Operational risk management in the financial services sector

Institutions in the banking and insurance sector are being prompted to design and improve operational risk management methodologies because of the changing regulatory environment, conclusions drawn from the deficiencies of risk management approaches previously applied, and the emergence of an added value side to risk management. The operational risk management services of our KPMG’s Financial Services practice, specialised in the financial services sector, provide a stable foundation for regulatory compliance and the efficient integration of operational risk management into everyday business operations, and can make a contribution to long-term business success.

Significance of operational risks

Nothing proves the importance of operational risks more than the fact that the operational risk capital requirement of the international and domestic financial system compared to the total capital requirement is substantial: according to 2010 figures the operational risk capital requirement accounts for 11% of the overall capital requirement in the Hungarian banking sector, and 4% in the international insurance sector. The significance of operational risks is further enhanced by interconnection with other types of risk, which can create extreme situations that are capable of shaking the very foundations of an entire financial institution (take Société Générale for example, where the joint impact of market risks and operational risks caused massive losses for the bank).

Challenges of the regulatory and business environment

Managing operational risks appropriately is a major challenge for Hungarian banks and insurance companies. Banks are further ahead in terms of designing operational risk management systems, and for them the main challenge is improving their framework systems; insurance companies on the other hand still have to create their frameworks.

Regulatory compliance

Basel II, introduced into the Hungarian banking system from 1 January 2008, and the regulations including Solvency II expected to be rolled out in the insurance sector from 1 January 2014 focus closely on operational risk management and create many challenges for organisations in the financial sector.

Risk-based review of business processes

Effective use of resources, increasing business efficiency and creating an operational environment defended of significant risks require that operational risk management be embedded more deeply into everyday routines. Integrating business performance management and operational risk management is not an easy task; it not only implies harmonising business performance and operational risk management, but also calls for a complete change in culture and mentality.

Our services

In the field of operational risk management our KPMG’s team helps to ensure effective compliance with regulatory requirements as well as integrate business performance management and operational risk management and create synergies.

We assist with regulatory compliance in the following areas:

- **Gap analysis**, where we assess to what extent the company complies with Basel II and Solvency II guidelines on operational risk management. Using the results of the gap analysis we determine what else needs to be done by the bank or insurance company, for which we can also prepare an action and resource plan to facilitate planning and implementation.
• Design, implementation and fine-tuning of operational risk management frameworks, which – based on client requirements – includes defining the “risk appetite”, helping to prepare a risk strategy, creating the organisational framework for operational risk management in line with the organisation’s size and complexity, supporting the identification of operational risks and conducting qualitative and quantitative assessments. When identifying and evaluating operational risks we help our clients to collect and analyse loss data, prepare self-evaluations and risk maps, set up key risk indicators to forecast risks, prepare scenario analyses to identify events that rarely occur but which imply significant losses and to quantify the impacts of these losses, and use as well as analyse external data. We also help in drafting appropriate risk mitigation measures and planning monitoring systems for operational risk management.

• Support of preparations for validation and pre-validation, which in the field of operational risk management involves gap analyses prior to supervisory authority reviews, expert support with implementations and targeted assistance in preparing for supervisory reviews (e.g. preparation of validation materials, training, conducting mock interviews) with a view to ensuring successful validation and regulatory compliance.

In terms of business performance management and operational risk management integration, as well as creating synergies, we help in the following areas:

• Creation and implementation of an integrated approach, which helps to exploit the synergies between the business and risk management processes of banks and insurance companies; this in turn facilitates decision making, more efficient analyses of business opportunities, and markedly increases the acceptance of operational risk management. During our work we review the business processes, structures and operations of the bank/insurance company, identifying the areas where integration is an option. At the business areas identified in this manner (e.g. internal audit, compliance, business continuity management, information security, quality management) we map the contact points (e.g. comparing BCP, DRP and BIA with scenario analysis and review processes). Using the results we draw up various methodological concepts on integrated risk management in the various fields, and provide professional support in implementing the concept.

• Change management and efficiency improvements, which help to embed operational risk management more deeply into business processes. The need for change management is brought on primarily by the decentralised nature of operational risk management and the antipathy from having to recognise one’s own mistakes. To overcome this we support our banking and insurance clients in setting up change history diagnosis procedures – which includes analysing involvement and assessing the reasons for change readiness and the case for change – before using these to establish an internal communication strategy. We expand these exploratory analyses with various efficiency tests (assessment of loss data collection procedure, assessment of labour expense and profitability), and base an action plan on the results of the two types of analysis.

• Improvement in data quality and reporting, during which we examine data collection sources and the results of reconciliation from the perspective of data quality. We propose a data quality concept and/or data quality procedures, thus ensuring the continuous operation of a suitable data control system, which is a prerequisite for running a risk management system to the required standard. Our service also includes making recommendations to improve reporting processes and management information services related to operational risk management.

It is vital for banks and insurance companies to manage operational risks as efficiently as possible, not just to comply with regulatory requirements but also to help their organisations achieve long-term business success. Our advisors will gladly assist in implementing these challenging tasks and carrying out related activities.

In addition and parallel to these services we support our clients with regular quality assurance advice, training courses and workshops, not to mention customised presentations on operational risk management.

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