

OPERATIONAL RISK

Operational Risk Losses among Financial Institutions Remained Small but Emerging Risks Warrant Close Vigilance

Occurrences of operational risk incidents in the financial system have risen amid increasing digitalisation and greater reliance on third party service providers. Nevertheless, the number of and total losses from these incidents have remained insignificant for banks, insurers and takaful operators relative to the volume of intermediation activities.

For banks and development financial institutions, total losses in 2019 from the materialisation of operational risk events accounted for 0.7% of total profit before tax, compared to 3.1% for credit risk

losses. Almost all of the operational risk losses were attributable to trade finance related fraud, involving the recycling of used bills of lading and invoice reference numbers for fictitious trades. Such fraud continues to account for a small portion of the total trade finance exposures.

In the insurance and takaful sector, operational risk losses were largely driven by fraudulent claims, typically in relation to exaggerated vehicle accident damage or injuries, and staged accidents or thefts. As these types of fraud often involve multiple parties, many cases are difficult to prove and often remain unreported as fraud. Consequently, total reported losses from the materialisation of operational risk events in this sector accounted for a much smaller proportion of total profit before tax (less than 0.5%).⁴⁷

Financial institutions' internal safeguards to detect and address fraudulent activities thus far have kept losses low. However, financial institutions should

Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events (Table 1.4). It is inherent in all activities, products and services of a financial institution. Often, operational risks materialise in the form of fraud, physical damage, transaction failures and business disruption. This may result in direct as well as indirect financial losses, for example, loss of business and market share due to reputational damage.

Table 1.4

Characteristics of Operational Risk

Idiosyncratic	The operational risk profile of a financial institution is unique to its internal processes, people and systems. For example, an institution that is reliant on manual processes is more at risk of human error, while an institution that is reliant on IT systems is more at risk of IT system failures.
Multifarious	Operational risk can traverse multiple business lines and external parties associated with the institution. For example, disruptions to an institution's critical system can be caused by the failure of a third-party service provider to follow terms of a Service-Level Agreement. Conversely, operational failures in a financial institution can affect other institutions through connections to a shared infrastructure.
Fat-tailed distribution	Most of the time, operational risk events incur small-scale losses, such as fraudulent insurance claims. However, some operational risk events, such as a cyber-attack on a major payment system infrastructure, could lead to severe disruptions in the provision of financial services and erode public confidence.
Difficult to model	The fat-tailed nature of operational risk losses, the absence of a clear link with macroeconomic factors, the lack of historical data and difficulty in mapping past operational loss events ⁴⁸ are among the factors that make operational risks particularly challenging to model. Risk modelling is also constrained by the evolving nature of a financial institution's operational risk profile with on-going changes in its business model, internal processes and the operating environment.

⁴⁸This is because the realisation of losses from an operational risk event may only happen some time after the occurrence date, for instance, losses incurred from a fraud event may only materialise well after the fraud event has occurred

Source: Bank Negara Malaysia

⁴⁷ This is an estimation as the Bank continues to refine the operational risk data reporting by insurers and takaful operators to improve the industry's quality and consistency in reporting.