MEMORANDUM

The Danish FSA

2 May 2016

Statement on inspection of operational risk at Sydbank A/S

Introduction

In November 2015 the Danish FSA conducted an inspection of Sydbank's management of operational risk. The inspection formed part of a cross-sector review where the operational risk of other SIFI banks was also inspected.

Operational risk is the risk of loss resulting from inadequate or failed internal processes or human or system errors or resulting from external events.

Significant operational risk at a bank is often caused by weaknesses in IT systems, including weaknesses with regard to their integration, as well as weaknesses in measures to prevent breakdowns and cyber-criminal attacks. In addition operational risk may be caused by a large number of manual routines, lack of effective separation of duties or insufficient controls, errors in advisory services provided to clients and inadequate measures to prevent money laundering and financing of terrorism. Substantial changes at the institution may also contribute significantly to operational risk, eg the launch of new IT systems, the establishment of new business activities, major organisational changes and strong growth in one or more business areas.

Summary and risk assessment

A bank must have an operational risk policy which describes the size of assumed operational risks acceptable to its board of directors. Moreover the adopted key principles of operational risk management must be stated. During the inspection the Danish FSA identified certain shortcomings in the policy, including an inadequate position on the size of operational risks acceptable to the bank and the inclusion of risk as regards internal models. Also, the policy should describe in more detail reporting as regards this area. Consequently the bank was ordered to adjust its policy so that it meets the requirements in a satisfactory manner.

The registration of operational risk events is another element in the bank's operational risk management. The bank's registration system is partly manual and it cannot handle risk events that have not resulted in losses but that could have resulted in losses. In other words the bank does not register this type of risk events. Such registration can give the bank insight into potential operational risk events and together with already registered events represent an important element in determining focus areas to mitigate risk. The bank was ordered to register all operational events that may result in losses, have resulted in losses or could have resulted in losses for the bank.

Internal controls that improve the quality of risk management and lower the risk of errors are another element in risk management. The bank's business areas carry out self-regulatory controls while the bank's central and independent risk management division carries out limited control of the area. The bank was ordered to ensure that the bank's independent risk management division carries out adequate control, on a test basis, of the business areas' self-regulatory controls of the bank's operational risk.

The Danish FSA pointed out to the bank that the internal audit department of some of the other SIFI banks has performed a more extensive audit of operational risk management and of the bank's processes, resources and qualifications in the area. The Danish FSA assesses that these audits contribute with knowledge and insight which may enhance the risk management of operational risk.

The Sydbank Group has calculated its solvency need at 9.7% at 31 December 2015. The capital ratio represented 17.6% at 31 December 2015. The inspection did not give rise to any change in the Danish FSA's assessment of the group's solvency need.