

Setting Up a Key Risk Indicator System

Checklist

This checklist describes what a key risk indicator (KRI) system is, how they can assist management, and why you should consider setting one up.

Definition

Key risk indicators (KRI) are measurements that are used by management to show how risky an activity is—a project or an investment, for example. They are called key because they warn of the most obvious areas where problems may arise. KRI help to flag up warnings of a possible adverse impact arising from an activity in the future.

In the United States the Risk Management Association (RMA) manages an initiative that is designed for financial services companies interested in improving their risk management. Going by the name of the KRI Library and Services, its aim is to achieve a degree of consistency and standardization to enable KRI to be compared, analyzed, and reported at the corporate level. The RMA's intention is that the library initiative will lead to distinct improvements in the effective use and benchmarking of KRI with peer groups.

Most companies find the development of effective KRI to be a key challenge. In financial institutions there are plenty of credit risk and market risk indicators, many with frameworks set out within existing financial legislation. However, pulling these data together and developing operational risk indicators is not easy. Conversely, nonfinancial institutions may be in possession of a mass of business and quality information gained from balanced scorecard and quality initiatives. However, their difficulty lies in developing KRI for financial risk or technology risk.

All companies have the awkward task of developing KRI that can provide effective early warning of potential future problems.

It is in the area of forecasting losses that KRI are most likely to gain their stripes, but the majority of companies have yet to master the techniques of setting up effective KRI systems that can do this.

Advantages

- KRI can provide early warning of future losses or other problems.
- They are useful in supporting management decisions and actions.
- They can be benchmarked both internally and externally.

Disadvantages

- Mastering KRI has proven difficult to date.
- The company has to believe in them, even though past history may not fully support their value.

Action Checklist

Some of the following resources can be useful in helping create your own KRI list.

- Policies and regulations, particularly those that are aimed at regulating the business activities of the company. Such KRI may include risk exposures relating to compliance with regulatory requirements and standards.
- Strategies and objectives. Corporate and business strategies, as established by senior management, are a good source.

- Previous losses and incidents. Databases containing historical losses and incidents can provide useful input on what processes or events can cause losses.

Dos and Don'ts

Do

- Make your KRI quantifiable.
- Base KRI on consistent methodologies and standards.
- Track them along a timeline against standards or limits.
- Link KRI to objectives, risk owners, and standard risk categories.
- Run regular overviews to check that your formulae are still relevant and accurate in assessing risk.

Don't

- Don't complicate risk.
- Don't be too simplistic.
- Don't put 100% faith in your initial KRI.

More Info

Books:

- Alexander, Carol. *Mastering Risk, Volume 2: Applications. Your Single-Source Guide to Becoming a Master of Risk*. Mastering Series. Upper Saddle River, NJ: FT Prentice Hall, 2001.
- PricewaterhouseCoopers for Committee of the Sponsoring Organizations of the Treadway Commission (COSO). *Enterprise Risk Management—Integrated Framework*. New York: AICPA, 2004. Hard copies (two volumes) can be ordered from COSO (www.coso.org) or from the Institute of Internal Auditors (www.iaa.org.uk)

Websites:

- KRI Library Services (US): www.kriex.org
- The Institute of Risk Management (UK): www.theirm.org
- The Risk Management Association (US): www.rmahq.org/RMA

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