



**Merrill Lynch & Co.**

**Process Risk Management Program**



## **ML Process Risk Management Program**

---

- **The Process Risk Management function at Merrill Lynch is focused upon motivating two key management practices**
  - **Learning from mistakes; and**
  - **Assessing the adequacy of controls for the risks we take**



## **ML Process Risk Management Program**

---

- **These two simple practices have as their aim the reduction in losses from Process Risks – defined as:**

**The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events**



## **ML Process Risk Management Program**

---

- **To the extent we compute and allocate risk capital for Process Risk (and we do), it is done purely as incentives to motivate these practices – which is important in the context of this conference.**
- **The implication is that the key criteria in determining the methodology for allocating capital for Process Risk is that it provide the proper incentives for business units within the firm to adopt these management practices.**





## **ML Process Risk Management Program**

---

- **Learning from mistakes involves the following**
  - **identifying and reporting process risk losses systematically**
  - **conducting postmortems on losses to establish clearly the cause and corrective action**
  - **implementing the corrective action**



## **ML Process Risk Management Program**

---

- **Assessing the adequacy of controls for the risks we take involves**
  - **a risk self-assessment program in which managers map their processes, assess key linkages and risk of process failure**
  
  - **and evaluate the effectiveness of compensating controls**

**This essentially amounts to thinking clearly about the way in which we conduct business.**



## **ML Process Risk Management Program**

---

- **There are policies providing guidance on implementing these standards**
  - **how loss events are recorded and escalated**
  - **management actions required at different levels of materiality in losses**
  - **formal reviews with management of the findings**



## **ML Process Risk Management Program**

- **Internal risk capital for Process Risk is allocated to business units using a method similar to the Loss Distribution Approach**
  - **we have an internal data record of losses which provides frequency and severity estimates**
  - **from this we estimate the level of loss associated with a given statistical confidence**
  - **which is allocated based upon an assessment of internal controls conducted by control functions and business management**





## **ML Process Risk Management Program**

- **As a predictive model for potential loss for process risk, this is inherently imprecise.**
- **It is not subject to the sort of empirical verification that can be conducted upon market and credit risk models.**
- **The key criteria for developing the model for us has been how well it motivates managers to adopt the practices we have endorsed. The internal mechanics of the model are a secondary priority – and become important only in so far as they influence behavior in the firm.**



## **ML Process Risk Management Program**

---

- **To this end, business units receive reductions in their risk capital allocations to the extent they engage in the practices prescribed by the program – and for initiatives which result in demonstrated reductions in process risks.**
  
- **Conversely, failure to implement causes increases in allocated capital.**



## **ML Process Risk Management Program**

- **Given our view that it is behavior – not quantitative modeling – that is important in managing process risk, our comments on the Basle proposal are as follows:**
  - **the objective of regulation should be to motivate management to create robust process risk controls and procedures**
  - **this is consistent with the treatment of process risk as a Pillar II supervisory review issue**
  - **the current proposal to capitalize process risk under Pillar I has framed Process Risk as a quantitative modeling problem – not a management control problem**
  - **perhaps an unintended consequence of this is that the message sent by the regulatory community to the industry is that process risk is adequately addressed by the computation of a capital figure – as opposed to the creation of controls.**





## **ML Process Risk Management Program**

- **In summary, the key message is that management practices that oversee the effectiveness of controls critically determine the likelihood of losses – and preparation for unanticipated external events.**
- **This should be the focus of regulators.**
- **The current regulatory focus on quantitative modeling risks framing the entire topic as a complex computational problem.**
- **Our recommendation is that you allow the industry to provide leadership in pioneering the management disciplines that prove effective at controlling process risk – and then develop risk models that support the implementation of those disciplines.**