

## **Response to feedback received**

### **Operational Risk**

#### **Introduction**

The Operational Risk policy document sets out the Bank's supervisory expectations on a financial institution's operational risk management framework and forms the basis for the Bank's supervisory assessments. The policy document is applicable to licensed banks, investment banks, Islamic banks, international Islamic banks, insurers, takaful operators, international takaful operators and prescribed development financial institutions pursuant to the Financial Services Act 2013, Islamic Financial Services Act 2013 and Development Financial Institutions Act 2002.

The Bank received a significant number of responses from the industry during the consultation period that were broadly supportive of the proposals set out in the concept paper. This document provides the Bank's responses on the comments received during the consultation period. Where appropriate, comments received on the concept paper have been reflected in the final policy document.

**Bank Negara Malaysia**  
**10 May 2016**

## **1. Specific requirements applicable to active financial market players (AFMP) and large financial institutions (LFI)**

- 1.1 The Concept Paper introduced specific requirements for LFIs to establish a dedicated sub-committee (paragraph 9.3) and to establish an embedded operational risk function (paragraph 9.8) at each significant business or functional line. AFMPs are meanwhile required to ensure that their operational risk appetite statement includes all major operational risks associated with the financial market activities that the institution is involved in (paragraph 8.5), in addition to having the embedded operational risk function.
- 1.2 This section elaborates some of the comments received in relation to these requirements, and the Bank's responses to them.

### **Dedicated sub-committee**

- 1.3 Several respondents asserted that the requirement for a dedicated sub-committee is unnecessary given the existence of senior management oversight on operational risk. Several other respondents also recommended that where a sub-committee already exists for the management of the business or functional line, institutions should be allowed to leverage on the existing sub-committee for compliance with the policy requirement.
- 1.4 While the industry assertion on the senior management oversight may be appropriate for small financial institutions, a dedicated arrangement to deliberate operational risk issues at each significant business or functional line ensures better support to the enterprise-wide oversight of operational risks in the following ways:
  - a. ensures that senior management devotes adequate and timely attention to relevant risks at significant business lines which can have a material impact on the institution;

- b. provides a strong and in-depth focus in managing specific operational risk issues within the business and functional lines, and encourages the development of a deeper level of competence in the business area; and
  - c. promotes greater risk ownership and pro-active operational risk management at each significant business or functional line.
- 1.5 Consistent with these advantages, the Bank's industry-wide review of operational risk management practices within financial institutions shows that among large financial institutions with strong operational risk management capabilities, the deliberation of operational risk issues at the significant business or functional lines is already a common practice.
- 1.6 The Bank however agrees that specific organisational arrangements may differ between institutions. Accordingly, the policy document has been revised to provide greater flexibility for financial institutions to determine the appropriate organisational structure to achieve the required focus and attention on the management of operational risk at the significant business or functional lines. This includes the ability of financial institutions to leverage on existing governance structures to meet the requirements of the policy document. A financial institution must be able at all times to demonstrate that operational risk issues specific to the business or functional line are being effectively identified, assessed and managed.
- 1.7 There were also queries from respondents in relation to the determination of significant business and functional lines. The Bank has not prescribed a definition of what constitutes a "significant" business and functional line in the policy document as financial institutions would, as part of sound risk management practice, already be aware of businesses and functions that are material to the institution based on its business objectives and risk assessments.

## **Determination of AFMP and LFI**

- 1.8 Several respondents requested further clarification on the determination of AFMP and LFI to enable financial institutions to plan for the adoption of the specific requirements, if required.
- 1.9 The policy document provides a revised definition of AFMP and LFI that hinges on the financial institution's criticality to the financial market and its relative presence in the industry, respectively.
- 1.10 The Bank expects each financial institution to conduct a self-assessment on whether the specific requirements intended for AFMP and LFI would be relevant to them. The self-assessment should take into account the institutional risk profile, historical loss data, number of significant business lines within the institution, its market share (e.g. in terms of assets, liabilities, revenue and premiums), number of subsidiaries, branches and agents, number of transactions, and other business considerations that could give rise to major operational risk.

## **Applicability for financial groups**

- 1.11 Respondents from financial groups requested clarification on the scope of applicability of the policy requirements. Additionally, respondents also sought greater clarity on whether an LFI in a financial group is allowed to leverage on existing group arrangements in cases where the group is organised such that the business or functional lines are centralised and cut across entities within the group.
- 1.12 The policy requirements are expected to be applied at the entity level. Where an LFI is part of a financial group, the financial institution may leverage on existing group arrangements and policies to the extent that they are consistent with the requirements of the policy document and effectively address operational risks at the entity level.

## **2. Operational risk appetite and limits**

- 2.1 Several respondents have requested for further guidance on the expectations proposed in paragraph 8.4 of the Concept Paper which requires the operational risk appetite to be supported by specific operational risk limits and aggregate operational risk limits that reflect a financial institution's tolerance towards operational risk.
- 2.2 The requirement is intended to ensure the risk appetite and the risk limits set by the Board are sufficiently clear such that they can be effectively operationalised and observed by the control functions as well as the business and functional lines in the institution. The requirements have been redrafted (paragraphs 7.8 and 7.9 of the policy document) to provide greater clarity on the expectations to achieve this intended outcome.

## **3. Use of scenario analysis**

- 3.1 Several respondents suggested for the requirement to use scenario analysis for the identification and assessment of operational risks to be streamlined with requirements under the Operational Risk Integrated Online Network (ORION). Some respondents from the insurance industry also requested clarification on whether the use of stress test results pursuant to the Guideline on Stress Testing for Insurers would suffice to meet the expectations of the policy document.
- 3.2 The scenario analysis conducted as per the policy requirements may be streamlined with the scenario analysis submitted for ORION reporting as both are intended to help financial institutions identify and assess major operational risks and facilitate appropriate mitigation actions.
- 3.3 Stress test scenarios may be useful in identifying and assessing operational risk. However, to leverage on the stress testing results, financial

institutions should ensure and be able to demonstrate that operational risk exposures have been adequately reflected in the stress test scenarios.

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