Operational Risk

Often lurking in the shadows, operational risk is critical to organisational resilience. Yet many businesses underappreciate and inadequately address it. In this article, we delve into the nuances of operational risk, its implications, and why organisations must elevate their focus on it.

What Is Operational Risk?

Operational risk encompasses the potential for loss arising from internal processes, systems, people, or external events. It spans a broad spectrum, including:

- **Process Failures**: Errors, breakdowns, or inefficiencies in day-to-day operations.
- **Technology Risks**: Cybersecurity breaches, system failures, or data leaks.
- **Human Factors**: Employee misconduct, negligence, or inadequate training.
- **Supply Chain Disruptions**: Dependencies on suppliers and partners.
- **Regulatory Compliance**: Violations leading to fines or reputational damage.

The Neglected Element

Despite its significance, operational risk often plays second fiddle to financial risk. Organisations allocate more resources to financial risk management, leaving operational risk in the shadows. Why does this happen?

The Illusion of Control

Operational risk is perceived as manageable because it arises from within the organisation. However, this illusion of control can lead to complacency. Organisations assume that robust processes and controls eliminate operational risk, but reality often proves otherwise.

Strategic Blind Spots

Many leaders focus on strategic risks related to market dynamics, innovation, and competition. Operational risk, being less glamorous, does not receive the same attention. Yet, it can incapacitate an organisation if left unaddressed.

Likelihood vs. Consequences

Organisations often emphasise mitigating risk likelihoods rather than understanding the potential consequences. This skewed focus impacts their ability to manage risk actively. Instead, consider:

- **Scenario Analysis**: Explore worst-case scenarios and their impact on business continuity.
- **Resilience Building**: Invest in redundancy, diversification, and crisis response capabilities.

Strategic Risk Appetite

Organisations must define their risk appetite strategically: this involves understanding the balance between risk-taking and risk aversion. Here is why it matters:

- **Competitiveness**: A well-calibrated risk appetite ensures that organisations take calculated risks to stay competitive. Being too risk-averse can hinder growth and agility.
- **Market Positioning**: Organisations must align their risk appetite with their market positioning. Aggressive risk-taking may suit disruptors, while stability matters more for established players.

Hence, a delicate balance is required to ensure the business takes sufficient risks to maintain a competitive advantage and seek to be a leader in their relevant niche market. However, adequately managing risks ensures the organisation is not put in a position detrimental to its survival.

Government vs. Private Organisations

Government entities and private companies approach risk differently:

Government Organisations

- **Risk Aversion**: Governments prioritise stability and public trust. They have secure funding sources (taxes) and minimal competition, so they are risk-averse.
- **Long-Term Perspective**: Governments focus on long-term stability, often at the expense of innovation.

However, this leads to complacency regarding operational efficiencies without the financial drivers to promote the need to achieve efficiency and cost-saving initiatives. Furthermore, the change management capabilities in government are slow at best, and should an economic downturn lead to reduced funding, the impact on the organisation could be substantial. Therefore, seeking early operational efficiencies will improve the capacity to maintain functions in a changing landscape.

Private Organisations

- **Competition and Survival**: Private organisations operate in a cutthroat market. They must balance risk-taking with survival. Innovation and growth drive their risk appetite.
- **Short-Term Pressures**: Private firms face quarterly targets, shareholder expectations, and the need to outperform competitors.

Equal to strategic risk, operational risk should be at the forefront of any business to ensure that achieving cost-effectiveness is combined with output capacity for market demands. Thorough risk management strategies allow an operation to move with market needs with minimal disruption to core functions, which is imperative for a thriving business.

Therefore, every business/organisation should focus heavily on operational risk to ensure that the operations are both stable and capable of being dynamic to market or funding shifts to ensure survival and market leadership.