

Operational risk management

What have battleship captains, burglars and drivers got in common? Some thoughts on why operational risk management often doesn't work as well as it could.



"Pass to starboard" was the message sent by the flashing light. The captain signalled that he would pass to port. "Pass to starboard" was the reply. The captain repeated his signal as the vessels neared. "Pass to starboard" was the repeated reply. Inexorably the two held their course, coming closer and closer. "This is a battleship. We shall pass to port". "This is a lighthouse. Pass to starboard..."



This little tale highlights how easy it is to make assumptions about the risks we face and how best to deal with them. A good framework will bring a proper sense of perspective to managing risk, and help prevent individuals and organisations from being blind-sided.

What is risk exactly?

The new AS/NZS ISO31000:2009 standard, which originated as AS/NZS 4360, defines risk as "effect of uncertainty on objectives", and risk management as "coordinated activities to direct and control an organisation with regard to risk"¹

What use is risk management to business?

Risk management often falls into three categories when used in business:

- Insurance;
- Treasury;
- Operational.

Insurance risk is the oldest and most familiar form of risk management. It was born of probability mathematics originally designed to help gamblers understand – and to a lesser extent control – their fate. As statistical techniques evolved, probability analysis was applied with more success to commerce, particularly setting premiums for government annuities and to help underwrite shipping ventures at Lloyd's.

As statistical techniques developed, they were found to have practical benefits – the law of large numbers, normal distribution (Bell curve) and regression analysis. These techniques formed the basis for the growth of the insurance industry, which has become an essential element of the global economic system.

Treasury risk became actively and systematically managed after the Second World War, when increasingly specialist mathematical models were developed to guide treasury decisions in financial intuitions. This led to the capital asset pricing and Monte Carlo models, amongst others.

Operational risk as a formal discipline is still relatively young, but is proving its value in applications across all types and sizes of organisations in the public and private sectors.

¹ AS/NZS ISO 31000:2009 Risk management – Principles and guidelines Standards Australia/Standards New Zealand pp1-2

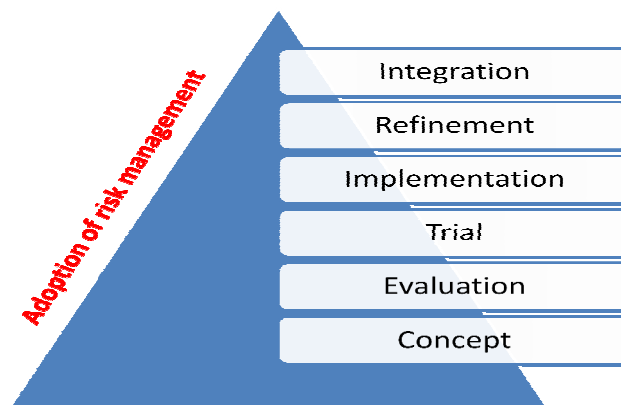


The management of operational risk is a systematic way of evaluating all the risks facing organisations, placing them in priority order, and ensuring that they are dealt with appropriately. In some respects there are similarities with the quality management approach, particularly in the use of statistics.

However, in many instances, statistics used for managing risk are crude and heavily dependent upon subjective values. The quality of any risk management system rests on the quality of the risk identification and analysis, which in some instances is reduced to a compliance exercise or the simple application of a series of automated lists. As the discipline develops, there will be improvements to make it increasingly relevant and practical – for example, the greater emphasis placed on communication and monitoring in the last revision of the Risk Standard.

In New Zealand, despite risk management processes being in place, organisations are often to be found at the reactive end of the spectrum. Management of risks is in practice largely reactive to events rather than anticipating or shaping them; intuitive rather than systematic; and ad hoc not systematic.

Anticipatory – explicit – systematic – risk culture



Reactive – implicit – intuitive – ad hoc

Characteristics and dangers:

Link to audit

More often than not, risk management is parked with, and tied into, the audit function. This seems to reflect a general trend in the movement of internal audit functions from “tick and flick” towards internal advisor and process consultant. By definition audit looks backwards and risk management looks forward, and the skills required to perform the two roles are quite different, so it can be awkward to combine the two.

Analysis paralysis

Assessment is not an end in itself. The process of identifying, analysing and prioritising risks is only of value when it informs the action taken to deal with the risks appropriately. Activity without action is futile.

An exercise in bureaucratic compliance

It's very easy for risk management to become a bureaucracy of form filling that submerges the process into irrelevance and drudgery. Mechanistic compliance is bad for turning people against the whole idea of managing risk systematically, but automated mechanistic compliance is even worse because it turns people off and chews through time and resources at an accelerated rate of knots.



A management fossil

Operating, political and economic contexts do not stand still. Risk management must mirror the operating environment to have any relevance for line managers. Without an appreciation of the dynamic nature of events, risk profiles ossify into historical curiosities.

Overlooking intangibles

Intangibles are by definition hard to measure directly; things like innovation, morale and the use of knowledge. As a result they are too often overlooked, even though organisations depend increasingly on intangibles to improve the provision of service for their customers. It is amongst the intangibles – the apparently immeasurable - that the occurrence or change of a particular set of circumstances is likely to take place. A risk management process is weak if it does not take account of intangibles.

An art not a science

For the foreseeable future, shortcomings in data collection and processing mean that risk assessment is a largely subjective exercise that uses a lot of judgement. The process of assigning numerical values to risks camouflages the art and gives the appearance of science. Risk management is a very useful tool to guide action, but it should not be forgotten that in most instances calculations of exposure are only determined by estimates of the likelihood and consequences of various events occurring.

Accentuate the negative

Unlike the song, risk management systems seldom accentuate the positive, despite the fact that risk is the effect of uncertainty on objectives, and that an effect is a deviation from the expected – positive and/or negative. To prosper (even to survive) every organism must take risks. Just getting something to eat entails risk, so organisations must similarly manage their risks to take advantage of opportunities. Too often the fixation of minimising the downside of an event is left unbalanced by consideration of the upside.

Summary

We naturally react better to clear and present danger than we anticipate uncertain or intangible events, for example, it is difficult to find a more careful driver than the one who has just seen the car in front pulled over by the police.

Like the battleship captain, it is easy it is to make assumptions about the risks we face and how best to deal with them. A good framework will bring a proper sense of perspective to managing risk, and help individuals and organisations to anticipate and treat risk appropriately – rather than, as many victims do, think about the risk of burglary only after a burglary has happened.

About the author



Adrian Sparrow has worked in senior management positions in a variety of industries. He was a consultant for Alexander Proudfoot, KPMG, and Deloitte. He has Masters degrees from Cranfield and Massey Universities. Adrian tries to bring insight and practical thinking to problems facing organisations.

