

ТЕНДЕНЦИИ И ПРЕДИЗВИКАТЕЛСТВА В РАЗВИТИЕТО НА ИКОНОМИКАТА

Сборник с доклади
от международна научна конференция

Том IV



Издателство "Наука и икономика"
Икономически университет - Варна

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2012

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THE ROLE OF OPERATIONAL RISK IN THE RISK MANAGEMENT FUNCTION

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University „Goce Delcev” – Stip, Macedonia

Abstract

The purpose of this paper is to discuss the different types of risk and general approaches to analyze risk in a company, and to describe the importance of implementing a formal risk management policy in a company. Business risks are diversifiable and specific to the industry and the market in which a firm operates. Part of the business risks is operational risk which incorporates the direct or indirect loss resulting from inadequate or failed internal process, people and systems or from external events. The paper explains the components of operational risk and situation of his appearance, as well as the steps for creating risk management policy.

Introduction

The risk as a measure of potential changes in value that can be experienced in a managed portfolio as a result of differences in the economic environment when the current situation and future point of time invoke a need for a risk management. Management of risk over specific period of time in situations where volatility exists and managers have the opportunity to change the expected cash flows is important for six primary reasons. Three of them can be classified as microeconomic in nature and they affect the performance of the individual corporation. Other three reasons are macroeconomic in nature and since they affect the overall financial system.

The importance of risk management, particularly in financial institutions, can be seen firstly with the analysis of the three microeconomic reasons. First, the management of risk reduces the volatility of earnings. Since, earnings will become more stable with the management of risk, investors are less likely to demand as high a premium for risk. As a result, the value of the firm to the shareholders increases. Second, the management of risk can reduce the volatility of cash flow from operations. Since operating income plus depreciation service debt payments, banks are more willing to lend larger sums to firms with more predictable and stable operating income. The company has greater debt capacity and can borrow more funds to

invest in tangible and intangible assets. Third, because the managers of the firm have more control over earnings volatility and thus performance, a firm can more easily achieve its goals and remain competitive.

When the macroeconomic aspects are considered, there are three reasons why risk management is important. From the financial institution's point of view, managers will be able to spend more time on the improvement of financial operations instead of spending time on capital adequacy. Second, lower volatility reduces the likelihood that a financial institution will fail. With lower volatility, depositors are more secure that their funds will be available over longer periods of time. Finally, from a global point of view, if financial systems are safer and less prone to disruption, the world economy in general will benefit.

The risk areas

Typically, risks are divided into systematic and unsystematic risk categories. To get a better understanding of a risk landscape faced by a business and to understand where operational risk fits into the risk areas, there is a need for breaking the systematic and unsystematic risks into their component parts. Nonsystematic, company-specific or business risk can be divided into five component parts, which are operational risk, legal risk, credit risk, liquidity risk and model risk.

Business risk is specific to the industry and market within which the company operates. If a firm produces hardware components, its business risks would be those specific to the hardware components production industry and the market for hardware components. The most significant risk among business risks are the operational risks. These are the risks arise from the failure of internal systems, or from errors by the people who actually run the business. The risks can be very minor event such as failure to update a computer program, or cataclysmic events that result in complete financial failure of the business.

The next component of business risk is the legal risk, which is related to operational risk. This risk occurs when contracts are not enforced. Companies also find that credit risk, even though it is often associated with legal risk, can occur independently of legal risk. Here, the problem is that the counterparty to the transactions recognizes their legal obligation but does not have the financial resources to make the promised payment. Another business-risk-related exposure is liquidity risk. This is the risk arising from the cost of unwinding a position. That is, if a position needs to be divested quickly, a sale at an unfavorably low price may have to be made

because buyers may be hard to find. An emerging and serious form of business risk is model risk. Since financial models are becoming extremely complex, designing and implementing the models tend to be extremely technical. Unfortunately, the complexity of a model often obscures the assumption used to generate a model's outcomes. As a result, the economic validity of the model is increasingly difficult for nontechnical but market-savvy professionals to verify. Model risk is an important component of business risk because business decisions are made based on the outputs from these financial models.

Additionally to business risk, all firms are exposed to market, or systematic risks. Market risk can be divided into three components, which are interest-rate risk, foreign exchange risk and commodity price risk.

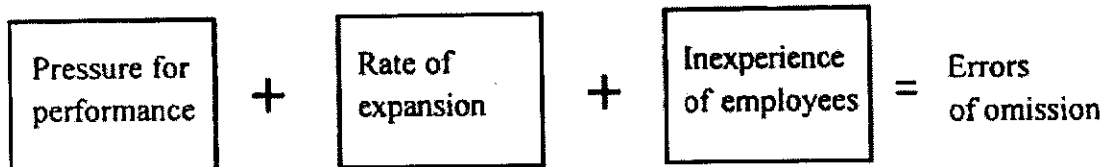
Operational risks

Operational risk, as part of business risk is risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and systems or from external events. This definition incorporates the interaction of individuals with the company and the company's activities with the outside world. The operational risk can be divided into four component parts. The first part is risk from operations which results from a breakdown in a core operating, manufacturing, or processing capability. In an organization charged with investment responsibilities, the risk is associated with the manager, marketing, and sales behavior, as well as technology-related transactions. The second component is asset impairment risk, which occurs when an asset loses a significant portion of its current value because of a reduction in the probability of receiving expected future cash flows. This risk centers on the organization ability to look after its assets. Places where transactions are processed or where data can be manipulated are important to maintaining the integrity of the financial system and the value of the assets. The third component is the competitive risk which results from changes in the competitive environment that could impair the business ability to create value and differentiate its products and services. In financial terms, this often means the company has failed to deliver superior performance as a result of a market downturn or from managerial failures. The last one is the franchise risk. It is a consequence of excessive risk in one of the three other operational risk components listed here. It occurs when the value of the entire business erodes due to a loss in confidence by critical constituents such as shareholders, investors, or customers.

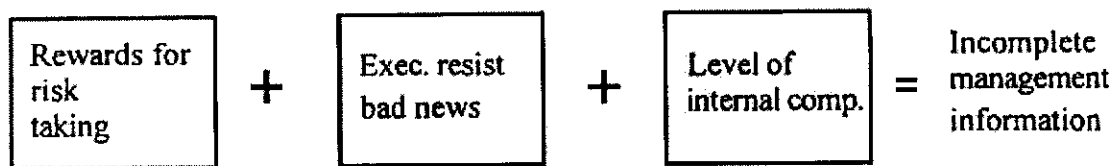
Bases of operational risk

The most common reason of operational risks arising can be divided in nine different handles of control. These nine different handles detail the places to look for operational risk within a company and can be used to measure the operational risk of a company.

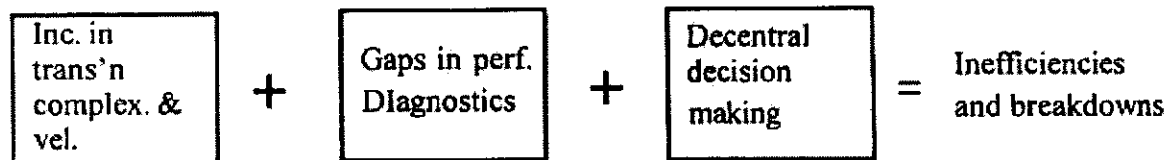
Growth



Corporate culture



Information management



Graph 1. Internal risk pressures

The first row evaluates the company's growth. Errors of command or instruction can occur when senior managers pressure employees to provide a very high level of performance, when the rate of expansion is so high that existing employees do not have enough time to perform their jobs well, or when the company is forced to use untrained or inexperienced employees in important positions.

The second row shows problems related to corporate culture. The problems here usually stem from incomplete managerial information. These problems can occur when managers provide high rewards. An example of this will be large year-end bonuses for outstanding performance. As previously stated, higher returns are usually associated with greater risks. Therefore, managers may be rewarding employees for taking greater risk in comparison to the situation when there will be no bonuses. A similar source of difficulty arises when management concentrates too much on the ultimate objective. What this means is that managers only want to hear about events that are in line with achieving their goals. As a result, some

managers may give employees the notion that bad news is unacceptable, and since many employees choose not to upset their managers, they do not report bad news in sufficient time for managers to take appropriate corrective actions. A final cause of insufficient managerial information arises when incentives create an excessively competitive work environment that encourages one employee to compete against the other. As a result, employees become reluctant to share information with their co-workers when certain information is needed to operate the company successfully. These reluctant employees are afraid they will be giving another employee an advantage in gaining recognition that can lead to financial rewards.

The third row discusses problems in information management. As a company grows, the nature and extend of the transactions in which it is involved often becomes much more frequent and much more complex. If employees are focused to do complicated functions and have less time to complete them, disasters can occur. A similar type of problem occurs when a company uses a system to evaluate its employees and the system is not adequate for the task. For example, suppose an employee is assigned a task that is not to be evaluated. A final cause of inefficiency and process breakdown occurs when an operation becomes so large that it has to decentralize the decision-making process. If this decentralization is not managed appropriately, transactions fall through the cracks because another division believes another division is responsible for performing the task.

Operational risk management

There are different strategies that can be used for operational risk management. But, the best method used for operational risk management can be divided in five stages which explain the evolution of operational risk management that a company must recognize as it becomes more and more sophisticated with and concerned about its risk management processes. The first point is that companies have always known that operational risk exists. Historically, these risks have been managed by relying on internal controls with periodic reviews by the internal auditor. Generally, the responsibility for risk control has remained with the individual managers in the business and specialist functions. The first stage as traditional baseline includes internal controls, reliance on internal audit, individual mitigation programs and dependence on quality of stuff and culture.

The second stage identifies the fact that operational risk can have a significant impact on the profitability of the company. Usually, a particular individual is appointed to be responsible for operational risk and that person is responsible for developing a common understanding and assessment of

operational risk. Risk policies are developed, early indicators of risk levels are identified, and operational losses are collected. The purpose of this stage as awareness stage is to provide a framework for risk identification, definition of controls, prioritization of issues, and collection of loss events develop simple economic capital models and establish value proposals.

The third, or monitor stage, focuses on the current levels of operational risk and the effectiveness of management functions. Risk indicators are established to monitor performance. These indicators are consolidated with other relevant performance measures to provide senior management with an overall assessment of the firm's performance. Because this stage provides a better understanding of the current operational situation, stage four concentrates on qualifying the relative risks and attempting to predict what will happen in the future. Usually, firms in this stage assign specific committees or task forces to develop empirical models and evaluate their validity. The final stage recognizes the pervasive nature of operational risk. The objective is to integrate and implement processes and solutions while, at the same time, recognizing the different levels of management needs. At this stage, operational risk management becomes a fundamental part of the strategic planning process.

In today's world the business must make profit to remain successful and the management of risk requires expenditure of a firm's financial resources. Appropriate risk management is not without expenses. The final goal of risk management is either the creation or protection of shareholders value. The risk management must incorporate knowledge of the effect of risk on the performance of the company, the amount of risk the company can tolerate, and the impact of volatility on financial performance.

The need for a risk policy

The main reason for a risk policy is the need for establishing guidelines for the management in the company and the need for describing the role of the different parties involved in the investment functions and the control of activities related to managing risk. Most policy guidelines are designed to meet or exceed any regulatory standards and to ensure that managers take a prudent course of action in the management of corporate operations and overall financial risk. There are two different reasons that can be analyzed as purposes of policy statements in a company. The first is that the policy statement is designed to protect the shareholders of the company from the management of the company. The second is to protect the managers from themselves. Giving the specific actions that manager should and should not

take, these policies force managers to work together within a unified structure that will achieve the general goal. The policy statement should outline the appropriate approval procedures that decision making must follow so that everyone knows who is responsible for what decision. Having the policy statement in a company, well-informed independent outsider can look at the investment decision and understand exactly why it was made.

The first step in establishing a company's risk policy is to define risk specific to that organization. The second step is to determine a level of risk aversion based on management's and other stakeholders' risk desire, or how much risk exposure the company is willing to take. After this, the management must define the investment philosophy. One of the basic purposes of an investment philosophy statement is to define how much risk a firm is willing to accept. The preparation of this document is one of the first steps to ensure that management has accurately identified the nature and extent of the risks faced by their firm. Management must decide whether they want the certainty of cash flows or the flexibility to earn additional profits. The third step is to identify the objectives of the risk management policy. At this point, senior management must decide which exposures are important enough to manage and how much of the corporate resources should be spent in the risk management process of these exposures. This discussion requires that they define and measure the exposures on several dimensions such as present vs. future transactions, the effect of historical vs. accounting reporting, and the economic impact of the future cash flows. Some of the policy objectives include the preservation of the value of the company in the long term regardless of the variation in underlying economic variables, ensuring the total risk position of the company managed in a prudent fashion through the imposition of reasonable limits, and also ensuring that within the limits imposed, the company receives a reasonable return for the risk it does take. The last step is to identify the areas where risk management will be required and the identification of the responsible parties for this risk management. So, the limitations that the risk management has to work within must be specially identified.

Conclusion

The implementation of the risk management strategy must have the following characteristics: acceptability, consistency and quality. Acceptability is needed because the strategies must make sense to professional who will implement the strategy. Consistency is needed because the strategies must make sense in the context of managements' stated values and objectives

and the strategies must have a logical flow from period to period. Quality is needed because the strategies can be seen to improve management decisions that is, management's beliefs with market realities. With those characteristics, the risk management process will become an important element in the strategic planning process.

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