -2009.12), and then united the two forms, we could discover that: even if the sub-branches are in the same Management Department, management results show large difference.


<table>
<thead>
<tr>
<th>The Name of Sub-branches</th>
<th>Operational Risk Events the Last Three Years</th>
<th>The Situation of Internal Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>sub-branches A</td>
<td>27</td>
<td>ordinary</td>
</tr>
<tr>
<td>sub-branches B</td>
<td>45</td>
<td>poor</td>
</tr>
<tr>
<td>sub-branches C</td>
<td>16</td>
<td>good</td>
</tr>
<tr>
<td>sub-branches D</td>
<td>9</td>
<td>very good</td>
</tr>
<tr>
<td>sub-branches E</td>
<td>14</td>
<td>good</td>
</tr>
<tr>
<td>sub-branches F</td>
<td>51</td>
<td>very Poor</td>
</tr>
<tr>
<td>sub-branches G</td>
<td>15</td>
<td>good</td>
</tr>
<tr>
<td>sub-branches H</td>
<td>6</td>
<td>very good</td>
</tr>
<tr>
<td>Total</td>
<td>183</td>
<td></td>
</tr>
</tbody>
</table>

III. THE ANALYSIS OF THE CAUSES OF OPERATIONAL RISK AS VIEWED FROM INTERNAL CONTROL

A. A Sense of Internal Control was Weaknesses, the Management Concept of Operational Risk Fell Behind

For the X branch, the occurrence of the branch operational risk events were so many, and direct economic losses reached up to ¥460 thousand; these related to weak internal control awareness and the lagging management of operational risk. For the Y branch, there were only two sub-branches whose internal control was very good in its jurisdiction eight sub-branches. To some extent, it reflected the sense of the branch's internal control is weak.

B. Internal Control Measures were not Perfect; the Ability of Operational Risk Control was not Strong

Practical internal control measures are key to achieving established internal control objectives and controlling operational risk for commercial banks.

For the X branch of operational risk events, we can easily found one of the reasons was the branch of internal control system which was not perfect and operational risk control which was not strong. For the Y branch, the internal control situation in its sub-branches had many differences, to which closely related its internal control measures were not perfect and operational risk control was not strong.

C. Information Exchange and Feedback Mechanism were not Unimpeded, Operational Risk Prevention was not Timely

For the X branch, there were many operational risk events to repeat themselves, that is, when some operational risk had occurred the relevant personnel didn't well distinguish, collect, process, exchange, communicate, feedback and disclosure the operational risk, so that managers couldn't fully understand and identify the operational risks which banks faced and the operational risks’ danger, and internal control systems get continual improvement, this couldn't play a warning bank and avoiding such cases happening again effect. For the Y branch, the sub-branches didn't well exchange and feedback information, the branch was not well understand and identify operational risks which bank faced and the operational risks' danger, so that the bank couldn't well resolve the operational risks.

D. The Power of Internal Audit was Weak, the Capabilities of Operational Risk Management Weakened

For X, Y branch, we could see the power of the internal audit was weak in the two branch, when the operational risk events had happened, internal audit department didn't well play a role in checking for errors and preventing loopholes, correcting violations, strengthening management, controlling risk, resulting in the same operational risk events occurred many times.

E. Lack of Effective Supervision and Restraint System

For X, Y branch, they lacked effective supervision and restraint system. Effective supervision and restraint system not only need to supervise the operation layer's position, but also need to supervise the management of senior managers. While the losses which key personnel committing the crime bring to the bank is much higher than normal operators.

IV. COMMERCIAL BANKS OF CHINA OPERATIONAL RISKS’ PREVENTION BASED ON INTERNAL CONTROL

From the above analysis of the reasons we can know, reliable internal control system can effectively prevent bank's operational risk, banks should adopt a comprehensive internal control framework and policy procedure to provide perfect internal control, fundamentally to reduce and prevent banks' Operational Risk

A. Improving the Professional Quality and Personal Qualities of Staff to Build "People-Oriented" Internal Control Management System

In an enterprise culture, the extent of integrity and the
In view of the commercial banks risk management philosophy that there are limitations, commercial banks establish a correct concept of operational risk management. First, commercial banks should strengthen internal control and risk management awareness when they rapidly develop, especially to operational risk awareness, commercial banks should recognize and grasp the operational risk in whole, comprehensively view operational risk events. In particular, commercial banks should strengthen advance prevention of the operational risk. Second, the operational risk may be hidden in each department in the commercial banks, so managing operational risk is the affair which all sectors of commercial banks should do, can not simply think that the operational risk management is only the internal audit department (or the audit oversight) to do.

D. Strictly Enforce Internal Control, Establish a Rationally Organizational Structure, Improve the Risk Assessment System

Banks' organizational structure relates to management level, the department set and the division of responsibilities, and define the duties and tasks at all levels and departments in the bank. Rationally organizational structure is essential to the effectiveness of internal controls. Through the establishment of a reasonable structure, each level, each department managers fully understand their responsibility for internal control and prepare their experience and skills which is commensurate with the positions. First, based on strengthening the internal management system construction, commercial banks clear the responsibilities of all institutions, all departments and various operating positions, strengthen the management of authority, decentralization, specify decision-making process, implement checks and balances at all levels and departments to reduce the decision-making errors through scientific and rational allocation of Right and Responsibility. Second, commercial banks should establish a regular job rotation system. Job rotation system can increase learning opportunities for employees between departments and positions in primary bank, master a variety of business skills, find presence problems in business post timely, and take remedial measures to eliminate hidden dangers. E.g. commercial banks implement job rotation among accounting, treasury and savings from time to time.

Establish the corresponding index system of risk control. Improve the commercial banks of the index system of risk control, risk control mainly through the science of risk indicators to achieve, including a series of indicators of the security, liquidity and profitability of bank assets etc. And provide warning signal timely to strictly control the risk and eliminate the risk based on these risk indicators. Through sound risk control index system to enable the business departments’ mutual restraint, mutual supervision, not only the business sector should be given the authority, but also commercial banks prevent excessive concentration of power in a sector.

E. Establish Internal Audit and Supervision Mechanisms, Strengthen Supervision and Control Functions, thus Reducing the Operational Risk Caused by Key Personnel
Internal audit mechanism is an important link which is indispensable in banking supervision and internal control system, is the key to the establishment of internal control monitoring system; it plays a supervisory role in internal control.

Commercial banks should establish independent internal audit and supervision departments to monitor, evaluate and correct the operation of internal control which the banks find internal control deficiencies in this process, can directly propose trialed Institution for suggestion and urge its prompt improvement. Audit departments exercise comprehensive supervision and feedback internal functions, to ensure the independence and authority of the internal audit department, while establishing the audit penalty system and audit inspection system urge the implementation of the internal management measures and regulations. Meanwhile, commercial banks establish monitoring mechanisms with self-discipline, and strengthen self-regulatory functions. China Banking Industry Association is the self-regulatory organization of banking, with self-management, self-service, self-supervision functions. It is an integral part of internal control monitoring system, play a role in monitoring constraints, promoting the same bank exchange and specifying the same bank behavior in the internal control monitoring system.

Commercial banks should strengthen key positions and key personnel to monitor and take periodic censuses, irregular spot-checks, temporary assault inspection, scene inspection at night, telephone inquiry, etc., to increase inspection intensity of the execution of internal control system, urge staff to comply with rules and regulations, by regulating the operation, reduce the operation risk loss case which is caused by key personnel.

F. Improve Internal Control Information Exchange and Feedback Mechanism, Prevent Operational Risk Timely

In connection with domestic commercial banks weak current situation in the exchange and feedback of information link, China's banking need to further improve internal control mechanisms for information exchange and feedback, and effectively prevent the occurrence of operational risk events.

a) Commercial banks should improve the information sharing system between departments and branches to ensure effective information is acquired within a short period of time, and the staff needs to clear their own responsibilities, understand the facing operational risks of the state, improve at any time, and then complete the task better.

b) Commercial banks should continue to strengthen the superior and subordinate's, horizontal and external exchanges and communication, enabling managers to grasp the information which is related to operational risk and control, preventing and controlling the positions or links which may occur operational risk in time.

c) Commercial banks must establish a sound mechanism for public information disclosure, develop banks website, set up the information exchange platform among regulatory departments, the principals, the beneficiaries and commercial banks.

d) Commercial banks should establish information feedback mechanisms which timely track and report commercial banks internal control situation, to feedback timely operational risk events have occurred and sum up the lessons of these operational risk events in order to alert. Efficient information exchange and feedback internal control mechanism can accelerate aspects of information delivery of market, business, management, and great events and so on, ensure efficiency and effectiveness about the implementation of internal control system, timely prevent operational risk. Therefore, it is imperative to establish a sound internal control information communication and feedback mechanisms for commercial banks in China.

REFERENCES