

Houston, we had a problem



That enemy of business continuity, risk, can come in many different forms, but this is not to say it should be unexpected. And knowing your enemy and anticipating potential hazards is the greatest protection available.

Jillian Simms*

explains the importance of Business Continuity Management

If you held a large bond portfolio and thought interest rates were about to rise by 200 basis points, what would you do? You would either try to unwind your position or hedge your exposure.

If you thought a counterparty was about to default on payment, what would you do? You would either try to unwind your position or hedge your exposure.

If you thought your company might not be able to trade for a week or even longer, what would you do? The answer *should* be you would either try to unwind your positions or hedge your exposure.

Financial institutions are becoming increasingly sophisticated at managing market risk and credit risk, but the way they manage what might be termed 'business interruption risk' is lagging far behind. Insurance is no answer as claims are rarely processed quickly or met in full. Insurance cannot protect you against loss of reputation due to poor customer service or loss of revenue due to being unable to rebalance hedges. Insurance is of no use if you have defaulted on swap payments and have had your capital charge increased. The owners of the company may eventually get some money back, but you and your colleagues are likely to be looking for new jobs. Clearly, a better way of managing this risk is needed than just taking out an insurance policy.

Before looking for an answer, let us consider how market risk and credit risk are managed. No one would expect IT departments to design pricing models and risk management tools, conduct scenario analysis and stress test results without a detailed understanding of the business. The models and analytical tools are specified by the users, who have an intimate knowledge of the business and of the consequences of the risks. The IT department is then tasked with developing or buying the tools and implementing the solutions.

However, when the risk is of the company not being able to trade, it is left to the IT department alone to sort out the problem. How would an IT department be able to decide who or what is needed? The IT department may have details of everything and every-

body that is in the office, but as any cost-conscious organisation is aware, risk management is not about full replication. There needs to be a way of focusing on what is really needed.

A few enlightened financial organisations now truly subscribe (as opposed to paying lip service) to a process known as Business Continuity Management (BCM). This is a process by which an organisation can assess the impact and likelihood of business disruptions – such as building outages, telecoms failures and data corruption – in the same way as it conducts any other risk management. Business management owns the process and determines the acceptable level of exposure. For example, the management may state that customers should see no disruption in service, or it may state that the organisation must be in the position of managing its own financial risks and exposures at all times. Whatever strategy an organisation wishes to establish, the BCM process will enable the company to model the risks, exposures and impacts so that the mitigating actions and hedging activities can be designed appropriately.

Requirement specs

As with any risk management process, business management specifies its requirement and obtains both IT and non-IT resources to develop the models and implement the solutions. Scenario analysis, stress testing and other recognised risk management techniques are used to assess whether the proposed management of the risk is acceptable.

The current methodology many institutions adopt to manage physical risk is based on acquiring a contingency site. However, for a contingency site to be effective, it is necessary to qualify and quantify the risk it is hedging. You would not use a short position in short sterling futures to cover any exposure to rising interest rates any more than you should expect a few desks in an alternative location to cover all business activities for all disruptions.

The existence of a contingency site should not be an excuse to avoid trying to reduce risk. More professional organisations (ironically, usually those with the best developed contingency plans) expend considerable effort in trying to avoid the

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need to use the contingency site. Is the office in a high risk location, such as above a railway station or next to a river? Is the datacentre above a kitchen or below a mains water pipe? Are various business activities only conducted in one location or can they be conducted in one of many locations? By assessing and, where cost-effective, eliminating risk, organisations can usually reduce many of the potential threats of disruption to their business.

A contingency site is of little value if normal business activities are conducted in a way that makes it difficult or impossible to resume operations following a disruption. For example, a lawyer who progresses transactions using paper-based files may not have the files in a contingency site. The business should either not provide for that lawyer in a contingency site or instigate normal working practices that are recoverable. Similarly, if completed customer orders are written on paper deal tickets, and only entered into a settlement system at the end of the day, the settlement department will have no record of the business on the day of disruption. The normal working practice might usefully be re-engineered to ensure that details of any trade are faxed off-site as soon as an order is completed. Alternatively, an electronic deal capture system with real-time replication to a contingency site might be usefully introduced.

Many institutions leave the decision as to who should be located in the contingency site and what equipment these people need to an individual who has never worked at the sharp end of the business. In several cases, we have observed, the individual has no understanding of the business processes involved, and is too in awe of the front office to ask for guidance. As with any risk management activity, the use and

structure of the hedge should be decided and owned by the business itself, with management deciding the parameters of acceptable exposures.

For a business to make appropriate judgements about its needs in the event of a disruption, it needs to appreciate the value of business interruption risk management. Many institutions, such as equity fund investment managers, are more exposed to business interruption risk than market or credit risk, but have yet to understand this or communicate it to their people. Education is necessary if an institution is to adopt an appropriate risk management strategy. For example, recently a head of derivatives sales, when asked to describe the impact of disruption and what would be needed in contingency, insisted on structuring his recovery requirements differently if there was a flood rather than a bomb. He stated that if there was a bomb his team could not be expected to go to contingency covered in shattered glass and blood, but they would go to the alternative site if they were a bit wet! The same individual, if asked by a customer to structure a hedge for an imminent 1,000 point fall in the stock market, would not waste time asking why the market is expected to fall.

How much to spend?

Once Business Continuity Management is viewed as a hedging tool, the amount to spend on prevention, recovery, and contingency sites can be set using the usual risk/reward criteria associated with the use of any hedge. This approach is a dramatic change from the all-too-typical strategy of spending only what is left in the IT budget at the end of the year. An assessment of the value of having an item of equipment in the contingency site should be based on the impact of not having that equipment, rather than the ease of installation and the absolute cost.

For example, a leading institution has decided not to put Bloomberg in its contingency site for its 100 bond traders – all of whom are absolutely reliant on it – because of the cost. The same institution is putting in EBS, which only the two spot traders require, because the absolute cost was low. Of course the cost per head of the EBS is about three times the cost of

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Bloomberg, and there are many very low cost ways of obtaining similar information, but the IT department could 'tick the box' that stated a contingency system requirement had been satisfied without eating into too much of the budget.

Business Continuity Management is about taking a consistent approach across the whole organisation; that is, there must be sufficient settlement staff to settle the trades being executed, there must be research support for salespeople talking to customers, and there must be market and credit risk management people ensuring that all business is being conducted in a controlled manner.

Business Continuity Management should enable an institution to focus its business interruption risk management on key business drivers, what Cornwood Risk Management has characterised as the Three Rs – Revenue, Reputation and Regulation.

A business activity that is high risk and high impact might usefully be redesigned. For other business activities where there are significant risks and impacts, the institution may look to a hedge. The hedge may be a contingency site, accommodating some of the people if the activity is recoverable, or may be an alternative contingency arrangement, for example, requiring traders in alternative locations to work longer hours to cover a global trading book. For business activities that are low risk and relatively low impact, it might be appropriate to do nothing. Many business activities undertaken by institutions are essential if the business is to grow and develop, but can be interrupted in exceptional circumstances. In these cases it might be difficult to justify expenditure on contingency arrangements, but this should not denigrate the worth of these people to the institution.

Continuity

Business Continuity Management is about ensuring the essential functions of a business are continuous regardless of interruption or disruption. It is an ongoing process that needs to be regularly reviewed as a company changes and grows. For example, as businesses stake their reputation on continuity of

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e-commerce services, their business interruption risk strategy needs to be realigned in parallel. One leading financial organisation is currently spending a considerable amount of money on continuous e-commerce (no interruption to be greater than five minutes), whilst having a business interruption policy which states that in the event of a disruption to its traditional business, it will not transact new business for three days. This strategy would imply that immediate contingency is needed for e-commerce managers but market makers could wait for three days. The question must be asked: would an e-commerce failure of more than five minutes have a greater impact on the organisation's reputation than an inability to facilitate its core business for several days?

Firms simply cannot continue to compromise their futures by relying on disasters only happening to others. It is, in short, time to manage your business interruption risk and establish proper Business Continuity Management as an integral part of your organisation's business strategy. ❖



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