

Managing Corporate Risk in the Post-Financial World:

CEOs would be smart to increase their focus on operational risk.

Ask just about any CEO what the first thing that comes to mind is when they hear the words “risk management,” and the response will probably include phrases like “trading risk,” “systemic risk,” or others similarly viewed as “strategic.” However, there is another, often overlooked, discipline within risk management that is increasingly capturing the attention of shareholders and other stakeholders – operational risk. It lurks in every part of a company, and when it comes to prudent risk management, overlooking operational risk is perhaps the biggest mistake a CEO can make.

CEOs consider risk almost exclusively from a strategic perspective. That is, they ask, “Are we doing the right things?” At first glance, this seems to be a reasonable approach. But it fails to adequately address operational risk, which encompasses the risk of loss caused by inadequate or failed processes, people, and systems, and by external events. The way to address operational risk is to ask another, equally important and inextricable question: “Are we doing things right?”

Take, for example, the notion of consumer privacy and data management. The common strategic position is, “We protect customer data and information.” But without an operational plan focused on how to do it right, that strategic intent begins to look more like a liability. What operational measures have been taken, for instance, to prevent a disgruntled employee from e-mailing a confidential spreadsheet containing personal data to a Hotmail address?

Likewise, look at Toyota’s strategic (and historic) reputation for great quality and reliability. Yet recently, operational risk reared its head in quality assurance and manufacturing faults that went unaddressed. The resulting crisis has not only significantly damaged the company’s bottom line, but has tarnished its hard earned reputation as the paragon of quality and reliability.

Another area where companies must pay close attention to operational risk is supply chain management. In the food industry, several companies have recently had to recall products after receiving tainted or unsafe food from one or more suppliers, resulting in significant costs and liability, lost revenue, and a sharp decline in trust among consumers. While the strategic imperative might have been “fresh and wholesome food,” without stringent tests or certification programs in place, operational risk once again held the trump card.

All these scenarios demonstrate that the real foundation of prudent risk management is to integrate and balance approaches to operational risk management with those focused on strategic risk. Unfortunately, for many organizations, this is easier said than done.

Why? Because operational risk does not enjoy the same mature and developed risk models typically used to assess market and credit risk. Operational risk lurks in many different parts of an organization, and is further complicated by the typical challenges of communication across any organization.

So, what’s a CEO to do? First, make it a company (or at least executive) imperative for each segment of the company to conduct a risk assessment. Involve people from all parts of the company and those with intimate knowledge of operations. Identify what could go wrong, how to prevent it, and how to recover from inevitable, unavoidable operational risk events. Your goal should be a comprehensive risk plan for each division or line of business.

Second, the CEO should “break down the silos” in a company’s management structure in order to identify potential risks that run across different divisions, or even different personalities among leaders.

Last, but not least, once the risk assessments are complete, it’s critical for a company to think seriously about its tolerance for risk. Risk assessments are just that – portraits of what could go wrong, how much it can cost, and how controls can be employed to reduce the risk. But minimizing risk costs money. A company can’t fully address the costs of mitigating operational risk without identifying its overall tolerance for risk. Unfortunately, a model hasn’t been invented yet to calculate a company’s risk tolerance.

Therefore, it falls to the CEO, the executive team and the board to apply their experience, skills, and awareness of stakeholder expectations to set risk limits, and to design and implement a risk control framework, including operational risk, consistent with, these established limits.

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