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Investigation of Operational Risk Management in the Insurance Industry

[1]Hossein Nejati Fard, [2]Dr.Geetanjali Mali
[1]Ph.D Student, Department of Commerce, SavitribaiPhule Pune University
Email: Ho.nejaty@yahoo.com
[2]Research Guide, Dr. B.N.Purandare Arts and Smt.S.G.Gupta Commerce & Science College
Email: geetanjalimali99@gmail.com

Abstract

This article investigates the current practice of operational risk management in the insurance industry.Insurance companies face several risks that need to be managed but their key competencies and main contribution to society is to accept the risks assumed by companies and people, hence the strategic significance for people and governments that insurers protect their incomes and assets.Operational risk is nothing new in insurance industry, because of regulatory necessities; companies have initiated computation of risk capital for their operational losses.The importantloss to the market values of both the insurers and the insurance industry caused by operational losses must provide an inducement for operational risk management in the insurance industry.Since operational risk management in the insurance industry is still in a stage of development a relatively new concept.The study can assist insurers with founding formal operational risk management processes and programs within their companies.

Key words:*Operational risk management, Insurance companies, Operational losses*

1. Introduction

We have witnessed the globalization of the world economy financial structure in previous years. This process has contributed to the insurance companies ' appearance of serious risks and the global economy as well.In order to stabilize of its business development and participate equally in a huge competitive market, primarily to protect its customers and maintain system stability and liquidity, insurance companies should expand on risk management strategies in their strategic objectives.Operational risk management in the last decade has attracted increasing attention.

Operational risk management has been described as being one of the key types of risk that will have to be dealt with stringent basis in the future for insurance companies.

Nevertheless, more complicate operational functioning of insurance companies has led to higher sensitivity to other risks that could threaten insurance companies ' business, one of these risks is operational risk.

Operational risk for both the insurance company and its customers is one of the most hard business risks. Among financial institutions, operational risk management is not just a new concept. Information system stability, consumer demands, and internal control failures have been followed for years.Considering that operational risk arises from the imperfection of business operations and technology processes, it is difficult and, in many situations, impossible to predict on the basis of historical data, special attention must be given to this subject.

Risk management is the practice of planning, managing, controlling and assessing an insurance company's processes in order to reduce the insurance company's potential risk and enhance its development,financial results and benefits.
Operational risk is a value change due to the fact that actual losses sustained due to insufficient and ineffective internal processes,systems and people or vary from the possible losses and from external events (including legal risk).

The idea is that operational risk management is the practice of identifying assessing, analyzing, planning, organizing, controlling, managing, removing or avoiding operational risk incidents to reduce their probability of occurring or decrease potential losses and near miss.This article gives a better understanding of operational risk and also focus of this article is to observe the importance of operational risk in the insurance industry and investigate its status in current process.

2. Definition of operational risk

Operational risk is delineating as "exposure to potential losses arising from defects and/or shortcomings within the execution of operations. Such losses are often caused by internal shortcomings and weaknesses of people processes and systems yet because the lack of ability of individuals, processes and systems to deal with the negative impacts of external factors (Young, 2005). Dowd(1998),indicates that, these risks cover a large vary of specific risks: risk from extralegal trade, corruption and human failure, employees shortage, interaction difficulties and collapse of control systems, computer breakdowns and alternative technological issues, natural catastrophes and lots of others. Operational risks are allover, ranging from minor to huge and include all layers of the corporate.
That is more in practice is that the company has clear definitions and uses them regularly for all risk sorts, while bearing in mind that different definitions may well have to be used for various purpose (Tripp, 2004).
Operational risk is not an equivalent as the other risks. They claim that operational risk is usually delineate by a variety of international sources, like governmental agencies, semi-governmental bodies, skilled organizations, and consultancies, because the risk of losses arising from insufficient or ineffective internal processes, people and systems or external events(Dickstein and Flast, 2008).

3. The components of operational risk
The FSA (2004)definition of operational risk disruptions the idea of operational riskinto four separate components, that is agreed with by the literature(Dickstein and Lam, 2003; Loader 2007) namely:

- **Internal processes risk**
- **People risk**
- **Systems risk**
- **External events risk**

Internal processes risk

The operational risk happens through ineffective or inefficient processes. Ineffective processes aredescribed as being those who fail to attain their goals, while inefficient processes described as those who attain their goals however at extremeexpenses. Process risk will occur throughout numerous processes together with errors in transactions like sales, pricing and documentation(Lam, 2003).

As processes form an important part of operational risk they can so be realizedas single of its mainfundamental risk factors, and alsoapproves that process risk is that the risk of business processes being inadequate and causing sudden losses. The components of process risk embrace the risk of errors arising from information being correct or incorrectly processed; the risks arising from insufficient processes, as well as time delays and inefficiencies and resultingin losses and loss of business; the risk of failure intrinsic within the process of information results in process failures or transaction mistakes (Young, 2005).

People risk

People may be arguably the most important resource of a company, but they have been traditionally ignored when evaluating operational risk as it is very hard to measure or model the risks posed by lack of experience; human mistake; illegal activity; lack of sincere and honesty; lack of division of duties; lack of focus and expertise of customers; ineffectiveness, confidence on key people; lack of skills, practice, management and supervision; inability to control and lack of incentive (Young, 2005).

People risk considerations risks related to the employment of people. Someexamples of specific loss eventualities regarding people risk areemployeemistakes;employee transgressions; employeeinaccessibility; employment performs; and also the risk ofkey peopleleaving the organization managing in loss of intellectual capital for theorganization(Hoffman, 2002).

Various elements of people risk are identified as follows:

- Systematized labour activities.
- Inexpert staff.
- Ineffectual staff.
- Neglectful staff.
- Illegal decision-making.
- Lack of reliability and integrity.
- No proper segregation of responsibilities.
- Lack of customer attention and facility.
- Absence of teamwork.
- Overreliance on key people risk.
- Inadequate skills or training.
- Inadequate management.

Systems risk

When innovation and technology has become more and more important in business areas, operational risk incidents have become an increasing concern due to system failures. This is particularly relevant when bearing in mind that in today's companysystems are both integrated throughout the enterprise as well as adapted to the specific business requirements of each organization (Lam, 2003).
According to Dickstein and Flast (2008), systems risk is formed once automatic processes or systems and the fundamental technology, protection or infrastructure break down or fail and reason of losses.
Systems risk encompasses all technological risks, including external pressure such as the risk of failing to keep up with the development of changing and progressing a technology, as it is usually accepted that the newer technology would greater the risk of failing to perform as anticipated. Organization's also faces the risk of systems when the systems they choose are not well designed or applied (Young, 2005).
Several risks are identified dropping under the domain of systems risk, these are represented as follows:

- Network errors
- Interface errors
- Communications errors
- Business system interruptions and mistakes
- Hardware and software errors
- Hardware errors
- Software errors
- Telecommunication issues
- Inadequate systems capacity
- Systems errors
- Data stealing
- Computer viruses

External eventsrisk

External factors could have an adverse impact on the internal, fundamental operational factors (people, processes and systems) beyond the organization's direct control and influence. Therefore, it is necessary that these external factors be considered during a phase of operational risk management process and that they create the external eventsrisk (Young, 2005).

The external risks occur as a result of third parties actions and other artificial and natural forces that makelosses for a company (Dickstein and Flast, 2008).
External events risks identified as follows:
- Vandalism
- Earthquakes
- Terrorism
- Fires

- Floods
- Legal risks
- Physical security risks
- Compliance risks
- Economic conditions
- Financial reporting needs
- Risks posed by outsourcing partners
- External fraud and criminal activity

4. Identification of operational risks

Risk identification is the process in which risks are found, recognized and registered. The aim of identification risk is to identifying what might occur or what conditions could exist that could impact the achievement of the structure or companies objectives.When part of the risk management system identification step, once a risk is identified, the company must identifyany current controls in the company for that specific risk. The method of risk identification includes identifying the sources or origin of the risk or threat in the context of physical harm, incidents, conditions and situations that could have a material effect on the goals and the nature of the impact (ISO, 2009).

5. Strategy of operational risk management

Operational risks characteristic of the insurance industry such as: deception and defalcation, people and abilities attrition, insufficient employee training, external trouble, sales practices, processing failures, contractual risks, non-obedience, computer security and changes in laws or regulations (Gokte, 2012).

The knowledge of risk management encompasses strategy formulation, record custody and reporting, risk identification,assessing of the benefit against risk management costs and most significantly, collaboration with other divisions within the organization (Greene & Serbien, 1983).

Mango (2007) recommends a variety of approaches in managing operational risks between them, including monitoring performances, identifying and control, operational risk modeling and retains a checklist of main risk indicators. Administrators also need to define the organization's operational risks inherent and join them directly to their respective teams(Gokte, 2012).

Thirwell(2004) described the culture of operational risk as the result of a successful execution of a structure where everyone in the insurance company is aware of operational risk and handles it. He recommends that methods for operational risk management should be part of the company sections' existence.

Hence, operational risk must be part of any company decision to provide a framework for risk assessment, including new products and categories, strategic changes, re-engineering. Insurance companies without a strategy of risk management are most likely to pay for the consequences of threats and crises (Sadgrove 2005).It should start investing funds in prevention as the companies are aware of the need to handle business and operational risks.

6. Operational risk management sources

A particular approach to operational risk management selected by specific insurance companies depends on a variety of factors, including their size and level of technical equipment, as well as scope and complexity of their activity.Furthermore, regardless of these approaches, a clear strategy and supervision of directors board and top management, a strong culture of operational risk, such as the system of internal control, efficient internal reporting and planning in the occurrence of unexpected circumstances, are key components of the structure for an efficient operational risk management of the insurance company.
Coupled with increasing levels of financial technology, privatization and globalization of financial services, make insurance companies operations more complicated (Wei, R. 2003).As an example of these new and developing risks are as follows:

- If not properly controlled, the increasing use of highly automated technology can turn risks resulting from failures in manual data processing systems at risk, due to increased presence relying on a worldwide integrated system; the development of e-business carries with it potential risks, that are not completely understood.
- Integration, acquisition, division and consolidation of huge-scale evaluation of new or integrated and ambitious systems.
- Regardless of the precise meaning, efficient risk management and control of this class of risk, it is important that insurance companies understand clearly what operational risk means.

It is also essential that the concept takes into account the whole array of important operational risks encountered, including the most significant reasons of serious business losses. Insurance companies are required to recognize existing sources of operational risk along with potential sources of risks that may occur as new products, systems or practices are launched. Identifying risk resourcesimplies (Epetimehin, F.M. 2013):

1. Internal failures and abuses:
   - Employee unauthorized actions,
   - Authority abuse

2. External abuses including:
   - Illegal conduct by people who are not employed by the insurance company,
   - Communication between insurance company employees,
   - Gaps in the system of employ and protection at work,
   - Safety at workplace,
   - Security system gaps,
   - Discrimination in the work

3. Challenges in the functioning of customer relationships, product marketing and business processes , where they are insufficient:
   - Standardization of products protection of data and trade secrets,
   - Damage to insurance companies' property due to natural disasters and other incidents,

- Irregularities in the organization of insurance company or failures in the operation of the established systems.
- Business flows (flows, producing and data flows)
- Customer choice and access to them,
- Consulting function,
- Operational processes,

4. Implementation of business processes and decision making:
   - Monitoring and reporting
   - Supplier relationships.
   - Interactions with other business partners,
   - Collecting customers and documentation
   - Managing customer claims and responsibilities,

7. The different programs for operational risk management are (Gokte, 2012):

Deception control programs: The creation of fraud control groups by some insurance companies to assess and examine frauds. Because of the nature of the business, many kinds of policyholder-related frauds are possible, furthermore to employees or supplier frauds.

Information Security program: These would be implementation of policies, processes and controls to avoid disclosure or misuse of information. Insurance companies provide various types of information to be protected. For instance, personal information, medical and financial information or claim data. Imagine if the claim information and financial data get leaked to criminals, they may identify possible victims or commit crimes.

Business continuity program: Companies organize their responses and how if they are faced with disasters or problems they can continue their business. Companies usually have such a business continuity planning in place, checking it periodically, then assessing critical or recovery periods if the office was to be inaccessible for a long time.

Quality programs: The transaction nature of the new business, claims and policy management of the insurance company, renders it ideal for process mistakes, grievances from customers or quality loss. Many insurance companies have introduced quality improvement programs such as E&O (errors & omissions) to monitor errors as well as 6 sigma or ISO 9001 to enhance processing and service efficiency.

Legal/compliance program: Insurance companies are subject to significant legal as well as regulatory risks. Legal risks involve inaccurate policy wordings, agency arrangements; outsourcing Service Level Agreement (SLA) risks and so on compliance with IRDA is constantly evolving, so insurance companies usually have a compliance team to manage compliance requirements.

8. Conclusion:

This article provides information on operational risk exposure in the insurance industry and presents operational risk management Strategy and sources in the insurance companies.

Operational risk has become extremely important to insurance companies' management and corporate governance. Such companies ' different activities and processes are progressively having greater interactions and implications with the other risks they face, such as credit and market risks.Operational

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risk management and financial analysis is an essential activity for insurers, providing adequate development opportunities and a significant field of study on theoretical and practical problems, despite the complexity and particularity involved in this type of risk.Recently, the value of managing operational risk has been increasingly recognized by many kinds of organizations, among both companies and regulators. The identification and perception of operational risks is the foundation of effective operational risk management.This study could be used as a platform to facilitate discussions and promote fresh thinking regarding operational risk in the insurance industry.

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