

# Pathways to Management and Leadership

Level 5

Management and Leadership

Unit 5021V1

Operational Risk Management

# Pathways to Management and Leadership

## Unit 5021V1: Operational Risk Management

Copyright © Chartered Management Institute, Management House, Cottingham Road, Corby, Northants NN17 1TT.

First edition 2010

Author: John Lambert  
Consultants: Peter Cumpstey and Peter Adlington  
Series consultants: Roger Merritt Associates  
Project manager: Trevor Weston  
Editor: Suzanne Pattinson  
Page layout by: Decent Typesetting

Revised July 2013

British Library Cataloguing-in-Publication Data. A CIP catalogue record for this publication is available from the British Library.

ISBN 0-85946-552-7

All rights reserved, save as set out below. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the written permission of the copyright holder except in accordance with the provisions of the Copyright, Designs and Patents Act 1988 or under the terms of a licence issued by the Copyright Licensing Agency Ltd, 90 Tottenham Court Road, London, England W1T 4LP.

Applications for the copyright holder's written permission to reproduce any part of this publication should be addressed to the publisher. Permissions may be sought directly from the Chartered Management Institute in Corby, UK. Phone Publications on (+44) (0) 1536 2073479, or email [publications@managers.org.uk](mailto:publications@managers.org.uk).

This publication is sold subject to the condition that it shall not, by way of trade or otherwise, be lent, re-sold, hired out, or otherwise circulated without the publisher's prior consent in any form of binding or cover other than that in which it is published and without a similar condition being imposed on the subsequent purchaser.

Approved centres may purchase a licence from the publisher, enabling PDF files of the publication to be printed or otherwise distributed solely within the centre for teacher and student use only according to the terms and conditions of the licence.

Further information on the licence is available from the Chartered Management Institute. Phone (+44) (0) 1536 207379, or email [publications@managers.org.uk](mailto:publications@managers.org.uk).

Every effort has been made to trace holders of copyright material reproduced here. In cases where this has been unsuccessful or if any have inadvertently been overlooked, the publishers will be pleased to address this at the first opportunity.

The publishers would like to thank the following for permission to reproduce copyright material:

- MED Publications and Bank for International Settlements for the Basel II Accord on p.27
- St George's, University of London, for its strategic level risk management remit on p.25
- BSI Group for extracts from *ISO 31000:2009: Risk Management - Principles and Guidelines* and for *ISO Guide 73:2009: Risk Management - Vocabulary*, including the risk management process diagram (throughout workbook). British Standards can be obtained in PDF or hard copy formats from the BSI online shop: [www.bsigroup.com/Shop](http://www.bsigroup.com/Shop) or by contacting BSI Customer Services for hard copies only: Tel: +44 (0)20 8996 9001, Email: [cservices@bsigroup.com](mailto:cservices@bsigroup.com).

# Operational Risk Management

SAMPLE MATERIAL

SAMPLE MATERIAL

# Contents

<b>About this workbook</b> .....	<b>7</b>
The unit .....	7
The aims of this workbook .....	7
Syllabus coverage.....	8
Getting started.....	8
How to use the workbooks .....	9
<b>Section 1 Aspects of risk management</b> .....	<b>13</b>
Why manage risk?.....	13
Key risk concepts and components .....	17
The nature of operational risks.....	27
Health, safety and environment risk .....	36
The risk management process .....	36
Summary .....	39
<b>Section 2 Risk assessment</b> .....	<b>41</b>
Establishing the context: risk criteria .....	41
Risk identification .....	46
Risk analysis .....	59
Risk evaluation.....	66
Summary .....	69
<b>Section 3 The risk response</b> .....	<b>71</b>
Risk treatment .....	71
The risk register .....	82
Managing the disaster recovery plan .....	84
Monitoring and review .....	88
Summary .....	91
<b>Before you move on</b> .....	<b>93</b>
Preparing for assessment.....	93
Reflecting on progress .....	94
Planning your next steps .....	94
The Management and Leadership Standards .....	95

How this workbook relates to the standards ..... 95

**Bibliography** ..... **97**

    Websites ..... 98

SAMPLE MATERIAL

# About this workbook

## The unit

The main purpose of this workbook is to support you as you study for the Chartered Management Institute Level 5 in Management and Leadership qualifications. Specifically it focuses on the content relevant to Unit 5021V1 *Operational Risk Management*.

This workbook provides underpinning knowledge and develops understanding to improve your skills as well as to prepare you for future assessment. If you are studying for the Level 5 in Management and Leadership qualifications, then you will be assessed by your approved centre on 'your knowledge and understanding of' the following learning outcomes:

1. Understand the concept of risk management
2. Understand the identification of risk and risk probability
3. Be able to manage risk response.

## The aims of this workbook

This workbook aims to help you learn how to:

- manage risks in your operational environment based on an appropriate risk management model
- assess risks using a variety of risk identification and analysis techniques
- identify risk treatment options suitable for your area of operation
- implement and manage a disaster recovery plan.

## Syllabus coverage

The table below shows which sections of the workbook address each of the assessment criteria of the qualification syllabus.

Unit 5021V1 Syllabus coverage	Addressed within section:
<b>Operational Risk Management</b>	
1.1 Discuss the meaning of risk to an organisation	1
1.2 Define the responsibilities for risk management at operational management level	1
1.3 Explain a risk management model	1
2.1 Develop and justify a risk management criteria against which risk can be assessed	2
2.2 Identify and evaluate techniques to specify risk and risk interdependencies	2
2.3 Analyse a risk management model to quantify risk	2
3.1 Evaluate the level of risk against pre-established criteria	2
3.2 Select and evaluate activities to eliminate, mitigate, deflect or accept risk	3
3.3 Determine a process for implementing and managing a disaster recovery plan	3

## Getting started

Recent events have focused all our minds firmly on the issue of risk management. We've seen a recession caused by the sub-prime mortgage market collapse in 2007, coupled with the bailouts of seemingly safe financial institutions by governments who had themselves presided over the creation of collective debt. But risk management is not just the preserve of the financial world, or indeed organisations keen to keep their workers healthy and safe. It covers all areas of the organisation's activities, both strategic and operational.

This workbook starts by looking at the nature of risk, why it's important to manage risk and what is meant by operational risk, including the various categories of such risk. You'll be introduced to a model for managing risk recommended by the International Organization for Standardization (ISO), which you will then use throughout the workbook.

As part of the ISO framework, the key process of risk assessment is covered in Section 2 and includes the various techniques and approaches to identify, analyse and evaluate risk. In particular, you'll learn how to use a flexible model of risk analysis, and then apply this and other assessment techniques to risks in your own area of responsibility. Finally, in Section 3, you'll consider seven options for treating risk within the concept of your 'response' to risk. You'll learn about the 'risk register', how to implement and manage a disaster recovery plan and the role of monitoring and review and communication and consultation as part of the risk management process.

The workbook is full of examples and case studies so that you can understand how risk permeates virtually everything you do in the organisation. In the end, you should have a firm view of the nature of 'holistic' risk management and why you need to take it seriously.

## How to use the workbooks

The workbooks provide ideas from writers and thinkers in the management and leadership field. They offer opportunities for you to investigate and apply these ideas within your working environment and job role.

### Structure

Each workbook is divided into sections that together cover the knowledge and understanding required for that unit of the Chartered Management Institute Level 5 in Management and Leadership. Each section starts with a clear set of objectives that identify the background knowledge to be covered and the management skills in the workplace that enable you to demonstrate this knowledge. You do not have to complete the sections in the order they appear in the workbook, but you should try to cover them all to make sure that your work on the unit is complete. There are self-assessment questions at the end of each section that allow you to check your progress. You may want to discuss your answers to these questions with your line manager or a colleague.

### Activities

Throughout the workbooks there are activities for you to complete. These activities are designed to help you to develop yourself as a manager. Space is provided within the activities for you to enter your own thoughts or findings. Feedback is then provided to confirm your input or to offer more ideas for you to consider.

To get the best from the workbooks, you should try to complete each activity fully before moving on. However, if the answer is obvious to you because the issue is one you have encountered previously, then you might just note some bullet points that you can then compare quickly against the feedback. You may sometimes find it difficult to write your complete response to an

activity in the space provided. Don't worry about this – just keep a separate notebook handy, which you can use and refer to as needed.

Try not to look at the feedback section before completing an activity. You might like to try covering up the feedback with a postcard or piece of paper while you are working through an activity.

### Timings

Timings are suggested for each section and activity, although it is important that **you** decide how much time to spend on an activity. Some activities may occupy only a few moments' thought, while others may be of particular interest and so you might decide to spend half an hour or more exploring the issues. This is fine – the purpose of the activities is to help you reflect on what you are doing, and to help you identify ways of enhancing your effectiveness. It is always worth writing something though, even if it's brief – the act of writing will reinforce your learning much more effectively than just referring to the feedback.

### Scenarios

There are scenarios and examples throughout each workbook to illustrate key points in real workplace settings. The scenarios cover a wide range of employment sectors. As you work through, you might like to think of similar examples from your own experience.

### Planning your work

The reading and reflection, scenarios and activities in each section of the workbooks are designed to take around two hours to complete (although some may take longer). This is a useful indicator of the minimum length of time that you should aim to set aside for a study session. Try to find a quiet place where you will not be interrupted and where you can keep your workbooks, notes and papers reasonably tidy. You may also like to think about the time of day when you work best – are you a 'morning person' who likes to get things done at the start of the day, or do you work better in the evening when there may be fewer disturbances?

### Preparing for assessment

Further information on assessment is available in the *Student Guide* produced as part of the *Pathways to Management and Leadership* series. If you have any further questions about assessment procedures, it is important that you resolve these with your tutor or centre coordinator as soon as possible.

### Further reading

Suggestions for further reading and links to management information are available via ManagementDirect through the

Study Support section of the Institute's website at <http://mde.managers.org.uk/members>. Alternatively, email [ask@managers.org.uk](mailto:ask@managers.org.uk) or telephone 01536 207400. You will also find titles for further reading in the Bibliography at the end of this workbook.

SAMPLE MATERIAL

SAMPLE MATERIAL

# Section 1 Aspects of risk management

Time required: about 2 hours 30 minutes

## Learning outcome

By the end of this section you will understand the concept of risk management and be able to:

- 1.1 Discuss the meaning of risk to an organisation
- 1.2 Define the responsibilities for risk management at operational management level
- 1.3 Explain a risk management model

Risk is something we deal with every day of our lives and often don't give it a second thought. In this section you'll learn why organisations, on the contrary, should give it a second thought. You'll also discover what we mean by 'risk' and 'risk management', what responsibilities managers have for managing risk at operational level, and how a risk management model will enable you to deal with risk in your own organisation.

## Why manage risk?

### Scenario

#### Scenario

It was the oldest merchant bank in Britain, founded in 1792. In 1992 a young, talented trader was appointed to manage its new subsidiary in Singapore. He was an expert in a type of financial instrument which the bank had diversified into and which had become increasingly popular since the 1980s – derivatives. Derivatives can be a fairly risk-free operation, as long as you match your expectations of prices going up with prices coming down, a process known as 'hedging'.

The bank's senior management gave him free rein, impressed by his early success – his operation was responsible for half the bank's profits in 1994 – and with little understanding of how he was operating. He not only traded freely, but was also in charge of reconciling his trades. In other words, he managed both the front and back office. Senior management had no idea he had an account called '88888' where he indeed 'reconciled' his accumulating losses, and were quite happy to pay the 'margin calls' on these losses, assuming they were advances to clients rather than losses from 'proprietary' trading.

In early 1995, this still young, talented trader held 61,000 futures contracts on various Asian stock exchanges. The trouble was he held unmatched long positions on the stock market at a time when the Nikkei and other Asian stock exchanges were falling heavily. As the margin calls got larger, the costs of financing this exposure became more than the bank's capital. The bank went bust and its young and talented trader went to jail for fraud. At

least he was sorry. He had brought down an old and famous bank which numbered the Queen among its clients, and his faxed resignation to his employers started: 'My sincere apologies for the predicament that I have left you in ...'

### Activity

#### Activity 1.1

(about 5 minutes)

The story of Nick Leeson and the collapse of Barings Bank is a failing of operational risk management. But what exactly were the senior management failings here? Make a list.

### Feedback

*You may have pinpointed the following:*

- *a failure of management to understand its own operations – most senior staff, including the board, didn't understand derivatives or how they worked*
- *a 'so-what-as-long-as-it-works' attitude to operational risk – as long as the profits roll in, why question the piper?*
- *no division of responsibility between front and back office – effectively, an absence of operational accounting and audit control*
- *lack of supervision – no one kept a check on what Leeson was doing; lines of responsibility and reporting were blurred.*

It seems inconceivable that what are essentially basic operational attitudes and controls could have been so lacking in a modern-day company. Yet, on the other hand, the organisation was expanding into unknown territory; it had a laissez-faire attitude to its operational profit-makers, and was also part of an international business culture of short-term profit-making playing to the mantra 'growth'.

**Activity****Activity 1.2****(about 5 minutes)**

Look again at the reasons for the failure of Barings Bank. Could any of these apply to your own organisation's operations? Is anyone being allowed to 'do their own thing'? Is dynamic growth sidelining best operational practices? Is the pursuit of quantity outstripping the retention of quality (think Toyota)? Make some comments below.

**Feedback**

*The strange thing is that history seems to repeat and we appear to learn little from these debacles. There have been any number of 'Nick Leesons' since 1995 – John Rusnak at Allied Irish Banks, Luke Duffy at National Australia Bank, Jérôme Kerviel at Société Générale and Boris Picano-Nacci at Groupe Caisse d'Epargne. The phenomenon is called 'rogue trading' and, as the operatives themselves generally say, it wasn't so much a question of dishonesty and breaking the rules, but more being driven by an organisational culture of short-term gain, which, as far as this applied to them, meant the 'bonus culture'.*

**The consequences of failing to manage risk**

It seems we have difficulties in managing risk, or wanting to manage it – banks certainly seem to – and yet, if you weigh up the consequences of failing to manage risk, you'd think it would be a top priority.

**Activity****Activity 1.3****(about 5 minutes)**

Think about the consequences of financial institutions failing to manage their operations in terms of the wider context of the sub-prime mortgage crisis which began in 2007. This was also brought on by short-termism and the bonus culture, so what were the consequences? Identify four or five consequences.

- 1.
- 2.

3.

4.

5.

**Feedback***The consequences were huge:*

- *People lost their savings and investments and some lost their job and home.*
- *Organisations went bust.*
- *Assets became worthless.*
- *The whole world went into recession.*
- *Debt has substantially increased ... and the consequences will be with us for some time.*

Bad as these consequences were, it can get worse.

**Scenario****Scenario**

In 1986 a reactor at the Chernobyl Nuclear Power Plant in Ukraine exploded, spreading radioactive fallout across Belarus, Ukraine and Russia. Although only 56 deaths were directly attributed to the explosion, the ongoing health problems resulting from the disaster has affected thousands, particularly those who were children at the time of the disaster.

The reasons for the disaster were mostly operational: poor product design, poor quality of operating procedures and instructions – and a poor safety culture.

In a similar vein, you might take some time on the internet (try Wikipedia) to find out about the consequences – and the reasons for these consequences – of similar operational disasters like the chemical explosion at Bhopal in 1984, the space shuttle Challenger and Columbia disasters in 1986 and 2003, the Exxon Valdez oil spill in 1989 and the Buncefield fire in 2005.

**Activity**

**Activity 1.4** (about 5 minutes)

Not all consequences of failure to manage risk need be quite so dramatic. Supposing your line managers haven't been trained properly in your organisation's disciplinary procedure. What might be the costs and consequences of this? List three or four.

Risk 1	
Risk 2	
Risk 3	
Risk 4	

**Feedback**

*Here are some possibilities. You may have similar ones.*

- *The organisation is hit with litigation and its associated costs. This could include discrimination and unfair dismissal.*
- *Bad publicity affects recruitment and customer perceptions resulting in poor returns.*
- *Morale and hence productivity may suffer where the process is not being applied fairly.*
- *Performance and behaviour issues don't get sorted out, affecting the organisation's efficiency and effectiveness.*

You'll consider more examples and types of operational risk later in this section, but now step back a little. Risk management definitely seems important, but what is 'risk', why do we take risks, and what are the key elements in risk management?

**Key risk concepts and components**

*'People who don't take risks generally make about two big mistakes a year. People who do take risks generally make about two big mistakes a year.'*

Peter Drucker

**What is 'risk'?**

'Risk' is an interesting word. Some people think it derives from the Arabic *risq* meaning 'anything given by God from which you draw profit', which suggests a favourable outcome. Or it may derive from the Medieval Latin term *riscum* referring to hazards the sailor faces at sea, suggesting a negative outcome. Then

there's the Italian *riscare* meaning 'to dare', which suggests the possibility of either good or bad outcomes.

### Activity

#### Activity 1.5

(about 1 minute)

How would you define 'risk'?

### Feedback

*The English Oxford Dictionary mentions 'the possibility that something unpleasant or unwelcome will happen'. The Health and Safety Executive (HSE), meanwhile, defines risk as 'the chance, high or low, that somebody could be harmed ...' The ISO risk management standards meanwhile, speak of 'the effect of uncertainty on objectives'.*

Whatever the best definition, we can ascribe certain characteristics to risk:

- It's something many feel they must pursue.
- It's a process with favourable or unfavourable outcomes.
- There's 'uncertainty' about the outcomes.
- There are different types and sizes of risks – from Chernobyl to crossing the road.
- People's attitudes to risk, and perceptions of it, are different – remember Nick Leeson. He didn't 'hedge his bets'. He was essentially gambling, though he probably wouldn't have thought of it that way. The psychological aspects of risk are important as it seems that, no matter what standards may be put in place, some people feel more inclined to take risks than others. They have a greater 'risk appetite'.

#### Why do we take risks?

*'Behold the turtle. He makes progress only when he sticks his neck out.'*

James Bryant Conant

To some extent, we have to take risks as life is more or less a risky business. Think about your average working day. How many risks are inherent in it? You may have a car crash, get caught speeding, make a bad mistake at work, have an argument with your spouse, catch a virus on your computer, catch a real virus, twist your ankle out running ...