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OPERATIONAL RISK MANAGEMENT AND THE FINANCIAL SECTOR DEVELOPMENT: AN OVERVIEW

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Abstract

Operational risk in inherent in all financial products, activities and processes and systems and the effective management of operational risk is paramount importance for every financial institution board and senior management. With globalization and deregulation of financial markets, increased competition combined with the advent of high-end, innovative, sophisticated technology tremendous changes have taken place in the products distribution channels and serviced delivery mechanism of financial sector. These have introduced more complexities into the operations and consequently the risk partners and profiles of the sector have also become complex, diverse and catastrophic. The New Capital Adequacy Framework of most of most financial institutions requires them to study the regulatory frame work related to operational risk management. A research was conducted on 150 employees from different financial institutions, such as banks, insurance, stockbrokers and microfinance companies. Analysis of Variance (ANOVA) was used to test the hypothesis and response of respondents was analyzed through the use of Statistical Package for Social Science (SPSS). The result showed that operational risk management effects have positive effects on the financial development and growth in the financial sector.

Keywords: Operational Risk, Risk Management , Economic growth, Financial Institution

INTRODUCTION

Since the late 1990s, globalization, deregulation, consolidation, outsourcing, breaking of geographical barriers by used of sophisticated technology, growth of e-commerce etc, have significantly change the business, economic and regulatory climate of the banking sector. These developments introduced more complexities into activities of the financial sector and their risk profiles. Consequently a series of high profile operational loss events, have led banks, insurance and other financial institutions and their managements world over to increasingly view operational risk management as an integral part of their risk management activity like the management of market risk and credit risk. The identification and measurement of operational risk is a significant issue for modern-day banks, particular since the decision by the Basel Committee on Banking Supervision (BCBS) to introduce a capital charge for their risk as part of the new capital adequacy framework (Basel II).

Operational risk has been the Basel committee on banking supervision as the risk of loss resulting from in-adequate or failed internal processes, people and systems or from external events. This definition is based on the underlying causes of operational risk. It seeks to identify the causes of a loss event and at the broadest level include the breakdown by four causes: people, processes, systems and external factors. Operational risk may materialize directly, e.g in electronic fund transfer (transfer of funds to the wrong person) or could result indirectly as a credit or market loss. Since there is a close linkage of operational risk with other types of risks, it is very important for every institution to first have a clear understanding of the concept of operational risk before designing the appropriate operational risk measurement and management framework. Determining operational risk management in different communities has recently involved the aims to examine and evaluate the prospective factors that might effects on the performance of risk management in modern financial markets. The most consequential kinds of functional risk involve breakdown in internal authorities and collective governance.

This paper aims to determine the possible effect of operational risk management on the financial development and economic growth of some financial institutions in Nigeria companies.

LITERATURE REVIEW

Operational risk is a new dictum in financial service industry. It emerges in the 1990s as a chain of operational catastrophes affecting numerous financial institutions around the globe. The most notable among them included the collapse of the Barings Bank. The entire last decade of the twentieth century witnessed news of banking failures grabbing cover page headline the world cover, the latest being reports of failure by several Australian banks to provide online services.

The Basel committee has made it clear that operational risk is now a core issue for financial institutions and has set a deadline to allocate capital aimed expressly at reducing exposure to operational risks. The term operational risk has been defined only in the last few years. Risk simply cannot be understood as "uncertainly about the future" or the "probability of sustaining a loss" Rather, it is "an expression of the danger that the effective future outcome will deviate from the expected or planned outcome in a negative way". This definition means that a bank does not accept risks simply as fate but deals with them intentionally.

Operational risk management in different communities has recently involved the aims to examine and evaluate the prospective factors that might effect on the performance of risk management in modern financial markets. The most consequential kinds of financial risk involve breakdowns in internal authorities and collective governance (Di Renzo, et al, 2007). This sort can direct to defeats through error, embezzlement, or failure to execute in opportune mode or start the significances of the institution to be agreed with other procedures ,for instance, by its traders, loaning representatives exceeding their power or administering business in an unprofessional or risk manner. However, different characteristics of functional risk comprise major downfall of information technology techniques or consequences such as major fires or other disaster (Kle, et al 2008).

There was no generally accepted universal definition of operation risk until the advisory report of the Committee on Banking Supervision, Basel II… Other institutions have defined it as the risk of loss from various types of human or technical errors, and other have associated it with business interruption and legal and administrative risks. In contrast, all the institutions participating in this study (Committee on Banking Supervision Basel II advisory report) share the view that there is some kind of union or axis between the deferent risks of a company, such as market, credit and operational risks. In particular, an operational problem with a business transaction, as for example and error in recording data from clients, can create a credit risk or a reputational one if it affects the client's personal data.

While many organizations believe that technology risk is part of operational risk, some considerate as a separate category with its own risk factors. Operational risk is sought in the business areas with a high volume of business or operations, which have more structural changes or have complex support system, as in policy administration and receipt collection activities.

The operational risk of a company come from the influence and interaction of internal and external events in people, processes and technology applied to business processes of an organization. Since each entity is unique in the way of combining human resources, processes and technology, is actually a very complex task creating a single generic definition of what

constitutes operational risk. The former existing definitions of operational risk are not clear and are focused primarily on the negative aspect of risk, including the potential that, for any reason, business processes were interrupted resulting in a direct or indirect financial loss.

The event that trigger losses may have been caused by several factors, including failure in information system, processes and controls, human error or fraud, or unforeseen natural disaster. Direct losses refer to losses in current income, while indirect losses relate to potential revenue, for example, due to impediments to business expansion or reduction in customer due to reputational issue. Such definitions refer to historical facts and their uses are limited to prevent future losses or to anticipate thereat to organization. Loss traditional operational risk definitions, but potentially more strategic, incorporates a positive view of risk instead of considering the risk solely as a financial loss due to exposure to market or credit risk, operational risk includes the consideration of a failure in the process or strategic investment decisions to optimize revenue or financial performance; and introduces the concept of opportunity cost.

The obstacles facing most organizations today is the reviewing and commanding the risks that the generated from the risk operations. Through the representation of a business procedure a lot of oddities, that is, aberrations from the succession of occurrences might happen. To warrant that a procedure is still able to carry through its organizational targets, procedure entrants must be able to expose, analyze and prosperously resolve such unusual conditions as they occur (Dalla Valle & Giudici, 2008) Even though managers have relied on their experience and understanding of a process in order to handle deviations from the expected flow of events, however, the increasing complexity of modern business processes and the accelerating pace with which these processes change has made the reliance on individual managers' experience and intuition an increasingly less satisfactory way to deal with operational risks.

There is an increasing need for systematic business process operational risk management methodologies. Such methodologies will assist process designers to anticipate potential issues and instrument their processes so that loses can either be detected timely. Furthermore, when exception manifestations occur during process enactment, these methodologies assist in selecting the bet way of resolving them (Azvine, Cui, Majeed,& Sport, 2007).

Determine the operation risk management helps to perceive the expected changed in the business and economic status. Adeleye, Annansingh and Nunes (2004) observed the observed changes in the risk peculiarities bank's liability performance: the author described the main risk management issues. Break by conventional commercial bank risk management

method, according to the existing attitude of core capacity, they considers that to supply a secure and pacifist banking structure. Its then must provide essentially enhancement in the capacity to conform and acknowledge to external risk.

They evaluated the action mechanism that core capability to the commercial bank risk management. Based on this evaluation of the operational risk management among the commercial bank core competence to risk management, it seems that risk actions depends accordingly to the action mode based on the concept orientation and resources supporting, and function mode, etc., put forward new ideas of risk management. From the other hands, both Sundstrom and Hollnage (2004) indicated the operational risk management issues in managing the management tasks, i.e, management of risk connected with individuals, organizations and practices, which developed as one of the key qualifications financial service corporations. They suggested that the evolvement of approaches to operational risk management might extremely benefit from leverage structures by the different human –machines system's populations, particularly focused on the model based examinations and design of entangled systems.

Cristina, Cornelia and Nicolate (2004) explained the produced for performing strategies of the financial traditions in terms of the banking risks, which have as the principal purpose to reduce the chances of risk generation and the bank's prospective exposure. Cristina presented the main operational risk management and qualification methods. Meanwhile, they present the mode of minimum finance needs for the operational risk. Hence, the author initials the conceptual approach of the operational risks through the point of view of the financial institutions exposed to this types of risk. The second part describes the management and evaluation methods or the operational risk.

Also Indian banking system in the framework Basel II. The predictable assuming of the banking obtained, which matched extensively with the arrangement of the banking system in Asia, Africa and the Middle East. A review behaved on the twenty two Indian banks shows inadequate intimate data, problems in the collection of external loss data and modeling intricacies as significant obstacles in the execution of the operational risk management structure in the banks in Indian. They survey emphasizes the needed time to dedicate financial means if banks desire to execute the advanced approach under Basel II.

Different types of operational risk in the Financial Sector

The Basel Committee has identified the following types of operational risk events as having the potential to result in substantial losses for banks and institution operation like a bank.

1. Internal fraud for example, intentional misreporting of positions, employee theft, and insider trading on an employee's own account

2. External fraud, for example, robbery, cheque kitting, and damaged from computer hacking
3. Employment practices and workplaces safety. For example, workers compensation claims, violation of employee health and safety rules, organization labour activities, discrimination claims and general liability.
4. Clients, products and business practices. For example, fiduciary breaches, misuse of confidential customer information, improper trading activities on the bank's accounts, money laundering, and sale of unauthorized products.
5. Damage to physical assesets. For example, terrorism, vandalism, earthquakes, fires and floods.
6. Business disruption and system failures. For example, hardware and soft ware failures, telecommunication problems and utility outages.
7. Execution, delivery and processes management, for example: data entry errors, collateral management failures, incomplete legal documentation ,and unauthorized access given to client accounts, non-client counterparty misperformance, and vendor disputes.

Operational risk management process

Operational Risk management generally encompasses the process of identifying risks, measuring exposures to those risks. Ensuring that an effective capital planning and monitoring programme is in place. Monitoring risk exposures and corresponding capital needs on an ongoing basis, taking steps to control or mitigate risk exposures.

1. Identification of operational risk. Financial institutions should take pain to because the conditions under which firms operate change, the risk management process has a necessity to be dynamic. All the three aspect containing risk analysis, risk control and risk financing must be adopted as a continuing reassessment and monitoring of their business. The operational risk inherent in all products, service, activities, processes and systems must be identified and assess. Effective risk identification should consider both internal factors (such as the financial companies structure, the nature of their activities, and the quality of their human resources, organizational changed and employee turnover) and external factors (such as changes in the industry and technological advances) that could adversely affect the achievement of their objectives.

2. Assessment of operational risk. In addition to identifying the risk events, banks should assess their vulnerability to these risk events. Effective risk assessment allow a bank to better understand its risk profile and most effectively target risk management resources. Amongst the possible tools that may be used for assessing operational risk are:

Self Risk Assessment: A financial institution assesses its operations and activities against a menu of potential operational risk vulurabilities. This process is internally driven and often incorporates checklist and/or workshops to identify the strengths and weakness of the operational risk environment.

Risk Mapping: in this process, various business units, organizational functions or process flows are mapped by risk type. This exercise can reveal areas of weakness and help priorities subsequent management action.

Key Risk Indicators: key risk indicators are statistics and or metrics, often financial, which can provide insight into a bank's risk position. Such indicators may include the number of failed traders, staff turnover rates and the frequency and/or severity of errors and omissions.

Measurement: A key element of risk management is measuring the size and scope of the bank's risk exposures. However, there is no clearly established, single method to measure operational risk on a bank-wide basis. Banks may develop risk assessment techniques that are appropriate to the size and complexities of their portfolio, their resources and data availability. A good assessment model must cover certain standard features. An example is the "matrix" approach in which losses are categorized according to the type of event and the business line in which the event occurred. Banks may qualify their exposure to operation risk using a verity of approaches. For example, data on a bank's historical loss experience could provide meaningful information for assessing the bank's exposure to operational risk and developing a policy to mitigate/control the risk.

Monitoring of Operational Risk: An effective monitoring process is essential for adequately managing operational risk. Banks should implement a process to regularly monitor operational risk profiles and material exposures to losses. In addition to monitoring operational loss events, banks should identify appropriate indicators that provide early warning of increased risk of future/losses. Such indicators should be forward-looking and could reflect potential sources of operational risk such as rapid growth, the introduction of new products, employee turnover, transaction breaks, system downtime, and so on. There should be regular reporting of pertinent information to senior management and the Board of Directors that supports the proactive management of operational risk.

Controls/mitigation of Operational Risk: with regard to operational risk, server al methods may be adopted for mitigation of the risk. For example, losses that might arise on account of natural disasters can be insured against losses that might arise from business disruption due to telecommunication or electrical failures can be mitigated by establishing redundant backup facilitates. Loss due to internal factors, like employee fraud or product flaws, which may be difficult to identify and insure against, can be mitigated through strong internal auditing

procedures. The Board of Directors and senior management must make efforts for establishing a strong internal control culture in which control activities are in integral part of the regular activities of the bank. Bank should periodically review their risk limitation and control strategies and should adjust their operational risk profile accordingly using appropriate strategies, in light of their of overall risk appetite and profile. Investment in appropriate processing technology and information technology security are also important for risk mitigation. Bank should also have on place contingency and business continuity plans to ensure their ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

With the reforms in the Nigerian banking sector and banks being allowed to access new markets and sophisticated products, the Central Bank of Nigeria has also been repeatedly advising the banks to have in place an effective and resilient control framework in place to manage risks. Specific guidance on management of operational risk has also been issued as per which some banks; especially the larger and internationally active banks are expected to move along the range towards more sophisticated approaches as they develop more sophisticated operational risk management system and practices which meeting the prescribe qualifying criteria.

METHODOLOGY

A quantitative method to observe the acceptance level of customer based on the impact of operational risk management on the financial development and economical growth in Survey design with quantitative analysis was employed to examine the variable interaction in the model and to achieve the project objectives.

Through the judgment sampling 150 Nigeria employees from different finance companies were chosen. Based on the answer extracted from the structure questionnaire, they will contribute their perspectives on guessing the impact of operational risk management on the financial development and economic growth in Nigeria financial companies.

Convenience method was employed to collect respondents' perspectives on the impact of operational risk management on the development and economical growth in the Nigeria finance companies. Descriptive statistic used in this study to confirm the mean level of questionnaire item.

ANALYSIS AND RESULT

Respondents, characteristics were categorized in terms age, experience, and academic level of education. Table 1 presents the participants age groups 4.1 50.1% (n=76) of the respondents were within the 20-29 age range, 32.7% (n=49) of them were within the 30-39 age range, 10.7%

(n=16) of the respondents were within the 40-49 age range only 6.0%(n=9) of respondents were more than 50 years old.

Table 1: the Distribution of Respondents by Age Groups

Age	Frequency	Percent
20-29	76	50.7
30-39	49	32.7
40-49	16	10.7
>50	9	6.0
Total	150	100%

Respondents practical experience showed that 29.3%; (n=44) of them had 1 to 5 years of experience 21.3%; (n=32) had 6-10 years of evidence, 32.0%; (n=48) had only 11 to 15 years, and only 17.3%; (n=26) had 16 or more years of experience as shown in table 2.

Table 2: The Distribution of Participants by Experience Groups

Experience	Frequency	Percent
1-5	44	29.3
6-10	32	21.3
11-15	48	32.0
Over 16	26	17.3
Total	150	100%

Table 3 shows the results related to the respondents level of education. The majority of the respondents 70.0%; (n=103) were holding bachelor degree, 11.32%; (n=17) were holding a master degree, and only 18.7%; (n=28) were holding diploma.

Table 3: The Distribution of Respondents by Level Education

Level of Education	Frequency	Percent
Bachelor	105	70.0
Master's	17	11.3
Diploma	28	18.7
Total	150	100%

After analyzing the questionnaire items. The highest mean score among respondents was "Has the finance company defined operational risk categories or 'event types?" which may help to increase the organizations performance whereby the result of the mean and the Std was (mean 3.80, SD=1.000), However, the second highest means score was "Does the finance company

have an ongoing monitoring program for control effectiveness?" at (mean 3.6, SD=1.345), and "Has the insurer have a specialist operational risk function/manager?' AT (mean 3.64, SD=1.411) and "Has the finance company adopted a formal definition of operational risk (OR) as part of its internal risk management processes?" (Mean 3.28, SD=1.242). The lowest mean scores was "Has the insurer attempted to quantify its exposure to operational risk?" at (mean 3.40, SD=1.225). The overall mean result showed that operational risk management has positive effects on the financial growth and development in the Nigeria finance companies.

CONCLUSION

Managing Operation Risk is emerging as an important element of sound risk management practice in modern day banks in the wake of phenomenal increase in volume of transactions, high degree of structural changes and complex technological support systems. The Central bank of Nigeria expects all Nigeria banks and other financial institutions to strengthen their operation risk management system and to be in readiness graduate to more sophisticated approaches of operational risk management under Basel norms, in order to drive maximum gains bank and financial institutions need to gear up efforts for speedy and effective implementation of comprehensive operational risk management frameworks and thereby bring more efficiency, transparency, profitability and sustainability into their operations No doubt this will result in growth.

This study focuses on the chosen case study for purpose of data collection is the operational risk management. A study like this, expectedly, would not be totally representative of the whole public sector setting, but the researcher put total effort in placer to make the study in-depth. This will afford other researchers to penetrate deeply into other areas of the topic.

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