FINANCIAL SUPERVISORY COMMISSION
OF THE
COOK ISLANDS

Banking Prudential Statement

BPS10

<u>Operational Risk</u>

Objectives and key requirements of this Prudential Statement

This Prudential Statement aims to ensure that all banks control operational risk by adopting a prudent operational risk management framework, centered on comprehensive policies and procedures. These policies and procedures must particularly apply to the recognition, measurement, reporting of and control of operational risk.

The key requirements of this Prudential Statement are that a bank must:

- have an effective operational risk management framework that is supported by a robust system for the prompt identification, monitoring, measurement and control of its operational risk that is commensurate with the nature, scale and complexity of the institution;

- regularly review its operational risk management systems, taking account of changing operating circumstances, activities and risks.

Contents

Authority

1. This Prudential Statement is issued by the Financial Supervisory Commission (FSC) in accordance with section 65 of the Banking Act 2011 (the Act).

Application

2. This Prudential Statement is applicable to all financial institutions licensed under the Banking Act 2011.

Definitions

3. This Prudential Statement has used the following terms, which unless otherwise indicated, have the meanings specified below:

    3.1. **Bank** – an entity licensed under the Banking Act 2011.

    3.2. **Operational risk** – defined under paragraph 4 of the Prudential Statement.

    3.3. **Operational Risk Appetite** – a statement providing a clear direction from the Board and senior management of its expectations for the level of operational risk it is willing to accept in pursuit of its strategy and business objectives. A risk appetite is expressed in the form of both high-level qualitative statements and where appropriate, quantitative measures.

    3.4. **Operational Risk Management Framework** – systems, structures, policies, processes and people within a bank that identify, measure, monitor and control operational risk.

Key principles

4. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

5. The key components of operational risk are:

    5.1. internal and external fraud;

    5.2. employment practices and workplace safety issues;

    5.3. clients, products and business practices;

    5.4. damage to physical assets;

    5.5. business disruption and system failures; and

    5.6. transaction processing and process management failures.

6. It is the responsibility of the Board of Directors (Board) and senior management of a bank to oversee the nature and level of operational risk within the bank. This responsibility includes ensuring that a bank has in place:

   6.1. operational risk management policies, procedures and controls appropriate to the complexity, scope and scale of its business;

   6.2. appropriate controls to ensure compliance with the bank's stated policies and procedures, applicable accounting framework and the requirements of this Prudential Statement; and

   6.3. a realistic assessment of the inherent operational risk of the bank's operations.

Board and Senior Management Responsibilities

7. The Board and Senior Management (management) are responsible for the sound management of the bank's operational risk and must ensure the bank has a robust operational risk management framework to manage this risk accordingly.

8. The Board must establish an operational risk appetite and adopt an operational risk management framework in accordance with the operational risk appetite.

9. The Board and management must establish a system of independent ongoing operational risk review that provides the Board with regular information about the components of operational risk.

10. A bank's senior management must, at a minimum:

    10.1. develop the operational risk policies and processes in accordance with the Board-approved risk appetite;

    10.2. determine the structure, responsibilities and controls for managing operational risk;

    10.3. ensure that the bank has adequate internal controls to safeguard the integrity of its operational risk management processes;

    10.4. establish a set of reporting criteria specifying the scope, manner and frequency of reporting for various recipients (such as the Board, Senior Overseas Officer, senior management and the risk and credit committees) and the parties responsible for preparing the reports;

    10.5. closely monitor current trends and potential market developments that may present challenges for managing operational risk, so that appropriate and timely changes to the operational risk management framework can be made as needed; and

    10.6. continuously review information on the bank's operational developments and report to the Board or Senior Overseas Officer on a regular basis.

11. A bank must identify and manage operational risk inherent in all products and activities. The bank must ensure that the risks of new products and activities are subject to adequate procedures and controls before being introduced or undertaken, and approved in advance by the Board or its appropriate committee.

Operational Risk Management Framework

12. The bank's operational risk management framework must at a minimum include:

    12.1. a statement of the bank's operational risk appetite, representing the amount of operational risk that the Board is willing to accept in the bank, in order for it to meet its strategic objectives;

    12.2. a robust management information system that produces data and other information required for adequately assessing the operational risk exposure of the bank, for all operational risk components;

    12.3. a defined organisational structure for operational risk management;

    12.4. an operational risk management policy;

    12.5. policies, procedures and controls, for identifying, measuring, monitoring and controlling its operational risk in accordance with its operational risk appetite;

    12.6. senior management and other relevant personnel that have the necessary experience to manage operational risk;

    12.7. regular reporting on the existing operational risk of the bank, and information on new or emerging operational risks; and

    12.8. annual review and approval by the Board.

13. A bank's operational risk management framework must include comprehensive documented policies, procedures and controls addressing at a minimum the following:

    13.1. board and senior management responsibilities;

    13.2. the identification, measurement and control of operational risk;

    13.3. outsourcing of material business activities *(refer also to the Banking Prudential Statement on Outsourcing)*; and

    13.4. business continuity management *(refer also to the Banking Prudential Statement on Business Continuity Management).*

14. A bank's operational risk management framework must clearly set out the organisational structure as it relates to managing operational risk for the bank, and define the roles and responsibilities of management and staff involved.

15. The operational risk management framework must be subject to effective and comprehensive independent review on an ongoing basis. In most cases, the independent reviews could be facilitated by a bank's internal audit function but may require the engagement of parties outside of this function.

Issuance Details

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By Commissioner	
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