

# Strategic and Operational Risk Management

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## Lecture 10

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تسعى لتكون الكيان الأول الذي يتبنى مبدأ المجتمع التعليمي  
التعاوني ويقدم العلم مقابل العمل للتنمية وبناء المجتمعات.

PMG 630

The strategic nature  
of corporate risk management



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The risk review examines both intended and documented results of the risk response and action plans in dealing with identified risks. Included in the risk review is an evaluation of the residual risk against established risk levels.

Residual risk assessment considers both the risks as previously identified and the resulting risk from the response mechanisms and the control activities implemented.



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### RISK REVIEW and audit

The process evaluates the effectiveness, cost, and efficiency of the activities and its adequacy in providing reasonable assurance that the likelihood and impacts of the risk events are brought down to the established acceptable risk level (i.e., ALARP).



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It is critical that the risk review evaluates the significant risks that fall outside of the acceptable risk levels.

This may happen due to changing systems and policies or changing conditions and environments. These risks should be addressed with appropriate action plans to bring the risk within established levels.

Risk treatment and response plans should be updated accordingly.



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### RISK REVIEW and audit

An important oversight role in confirming that management is monitoring and managing all known risks in accordance with established levels can be done through a risk audit.

When possible, the audit committee should consist of both internal and external members.

A risk audit is a more comprehensive evaluation of the entire risk management system and processes. Thus it is conducted less often than risk reviews.



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### Effective Performance MONITORING

To be effective, it is emphasized that the performance monitoring processes should be treated as an integrated component in the system. There are two key elements in achieving an effective risk monitoring and review process.



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### Effective Performance MONITORING

First, clear communication channels between the members of the system increase the level of awareness with regards to the implementation of risk treatment and controls.

All stakeholders in the system must know specifically why particular risk controls or safeguards have been implemented.



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### Effective Performance MONITORING

Clear communication creates an environment where every member knows precisely his or her responsibilities toward addressing the risk. Communication is important especially in large systems that have a high level of interaction, ambiguity, emergence, huge data collection, and complexity.



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Second, it is necessary to establish a flexible monitoring process. The design of risk monitoring procedures should be flexible so that they can adapt and respond in a cost-effective manner to threats arising from emergence, turbulent environments, uncertainty, and contextual issues of a dynamic nature.



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### Effective Performance MONITORING

Flexibility is the ability to add, adjust, or remove both physical components and functions.

The level of flexibility should not cause the monitoring process to lose its identity; rather, it should provide an environment of trust where members of the system can share their pro-posed changes and strategies.



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### The nature of risk management

Risks are everywhere, as evidenced by many corporate events reported in the popular press, including major corporate scandals around once venerable companies.

We also witness a steady increase in man-made disasters around the world and even the emergence of mega-catastrophes caused by willful human actions that have both direct and indirect economic effects.



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### The nature of risk management

These developments have intensified our focus on corporate and public risks and the risk management processes that may be needed to circumvent the adverse economic impacts from such events.

All the while, we have seen a public risk perception aimed at reducing system errors, operational malfunctions and uncontrolled human behaviors that affect the way in which we try to deal with corporate risks



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### The significance of potential risk effects

Risk management as a professional discipline is nothing new. The insurance industry has operated for centuries on the basis of practices that allowed economic entities with specified risks to obtain cover by diversifying the exposures across many insured parties through the intermediation of professional insurance companies.



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### The significance of potential risk effects

Similarly, there is really nothing new to the various risk events we see play out today as they affect individuals, institutions and societies.

The history is replete with examples of accidents, operational disruptions, fraud cases, political unrest and market collapses, which all constitute incidents with adverse effects on business and economic activity.



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### The significance of potential risk effects

The sheer magnitude الحجم الهائل of potential economic repercussions has brought risk management to a new level of attention as the public has witnessed the (some-times) exorbitant personal gains derived from corporate fraud and excessive losses from extreme weather conditions, terrorist events and so forth.



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### The significance of potential risk effects

The increased risk alertness **اليقظه** has also affected politicians and lawmakers in their capacity to impose new legislation and rules that public companies must abide **بها** by as witnessed by growth **ملحوظا** in regulatory frameworks and corporate governance guidelines.



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### The significance of potential risk effects

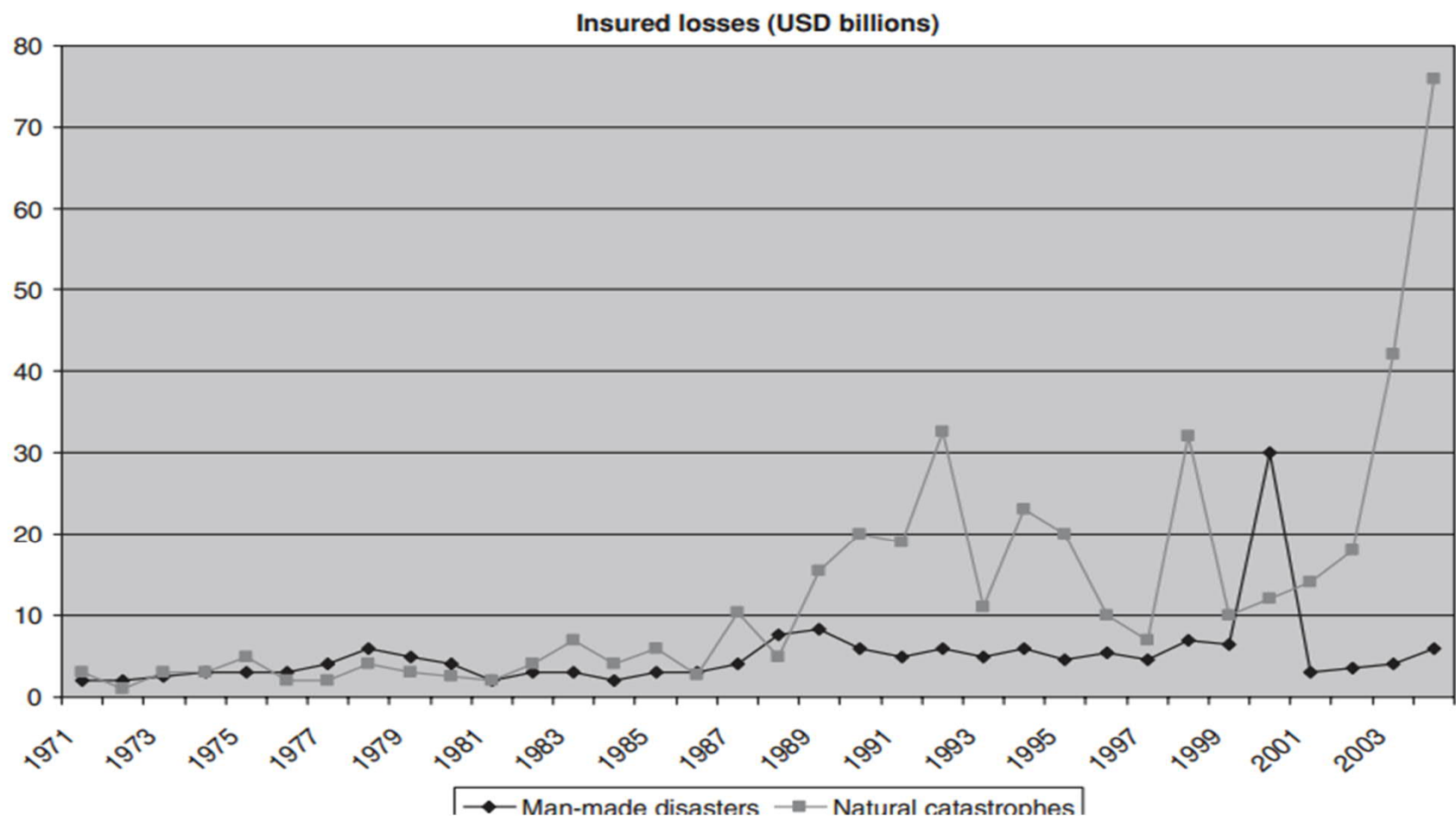
The frequency of earthquake events per se does not seem to increase, but the exposed economic infrastructure is extended. However, there seem to be other climatic changes that increase economic losses in exposed areas due to wind storms, hurricanes and flooding events.

The overwhelming consequence of these developments is that the insured losses from man-made disasters and natural catastrophes have been increasing dramatically (Figure 1.1).



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### The significance of potential risk effects

All in all, there is virtually no end to potential sources for economic disruption.

A conventional risk management focus has been concentrated on volatile financial markets, insurable casualties and macroeconomic conditions.



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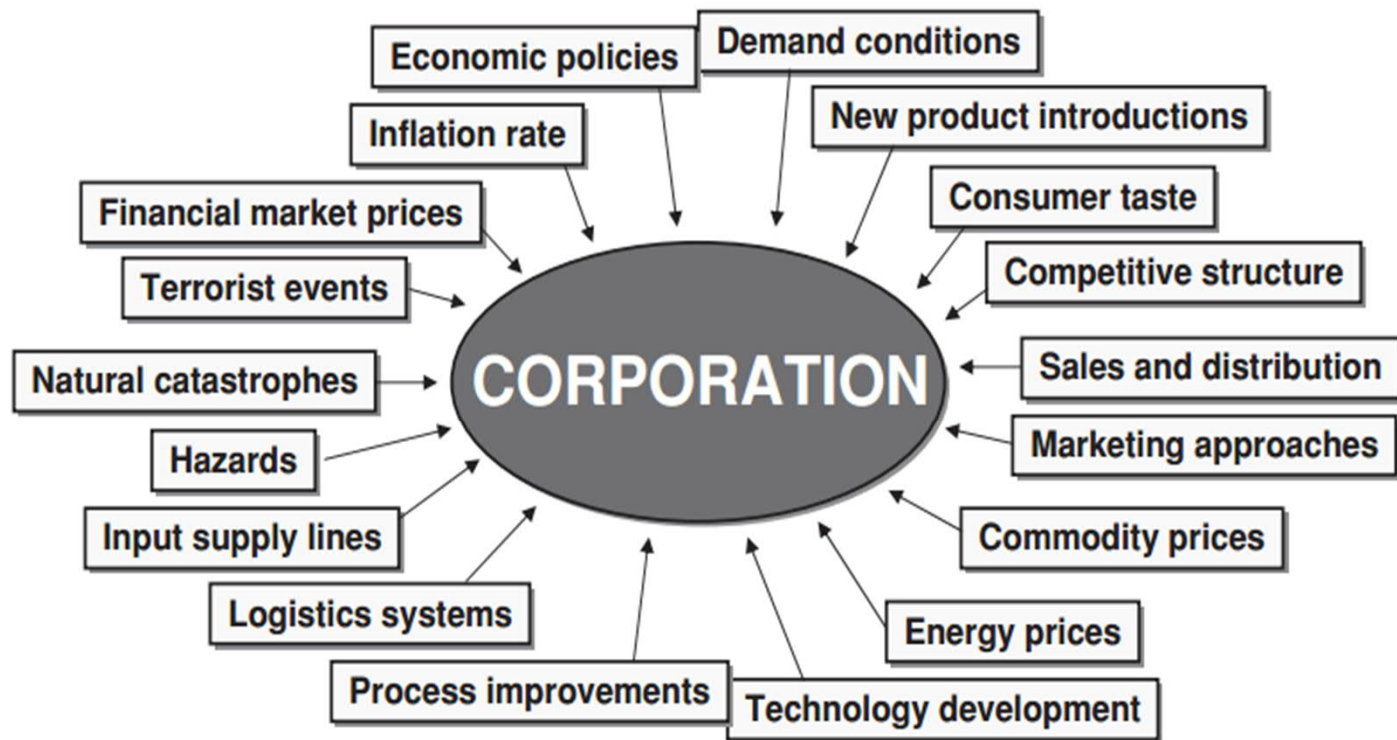


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### The significance of potential risk effects

However, these risks have been extended to include many other factors beyond managerial control, including systemic disruptions, industry paradigm الصناعة نموذج changes, competitive initiatives, technological shifts, political incidents, mega-terrorist events and the like, many of which are hard to foresee and predict (Figure 1.2).





**Figure 1.2** *The wide scope of corporate risk exposures*



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### Different approaches to risk management

The risk management challenge has been approached in many different ways depending on the assumed professional perspective.

The insurance profession looks upon risk management as a technique adopted to cover identifiable risks by diversifying exposures among many insurance takers through the active intermediation of insurance companies.



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### Different approaches to risk management

The insurers charge a risk premium reflecting the expected risk of the events based on actuarial calculations plus a margin to cover administration and capital costs.



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### Different approaches to risk management

While this approach works for many accidents and casualties where events are independent of each other, it becomes more complicated when risk events are related because the natural diversification across different insurance takers falls short.



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### Different approaches to risk management

That is, if the hurricane runs through certain region, all of the insurance company's customers in the vicinity are hit at the same time and the drain on capital reserves of local insurance companies becomes too large.



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### Different approaches to risk management

Therefore, cover for these types of catastrophe risks requires more comprehensive risk-transfer solutions involving the global reinsurance and capital market intermediaries.



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### Different approaches to risk management

Assuming a multinational financial management perspective, the emphasis changes more towards the foreign exchange rate exposures imposed on companies engaged in international trade and foreign direct investment.



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### Different approaches to risk management

These exposures extend from short-term transactions to longer-term economic risks arising from volatile foreign exchange markets, while also considering the potential adverse effects from different political risks that arise in connection with overseas operations.



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### Different approaches to risk management

As all of these risks relate to exposures that can be identified, quantified and assessed, they fit quite well with the cyclical activities described in the formal risk management process (see Box 1.11 The formal risk management cycle).



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# Different approaches to risk management

### Box 1.11 The formal risk management cycle

The conventional risk management process is often presented as an ongoing process comprising four consecutive activities that continue over time. First, the major risks that expose the corporation must be identified. Once this is done, various techniques are adopted to analyze event frequencies and the potential economic effects of the identified exposures. Based on assessments of potential exposures, corporate management decides whether these exposures are acceptable in view of prevailing organizational responses. Finally, the exposures are modified through risk mitigation efforts



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### Different approaches to risk management

With the emerging emphasis on various operational risks, there has also been an increased focus on the potential for human errors and misconduct as well as technological breakdowns. Managing these types of exposures depends on effective corporate accounting systems to identify and measure the relevant exposures as well as internal control processes adopted to check whether exposures are kept within bounds and whether processes remain in line.



All together, these perspectives on possible risk events are commensurate with the practices promoted by enterprise-wide risk management approaches that assume the formal elements of the risk management process.

They also resonate with contemporary public policy concerns where various legislative initiatives, regulation and supervision are imposed to reduce the adverse societal consequences of human error.



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### Different approaches to risk management

Other disciplines seem to take slightly varied views on the risk phenomenon. While total quality management, six-sigma and lean management principles seem focused on improving operational efficiencies, they ideally also pay attention to emerging customer needs and process improvements through continuous learning.



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### Different approaches to risk management

Similarly, risk assessments in project management see a need to balance advance planning with adaptive solutions that arise as the projects are implemented. We may even extend this perspective to corporate strategy formulation,



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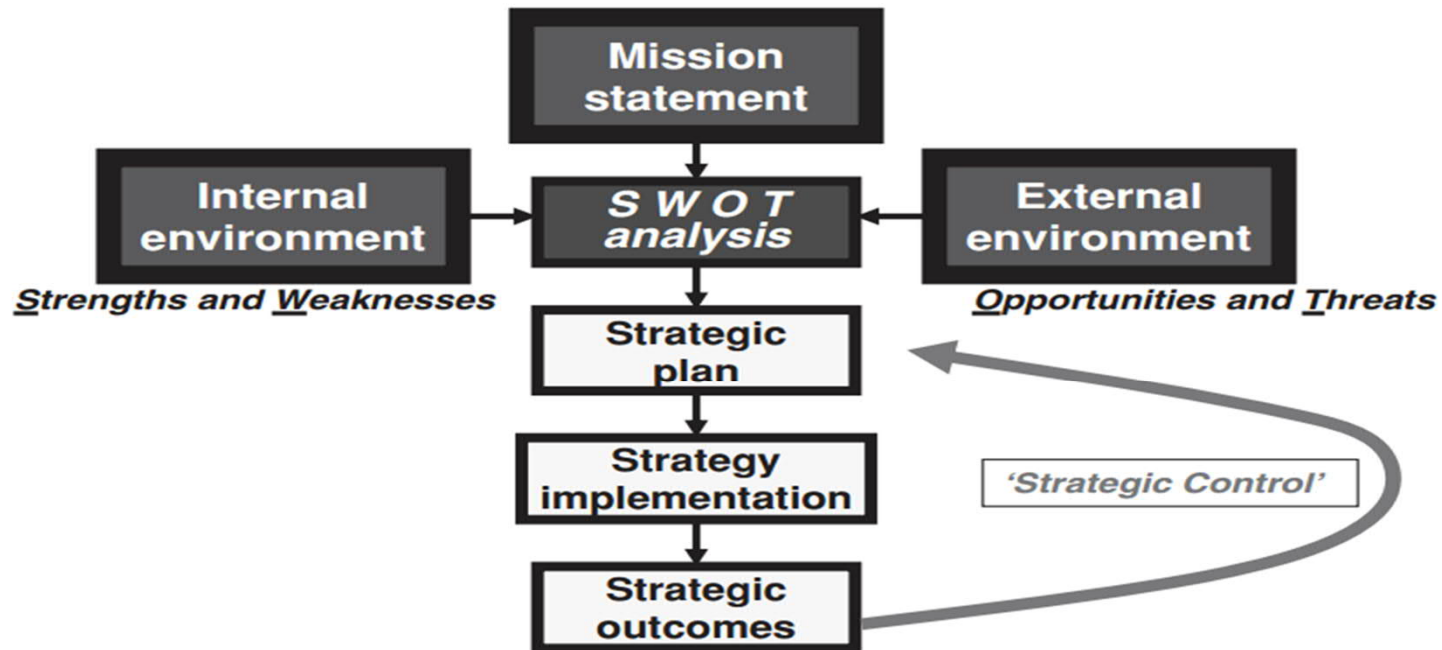
### Different approaches to risk management

which can be seen as the execution of a string of projects or strategic actions where the upside potential for improvements and uncovered opportunities should be exploited during implementation. Although the strategy-making process is rarely conceived this way, one might argue that strategic management, which incorporates analyses of institutional strengths, weaknesses, opportunities and threats (often epitomized as SWOT analysis), is de facto engaged in explicit analysis of strategic risks (Figure 1.3).



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# Different approaches to risk management



**Figure 1.3** Risk assessments in the strategic management process



Resources:

Operational Risk Management

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Chapter 4

