Operational Risk Management

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Define ‘operational risk management’
- ✓ Explain the factors on which operational risk management depends
- ✓ Outline the benefits of operational risk management
- ✓ Discuss the risks associated with people in a business

Operational Risk Management

A business that does not address operational risk management cannot claim to have an enterprise risk management process. The success of operational risk management will depend on how complete the identification process is.

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The FSA (2002) appropriately states that *ultimately firms need to decide for themselves what operational risk means to them* and every company needs to *consider a more specific definition of operational risk that is appropriate to the range and nature of its business activities and its operating environment*. Therefore, businesses need to adapt the operational risk definition in terms of their own end product and the resources and processes they use to produce that product.

Scope of Operational Risk

The sources of risk considered to be included within the term *operational risk* are quite considerable.

The FSA Integrated Prudential Sourcebook consultation paper (Financial Services Authority 2001) describes operational risk as that covering:

- Business risk that includes adverse changes to a firm's market, customers or products, changes to the economic and political environments in which the firm operates, and the strategic risk which a firm faces if business plans, supporting systems and the implementation of these plans adversely affect the firm.
- Crime risk, including potential theft, fraud and computer hacking.
- Disaster risk, such as fires, floods and other natural disasters, and terrorist activity.
- Information technology risk, including unauthorised access and disclosure, and data corruption.
- Legal risk, including loss arising from legal action against the business and from inadequate, incomplete or otherwise unsound legal documentation and practices.
- Regulatory risk, relating to the lack of observance of rules set by a regulatory body.
- Reputational risk from negative publicity about its business practices or internal controls.
- Systems risk loss, as a result of failure caused by the breakdown of business procedures, processes or systems and controls.
- Outsourcing.

The FSA's definition of *business risk* described above includes market, economic and political risk.

Benefits of Operational Risk Management

Operational risk management provides the following benefits:

- Enables the business to achieve its business objectives.
- Gives management the time and opportunity to generate income, rather than constantly dealing with problems.
- Reduces day-to-day losses.
- Places a strong enterprise risk management system in place.
- Establishes a system by which to correlate, understand and model different classes of risk.

Implementation of Operational Risk

Developing a solid operational risk management system will depend on a number of issues such as:

- The risk management system should not slow down decision making processes or reduce business output.
- Risk managers who implement the operational risk programme should not be the managers of individual business units.
- Risks should be managed at an appropriate level within the organisation.
- Developing a culture which rewards the exposure of risks when identified, rather than encouraging staff to hide them.

Strategy

Definition of Strategy Risk

A business's strategy is overall approach that a business takes to achieve its objectives. Objectives are the results expected within a particular time period. Results are the measures of performance. What the business will do and the reasons behind it is the strategy they follow.

Creating the wrong business strategy, not implementing a well-planned strategy, or not modifying a successful strategy over time due to changes in the business environment are all forms of operational risk. Strategic risk may thus be defined as the risk associated with initial strategy selection, execution or modification over time, resulting in a lack of achievement of overall objectives.

Objectives

Objectives must be clearly stated and understood to ensure that a strategy will succeed. Objectives are the basis for work and the mission of work. They govern the structure of a business, the main activities that are undertaken, and the allocation of people to tasks. Subsequently, objectives are the basis on which organisational structure and business processes are designed and impact the work of individual business units and individual managers. Drucker states that a business must first be able to create a customer. Hence there is a need for a marketing objective.

Businesses must have the capacity to innovate or they will be made obsolete by competitors. Thus, the presence of an innovation objective is essential. There are three factors of production on which all

businesses depend, human resources, capital resources and physical resources. There must be objectives for their employment, their supply and their development, respectively. The resources must be used productively and their productivity has to develop if the business is to survive. Therefore, productivity objectives are required. Businesses exist within a society and a community, thus, businesses must take responsibility for their impact on the environment. Therefore, Drucker argues that there is a need for social dimensions of business objectives.

Finally, he says there is a need to make profit; otherwise none of the objectives can be achieved. All of these have a cost and the risk of potential losses can be financed only out of the profits of the business. There are five key areas of risk associated with setting objectives.

1. The objectives are not aligned with the strategy.
2. They do not address the key business areas.
3. They are not SMART.
4. Management lacks the experience to achieve the objectives.
5. The initial assessment of the risks linked with each objective is superficial.

Business Plan

All businesses, regardless of maturity, need business plans to expand existing business. However, the business plan itself is a source of risk. It is meant to be a communication tool. Whether the strategy is a success or not depends on the plan's ability to communicate the business strategy upon which it is based. The disciplines required to articulate the business's vision, mission, objectives and strategy or delivery plan in a written document require a logical approach, rigorous analysis and clarity of thought.

The business plan must tell *a story* and describe how the business will attain its objectives in a comprehensive, clear, consistent and cohesive manner. The plan should identify the market, its growth prospects, the target customers, the main competitors, organisation, resources, social *fit*, and all forecasts of critical success factors and measures. The plan should be founded on reliable assumptions and must identify the assumptions to which the success of the business is most sensitive. These assumptions will address the future market size, the economy, potential market fluctuations, competitor behaviour and the capability of the business to deliver. All these assumptions are possible risks.

Therefore, the plan should highlight the risks the business is facing based on an understanding of the assumptions, how they will be dealt with, and the expected degree of success. The plan should also record the risk management process for the identified risks against their objectives, as discussed above in the *definition of strategy risk*. The plan will need to be updated regularly as it will be referred to constantly when making business decisions, not simply to document the original business idea. Thus, the plan will have a long-term influence on achieving the business idea.

Therefore, there are a number of possible areas of risk associated with creating and implementing a business plan. These include the inability of the plan to clearly describe the strategy, explain how the objectives will be achieved (especially at start-up through short-term detailed operating plans), explain

the assumptions, identify the risks(and their responses) associated with the assumptions, take account of regulatory priorities(where applicable) and regularly update the risks for each objective.

New Business Development

New business development risk addresses the risks associated with plans to move into new business areas, expand by means of mergers and acquisitions, provide new services and improve infrastructure (e.g. physical factory and equipment, information technology and networking). Businesses need to protect profitability by developing new products and services but such activities invite additional risks due to:

- Inability to recover costs of additional research and development or marketing.
- The loss of reputation if new information technology fails.
- Substandard work by third-party providers.
- The expenditure and staff costs from high-volume low-margin services outweighing the corresponding increases in profits.
- New customers not being attracted by the new products or services.
- The new products or services causing higher losses due to fraud or theft.

Businesses within the finance sector are particularly exposed to these types of risk. For example, with the inclusion of electronic bill payment services and the expansion of existing bank card issuing programmes, banks have significantly increased their risk exposure. Businesses in the financial sector that want to compete in high-volume transaction-intensive retail services need to make huge investments in information technology. Strategic plans should reflect these investments and link business-line goals and objectives with planned information technology enhancements. In short, strategic plans should show that the management has investigated the risks and documented the company's plan to mitigate them.

Resources

A business needs to be innovative in order to set itself apart from the competition. Thus, part of the business strategy will be to attain, sustain and improve competitive advantage. Businesses with resources that are inherently different from those of their competitors are more successful than others who are not able to obtain or reproduce similar resources. Businesses, therefore, need to acquire or develop unique resources in-house in order to achieve competitive advantage. Required resources include capital, energy, raw materials, people, buildings, land and machinery. While similar businesses may have the same resources, one business may outperform the other due to productivity. Resources have the following risks: a lack of comprehension of resources needed to meet objectives, an incompatibility between the objectives and existing resources, a disparity between production/sales projections and obtaining required resources, experience, staff qualifications and technical abilities and a mismatch between equity debt and spending profile.

Stakeholder Interests

The stakeholders are individuals or organisations that are affected by or can affect the business. These include shareholders, lenders, employees, suppliers, business partners, customers, analysts and sometimes even the society at large. A clear understanding of the stakeholders' interests should be kept in mind. A stakeholder analysis should be performed to identify the primary, possibly conflicting expectations of the stakeholders, as well as their power of influence.

Stakeholders would probably have different priorities or conflicting interests that need to be recorded, disseminated, openly debated (when applicable) and where possible aligned through negotiation. The agreed course of action should then be recorded and forwarded to the stakeholders, indicating where stakeholders' wishes have not been met. The business plan should reflect the stakeholders 'requirements. If not, this could cause problems in the long run.

Corporate Experience

The risk exposure profile of the company's strategy will highlight company's corporate experience. Aspects reflecting corporate experience will include knowledge of markets, customers, suppliers, contractors, distribution mechanisms, products and services and the legal and regulatory, context and risk of their industry. This is not a comprehensive list and will vary based on the services provided, the market segment and the industry.

Reputation

A good reputation is one of the most valuable assets that a business can have. A significant measure of a company's reputation is its brand value. As discussed in the previous unit, branding has value because it is a tool to increase market share. Effective branding can ensure long-term competitive advantage. Successful branding can lead customers to believe that a product is different from its competition, so much so, that they see the rival products as inferior, regardless of whether they are or are not. Brand value can be protected by trademark legislation; however, anything a business does or any statement it makes can add to or detract from the brand value.

Schmitt considers the need to consider five interrelated aspects, to practise effective reputation management (Schmitt 2001):

First, he considers reputation management needs to be broadly conceived, as over the last decade, the concept of branding has expanded from single products to the organisation as a whole, such as the Guggenheim museum in New York, or well-known leading figures such as Virgin Group's Richard Branson (Branson 2002).

Second, brand reputation is an on-going undertaking and should not be confused with short-term crisis management.

Third, the corporate brand has been discovered as an essential new marketing initiative. Businesses that traditionally focused on the branding of their individual products are now focusing on the organisation as a whole.

Fourth, organisations need to take a unified approach to reputation management across the entire business by instilling the brand into its employees so that they become familiar with it and practise it in their day-to-day activities. On every face of the organisation to the outside world, whether it is through trade fairs, news conferences or communication with the public, the message needs to be consistent.

Lastly, because of the internet, brand protection needs to be real time to cope with the new form of brand scrutiny. This requires effective management of the corporate website, links to other sites, selective presence on other websites, and fast and suitable responses to electronic queries.

Damage to the reputation from a single or multiple events can cause serious damage to a business. Abad reputation can hinder the sale of goods or services, prevent recruitment of good quality staff, discourage desirable business partners, and debt may become more expensive to obtain. Core value statements, which talk about trust and honesty, need to be spread and practiced throughout an organisation. Consumers are interested in everything related to a brand, from the ingredients of its products to an organisation's environmental programme, and even in the long run to economic, social and political issues.

People Risk

A business must establish systems and controls to manage people risk resulting from the actions of employees or the business itself. These systems and controls must be in place for the duration of an employee's tenure with the organisation, beginning with recruitment and ending with the employee's resignation, retirement or termination. On a positive note, people are an important source of competitive advantage and can set one organisation apart from another.

Definition of People Risk

People risk may be described as a combination of employer behaviour which affects employee efficiency, health and safety, or loyalty, and the detrimental impact of employee behaviour, which is anything from profit erosion to business failure. In simple terms, there are three levels of severity of the impact that people risk can have. At the lowest level, people risk covers possible events which would, in the short term, reduce profitability, share value or credit rating. At the second level, risk events may have a negative impact on the organisation's wealth or reputation in the long term. The worst case scenario would be to bring about the eventual collapse of a business due to conscious or unconscious actions of one or more employees.

Types of People Risk

Employees must be managed effectively as they have a high impact on business profitability. The success of human resource management can be measured by absenteeism rates (staff constraint), labour turnover (staff constraint), accident rates (health and safety), productivity (management), quality of finished goods (management), and customer satisfaction(management). Having said this, people risks are actually broader than just efficient use of employees, and often result from HR management practices like late payment of wages or salaries, not adhering to statutory or regulatory requirements,

staff constraints, dishonesty, corporate culture which does not cultivate risk awareness, risk management, or poor health and safety practices.

Staff limitations occur *either* when companies cannot fill critical positions because of shortages in specific trades or professions (salary and other incentives not drawing new candidates) or when staff retention is poor, causing business disruption. Incompetence becomes a problem when employees lack the level of skills and knowledge to do their jobs properly. The absence of professional training and development would cause human errors. Fraudulent activities, such as theft can be attributed to dishonesty within a company. Legal steps may be taken against companies when employees discriminate against an individual in terms of their age, sex, race, colour, religion, national origin or disability, either during the recruitment processes or selection of staff for promotion, transfer or bonuses.

The frequency with which employees miss work will directly impact an organisation, and will incur direct costs and reduced productivity. A corporate culture that does not actively promote risk awareness or encourages making profit, with no regard to the methods used to make them, can result in negative employee behaviour.

Health and Safety

Risk due to health and safety-related issues affect all businesses. These risks can be extensive and the direct and indirect costs to businesses have been calculated at about 3.8% of the market value of the 500largest EU and US companies that are at risk from these issues. Of this, 2.4% is internal risk (reviewed in this unit) and 1.4% is risk to market value as a result of risk to the public and customers.

The 2.4% risk to value is attributed to:

- Internal health risk at 0.7%.
- Internal workforce safety risk of 0.5%.
- Historical health liabilities risk is an average of 1.2%.

Maintaining a Health and Safety Management System

The company should develop increased awareness of its legal liabilities for the health and safety of its staff. In doing so:

- It will help keep ahead of legislation and regulators.
- Stakeholder, staff, community and customer relationships will all improve.

Categories of Health and Safety Risk

The health and safety priorities are viewed as management of the risks associated with the following:

- Chemical substances, carcinogens, asbestos.
- Stress, overload and pace of work, psychological factors, poor workplace relations and management.
- Communication of information on hazards.

- Ergonomics, repetitive work and musculoskeletal problems.
- Organisational and safety and health (quality) management issues.
- Preventive occupational health services, health promotion.
- Unforeseen impacts from using new technology.

The following types of health risks pose a threat to organisations and their staff:

- AIDS/HIV
- Asbestos
- Asthma
- Back pain
- Beryllium
- Biocides
- Carcinogenic materials
- Drugs and alcohol
- Electromagnetic radiation
- Environmental health issues
- Latex allergies
- Lead exposure
- Lung diseases
- Musculoskeletal disorders
- Neutral toxicity
- Noise
- Office-based illnesses, like computer and irritable desk syndrome and passive smoking
- Radiation
- Risks to new and expectant mothers
- Skin damage
- Work stress
- Vision impairment
- Vocal damage

Examples of high workforce health risk by sector include the following most dangerous jobs from the point of view of carcinogenicity:

- Agricultural workers, chemical exposure
- Asphalt roofers
- Cutting/sewing workers
- Glass and ceramic decorators
- Tobacco industry

- Insulators
- Metal platers and coaters
- Hairdressers and barbers
- Telephone installers
- Wholesalers
- Sculptors, painters

HRM Practices

Previously personnel management was seen as the selection, recruitment and development of company personnel.

HRM seeks to use the personnel policy to improve or sustain an organisation's competitive advantage with policies in areas like employee resourcing, employee development, employee relations, and rewards within a broad strategic plan for the people part of the business. Analysts are unclear if this paradigm shift was global. What is clear is that organisations adopt different human resource management strategies according to the threats and opportunities they face in their business environments (Tyson and York 1996). No single model of personnel management can fulfil all business requirements.

An organisation's HRM practices need to adapt to the changing environment so that they can contribute towards their organisational goals. HRM can contribute by improving working conditions to enhance job satisfaction, develop and train employees, maintain harmonious relationships and ensure fairness of rewards. It can also help reduce threats to the company, such as low productivity, unfair dismissals, absenteeism, accidents and social abuses, such as bullying, stress induced by unrealistic workloads and sexual and racial discrimination.

Ability to Pay Salaries

Employee remuneration requires an evaluation of the suitability of the risk indicators and their ability to provide accurate and timely information on which management can act. Liquidity impacts the ability to pay salaries. The salary burden must be balanced against the present and projected income and staff numbers.

Regulatory and Statutory Requirements

Contracts

When one person employs another to perform a particular task as part of their business in a manner that they dictate, a contract of employment comes into existence. The standard principles of the law of contract apply. Therefore, in a contract of employment, there must be an offer and an acceptance, which constitutes the agreement. There must be an intention to create legal relations, consideration, capacity, consent of the parties. There should be no mistake, misinterpretation, duress or undue influence. Additionally, the contract must be legal and comply with legislation.

Maternity

Under the ERA, a pregnant employee who has made an appointment for antenatal care, on the advice of her doctor, midwife or health advisor, must be given paid time off. An employer, who is unreasonable and does not afford the employee these rights, can be taken to a tribunal by the employee. However, this must occur within three months following the employer's refusal. Employees with two or more years' service, may take maternity leave from the eleventh week before the birth, with the right to return up to 29 weeks after the birth, with statutory maternity pay (SMP) payable for 18 weeks plus paid time for antenatal care.

Discrimination

Discrimination is prohibited in reference to those protected regarding recruitment, pay and benefits, promotion, training, terms and conditions, transfers, dismissal, action short of dismissal and any other detriment.

Whistle Blowing

Whistle blowing is the practice of an employee metaphorically blowing a whistle, drawing the attention of people outside of the business to some form of unethical practice inside the business. Employers need to take into account this relatively new form of influence on management.

Previously this was done by individuals taking a personal risk with their employment. After the enactment of the Public Interest Disclosure Act of 1998, workers who *blow the whistle* about any irregularities within their employer's organisation are protected as far as the *umbrella* of the Act extends.

In addition, employees who are *protected* by the provisions may sue for unfair dismissal if they are dismissed for making a protected disclosure. A qualifying disclosure will be a protected disclosure where it is made to the worker's employer or to a person whom the worker reasonably believes to be solely or mainly responsible for the relevant failure.

Certain types of disclosures qualify for protection and are termed to be *qualifying disclosures*. Qualifying disclosures are disclosures of information which the worker reasonably believes show that one or more of the following issues is currently taking place, took place previously or is likely to happen in the future: a criminal offence, the breach of a legal obligation, miscarriage of justice, danger to health or safety of any individual, damage to the environment or the deliberate concealment of information tending to show any of the issues just referred to.

Dismissal

Dismissing a staff member is never just about managing one person. Approaches to dismissal are part of a corporate culture and can change the behaviour of the remaining staff and in the wider context, if a trend emerges, can increase or decrease the attractiveness of the business for potential employees. The

risk faced by any employer in firing a member of staff occurs for not observing the legislation relating to wrongful and unfair dismissal.

Any employee may claim that they were wrongfully dismissed in a common law action for breach of contract in the civil courts or in an industrial tribunal. This is applicable where the employee claims that the employer did not dismiss them in accordance with their contract. One example of this type of claim is where the employer fails to give proper notice as required in the contract. The amount of compensation or damages awarded is normally intended to place the employee financially in the position in which they would have been, had the wrongful dismissal not taken place.

The grounds for categorizing a dismissal as being unfair, as defined by the Act, include: employees taking or seeking maternity, paternity or adoption leave, requesting flexible working arrangements, seeking to assert a statutory employment protection right, taking or proposing certain types of action on health and safety grounds, performing or proposing to perform duties relevant to their role as an occupational pension scheme trustee, etc.

Recruitment

The recruitment process will directly affect the quality of the staff employed, retain existing valued client relationships (and associated repeat business) and staff retention. A direct correlation exists between recruitment and the success of a business. The key aspects of recruitment are: recruiters, job analysis, job descriptions, interviews, selection, induction and integration.

Further Reading:

- ✓ ***Dun & Bradstreet, (2007), Financial Risk Management***
- ✓ ***Linda S. Spedding, Adam Rose, (2008), Business Risk Management Handbook: A Sustainable Approach***
- ✓ ***RonKenett, Yossi Raanan, (2011), Operational Risk Management***