

Operational risk in Latin American financial institutions. Current situation and trends

According to the Report prepared by everis on:

“The operational risk of financial institutions in Latin America”

FINANCIAL INSTITUTIONS SEE A COMPETITIVE ADVANTAGE IN RISK MEASUREMENT SYSTEMS

For 80% of institutions, regulatory compliance has stopped being the only driving force of the changes, to be a consequence of the implementation of a new management scheme of the business, whereby losses of up to 20 million euros can be avoided.

Madrid, April 2005. The report prepared by Everis among the main financial institutions of Brazil, Chile and Mexico shows that Latin American institutions are in the same line as the Spanish ones with respect to their concern for measurement of Operational risk.

The study focuses its analysis on two fundamental aspects of the risk: where the operational risks of the institutions arise and how the monitoring of their evolution has been measured and performed.

As the Report indicates, two effects coexist in Latin American financial institutions, regulatory obligation, increasingly closer and the positioning of the institutions in increasingly complete management schemes which provide them with competitive advantages. To this we need to add that Operational risk is one of the least typified and the estimate that larger institutions have made of this study is that their operational risks could exceed 20 million euros.

Nevertheless, irrespective of the country or sector analysed, all the institutions have shown differences between the perception of the institutions on where they should focus their attention to control Operational risk and its reality, which, in this case, has been measured using the **everis** Operational risk coefficient.

This coefficient is calculated based on two criteria

- Exposure and vulnerability, which combined provide a measurement of the “strength” of an organization to avoid operational risk events in accordance with the safeguards it has foreseen.
- Mitigated exposure and Frequency– which can jointly measure how great the potential loss of an institution may be when the loss event occurs.

The main difference generally arises because the institutions intuitively identify the critical areas by only weighing up the value of its potential loss and they do not jointly evaluate the two above criteria. Therefore, in some cases, the areas that the institutions consider as focus of attention are also those with greatest strength and have more safeguards and, therefore, are sufficiently “controlled”. The institutions could focus their efforts on those in which one of the criteria used in the **everis** coefficient are more unbalanced.

Areas with greater Operational risk

The institutions perceive the following risk types as critical: process management, control of external fraud and interruptions in the business and system failures.

If we analyse the concentration of Operational risk only by the Business Line, the line which stands out is that of Company banking, which represents 18% of the total analysed, being the second Business line in importance of the region.

The size of the institution influences the measurement of Operational risk

The larger the institution the worse positioning it shows in the situation of Operational risk, although with a greater maturity in its perception of the Operational Risk Map (greater affinity to reality). These institutions, despite the fact that the potential risks can be very high, are those with fewer safeguards.

If we deal with the country criteria, there is no template for the region since Brazil has greater permeability to risk whilst Mexico has greatest potential losses. Considering the overall Operational risk coefficient, Chile has the best positioning.

The institutions opt for advanced tools for risk measurement

The tools which are now generally being used are Self-assessment (33%) and Process Maps (23%) since they are the ones which allow improving knowledge on the organization. After this first step and with an eye on the future, the institutions are opting for tools which allow information to be managed in a complete and integrated manner. More oriented towards quantifying the information obtained by indicators and Alarms (31%) and Databases of Operational Losses (33%).

Organizational impacts of a new management model.

All the institutions perceive that, once they have achieved the first objective of raising awareness on the relevance and impact of operational risk, especially in large institutions, the main organizational impact that the use of the overall risk assessment as management measurement can come to have is the monitoring of the Risk Control Objective by Areas, which will significantly change the schemes used for setting objectives and calculating the results and their compliance.

Scope of the study

The analysis carried out in banking in Brazil, Chile and Mexico has involved an average coverage over 50% of its financial sector.

The total number of institutions analysed is distributed in accordance with their size equally in three ranges (small, medium and large segment), although 66% of the business is represented in the Large Segment.

The average distribution of the institutions analysed, complying with the eight lines defined by Basel, corresponds to that of an organization mainly oriented towards retail banking (43%).