OPERATIONAL RISK ISSUES ENCOUNTERED
BY INSURANCE COMPANIES

Violeta Mihaela GRECU (SIMEDRE)¹

ABSTRACT
The present paperwork illustrates the issues regarding operational risk as a part of risk management within insurance companies, focusing on specific features of the insurance industry. In this regard, there are highlighted the main components of operational risk and the international pursuits in other sectors. There are outlined the main events ranging from operational risk, focusing on the risk arisen due to human factor. Finally, there are suggested solutions for avoiding and mitigating operational risk factors.

KEYWORDS: operational risk, management, insurance, event, loss

JEL CLASSIFICATION: E24, G22, G32, J24

1. INTRODUCTION

We encounter risk every day of our life, in multiple and varied forms. A main characteristic of risk is uncertainty. This may be materialized in terms of probability, based on its turn on event occurrence, having an effect and result at a same time.

Risk appears when:
- an event is happening, but the result is uncertain;
- the effect of an event is uncertain, but the occurrence of the event is certain;
- both event and effect are uncertain. (Cornescu et al., 2003).

The origin of word risk is thought to be derived from arabic word risq or from latin word riscum (Kedar, 1970). The arabic word risq, means „anything gave” (from God) and from where you have a gain” and has the significance of a favourable and fortuitous result. The latin word riscum, was initially referring to a sailor challenge represented by a coral reef and has the significance of a fortuitous but unfavourable event.

A derived word from the arabic risq was used during twelfth century, in relation with the chance to obtain a result generally, not precising if there is a good or bad result. (Kedar, 1970). In modern french, the word risque has a significance mainly negative, but occasionally positive as „qui de risque rien n’a rien”, the romanian correspondent of saying „cine nu riscă nu câștigă”, meaning who doesn’t take any risk doesn’t gain anything, while in English, the word risk, has negative meanings, as „run the risk” or „at risk”, have the signification of danger exposure. (Merna, Al-Thani, 2005).

In a company, risk refers to the probability of not respecting the targets regarding performance (failure of quality standards) program (failure execution time) and cost (over budget).

¹ Bucharest University of Economic Studies, Romania, violeta_grecu@yahoo.com
1.1. Objectives
This paper work purpose is to highlight the fact that, in an insurance company, human factor, should not be only a matter of human resources, but it should also be taken into consideration by risk management department, being an important part of operational risk. Further, risk management is an important part of strategic management as it settles, among other criteria, the necessary capital for a company to continue its activity, even in the hypothesis of an important loss. In this perspective, all procedures regarding human resources should be originated in cooperation with the risk management department. In his manner, the rights and duties for every employee should be acknowledged and also the penalties for disrespecting the duties.

1.2. Hypothesis
The main hypothesis is that top management and shareholders from insurance domain are not fully aware of the importance of the operational risk caused by human factor, thus, does not gives the deserved importance to the human resources from risk management perspective.

The secondary hypothesis is that, top management does not take into consideration that, in order to build a strategy for the company, must begin with risk management. First, there must answered some questions: which is the target for the company? How many risks is the company willing to accept? How the risks affect the liquidities of the company? All these answers are calculated by risk management strategy, which will be an important part to the main strategy of the company.

1.3. Research Methodology
The hypothesis is that top management and shareholders from insurance domain are not fully aware of the importance of the operational risk caused by human factor, thus, does not gives the deserved importance to the human resources from risk management perspective.

The present paper research methodology was based on theoretical aspects related to risk management, but applied to the insurance domain. There was consulted also the actual legislation, as a comparison between operational risk related to bank sector and to insurance companies in Romania.

2. SPECIFIC FEATURES OF OPERATIONAL RISK MANAGEMENT FOR INSURANCE INDUSTRY

The term of operational risk appeared in the 1990s, in banking sector. This term arose because of the many errors that led to huge losses and scandals occurred in those years. Later, the term was extended to the insurance industry. In recent years, was paid attention to this type of risk, especially due to the numerous events that led to financial losses resulting from conducting operations in the wrong way, and the desire to increase shareholder role and last due to closer monitoring by financial authorities of this type of risk.

In 1999, banking supervisors announced plans for capital allocation regarding operational risk under Basel II regulations. Some of the representatives of major banks have described it as the most disorienting thing met. However, bank supervisors insisted and argued that operational risk is a major problem for banks.

Definition of operational risk in Romanian National Bank regulations is as follows:
"Operational risk - the risk of registering losses or of not reaching the estimated profits determined either by the use of processes, systems and human resources that are inadequate or who have not served properly or external events and actions. Operational risk includes legal risk."

Definition of operational risk given for the insurance market by Insurance Supervision Commission through the Order 18/2009 approving the Norms concerning the establishment of a system of
internal control and risk management, and organization and performance of internal audit Insurers / Reinsurers is:

"Operational risk - the possibility of incurring losses or reaching the estimated profits, arising from inadequate internal processes, employees fault or errors generated by the computer system and the external factors."

In relation to insurance field, operational risk is found in the same components as in retail banking:

*Operations risk* - the risk of losses resulting from errors arisen during the current work related to the operations of concluding insurance policies, registering policies and payments in the database, highlighting and tracking overdue payments, registering and assessing of claims, both because of errors and fraudulent.

*The risk of internal audit and control* - a form of operational risk consisting of inadequate and incomplete control of activities, so executive and administrative management are unable to make decisions in real time regarding remove deficiencies and minimizing losses.

*Systems risk* - risk caused by incorrect functioning or malfunction of communication systems, applications for current activities and procedural errors.

Considering the origin of risks and determining factors, operational risk can be divided into several categories:
- **Risk related to employees**
  This risk arises due to the staff, their skills and competencies that employees have and the changes in staff. During the last years, the Financial Supervision Authority has settled special requirements for the employees leading certain Departments of major importance for the company, including for the executive and administrative management. For some categories of employees is mandatory previous authorization by the Financial Supervision Authority, consisting in an interview sustained by the employees with specialists from Financial Supervision Authority. Following the interview, employees may receive authorization or may be rejected and the insurance company or undertake another person, either resubmit the same employee interview, following a better preparation.
- **The risk of material damage**
  It appears in cases of natural disaster and other factors which may lead to destruction of physical assets and company resources.
- **Technological risk**
  The risk arising from the malfunction of necessary systems for the company current activity.
- **The risk related to customers**
  The risk arising from mismanagement of customer relations, namely erroneous transactions carried out by them, wrong registration of customer records, poor cooperation with them. Customer feedback is very important for a company and has a major contribution to increase / decrease the level of customer retention.
- **Risk of fraud**
  The risk that arises from intentionally malicious action both company personnel and people outside the company who can cause company's losses through illegal operations or by actions which are contrary to internal company procedures.

Excluding the risk of technological and material damage that usually occurs with less frequency, the highest frequency have the following risks:
- Employees related risk
- Customers related risk
- Fraud risk.
All these risks are at human level risks, requiring careful analysis of all risk factors and events that could lead to these risks.

3. OPERATIONAL RISK EVENTS AND RISK FACTORS

In the insurance field, the operational risk associated adverse events are:

- Exceeding the powers to conclude an insurance contract;
- Noncompliance with premium quotations settled within the company;
- Infringement of criteria and procedures required to conclude an insurance contract;
- The agreement of overriding commissions contrary to the limits approved;
- Noncompliance with the deadline for compensation for clients claims;
- Inadequate claims assessment;
- Insufficient control of commercial and claims activity and other.

Operational risk events occur when:

- Clients payments recording is omitted, which could lead to the policy cancellation and thus, the customer will be not covered by the policy and is not aware of this.
- The company fails to report correct information to state authorities (for instance: declared income) and its subsequent correction can lead to penalties.
- The company fails to report correct information to Financial Supervision Authority and as a result beyond penalties, there could be sanctioned the executive and administrative management.
- The company trades securities when they have a diminished value against the acquisition, leading to financial losses.
- The company sends an erroneous payment and have to wait for the money reimbursement.

Beside these, there are the events due to technological errors: system crashes, incompatibility between systems, telecommunications systems crashes, etc.

4. HOW TO AVOID AND MITIGATE OPERATIONAL RISK RELATED TO INSURANCE BUSINESS

Regarding the risk associated with operations performed by employees, operational procedures must be implemented, both for sales, underwriting, reinsurance and for other departments such as finance, controlling, legal and administrative.

The entire operational system of an insurance company must answer the question: Which are input parameters to be acquired in order to fulfil the standard procedures and to offer high quality services to the clients?

The next question is: Which should be the requirements of a company regarding its employees?

Requirements before the employment:

- high professional preparation
- professional expertise
- skills
- adequate psychological profile
- good behavior
- interpersonal skills (a company where teamwork is essential, cannot hire solitary people who prefer individual work). Here comes the achievement of the psychological profile of the candidate.
- employees testing should be considered before signing any contract, both psychologically and professionally.
During daily activities:

- to comply with the internal working procedures and rules of conduct.
- to achieve a target (individual, on a team, on a daily basis, weekly or monthly).
- to comply with deadlines for carrying out the work and determination of compliance degree with the deadline. For a proper result, there could be developed graphics, determining the allowed percent deviation from the deadline.
- to comply with requirements regarding a project. There also could be developed graphics in order to reveal the compliance degree to the requirements. If there is settled a limit for the tolerance limits regarding deviations from requirements, beyond that limit could be taken measures regarding the employees.
- to comply with certain rules of conduct towards clients.
- to follow the hierarchical structures and fulfil the responsibilities of the job description.

As regards relations with third parties (partners, customers) there will be analyzed the customer retention degree per each employee who has clients in its portfolio. Through questionnaires for clients and collaborators there will be determined the customer satisfaction degree.

In order to have a complete image, there will be quantified all deviations, these being considered as parameters with negative sense. All negative deviations will be quantified on a valuable level where their quantification is possible.

On the other hand, there will be considered all positive reactions due to the occurrence of unwanted events or likelihood of an unwanted incident (learning from mistakes, mitigate damage due to the occurrence of an event, strict control in order to avoid an event). Positive feedback contributes to improving the organizational structure, to improve the risk management system and the entire company management.

Taking into consideration this, we must see risk management as a barometer of business. It must also have the ability to create valves to allow the company the opportunity to continue the work.

5. CONCLUSIONS

Risk management should not play a role for stopping the growth of a company, but should provide the support for balanced development, weighing the risks and benefits. Risk management gives the answer to the question: what are the possible scenarios in the event of a risk? The possibilities are: to avoid the risk or to accept it thereof and the subsequent calculation of benefits and losses and the presentation of balance.

In a company, the risk management department is that department kept to hear, follow and swing both voice of enthusiasm and desire to prosper, to achieve business performance and voice of failure (if anything could go wrong?). In principle, risk management must ensure that we achieve our business performance and that nothing will go wrong.

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