USING INCENTIVES AND DISINCENTIVES FOR OPERATIONAL RISK MANAGEMENT WITHIN AN INSURANCE COMPANY

VIOLETA MIHAELA GRECU (SIMEDRE)

PhD student at Bucharest University of Economic Studies, Romania
E-mail: violeta_grecu@yahoo.com

Abstract- Operational risk management gained in the last years a higher importance in most companies acting in financial services domain. Therefore, companies became aware of the fact that operation risk control and mitigation is an important element in the entire system of risk management. Taking into consideration that the most causes of the operational risk occurrence are related to human factor, this paper is aimed to highlight the fact that using the appropriate incentives and disincentives within a company, there is an important step in mitigating operational risk.

Index Terms- Incentives, Human, Operational Risk Management.

I. INTRODUCTION

In risk management process, when a risk is evaluated, there are more possibilities: either to accept it with all consequences or to use some measures designated to avoid, control or mitigate it. The same paradigm is applied also for operational risk management. Insurance companies are offering financial services to the clients, using people as the most important resource. Other companies from other domains, for instance manufacturing industry, may have as the key to win the competition with other companies from the market, a special product, a secret recipe to fabricate a certain product but, the insurance companies have as the most important element to win the market competition, the human capital. It is very important how they approach the clients, how they sell a product, how are offering the post sales services, how are they assessing and settle a claim.

Therefore, companies should be preoccupied in hiring, motivating, training and retaining the most valuable employees. Using incentives and disincentives may be a method that could help not only for obtaining better performances, but to control and mitigate operational risk related to human factor.

II. THE NEED FOR INCENTIVES

There are companies having as the only policy settled for the employees, a good average salary, holiday as stipulated in the letter of law and lunch breaks. These companies should revise their strength points and to find other than their own employees. In insurance companies, the products offered are more or less the same. If a company is bringing this week a new product, we may be sure that, within one week, at least one more company will release a similar product. Because the products are for the clients, so anybody could be a client, even a competitor's employee, who will see exactly how functions the product, reading carefully the insurance conditions. So, in this way, the competitor's employee will bring an advantage to the company, by helping the company to face the competition. But, what determines the employees to be receptive to the market, to be determinated to do more than is doing his competitor? His wage remains the same, he won't get any recognition from executive management and neither a longer holiday during the summer.

On the other hand, there are wellknown the cases of companies failure, due to the fault of the employees. As an example, the case of Baring Bank that appointed Nick Leeson, as general manager of a new operation in futures markets in Singapore. He made some unauthorized trades, who went in loss and he kept hidden the losses until their amount raised to 827 million pound sterling. The company collapsed as the losses were twice the trading capital. There were many discussions regarding the reasons which led to this failure. So, what motivates the employees to do their job correctly, to follow all procedures and to be loyal to a company?

In order to see beyond the costs of the incentives granted to employees, company management must see the advantages of this policy regarding incentives and how could improve company performance, help creating team leaders and bounding employees in achieving all the same target of doing their best. Incentives must be considered as an investment and not as a cost for the organization. Looking from this point, may not seem such a big effort to introduce them in the company's budget.

III. OPERATIONAL RISK MANAGEMENT

The definition of operational risk management stipulated in directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009, on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) is: "operational risk means the risk of loss arising from inadequate or failed internal processes, personnel or systems, or from external events".

Most important in operational risk management is to quantify all losses, grouped by each cause and event.

Statistics helps companies to settle their own risk management strategy, based on other companies experience either good or bad. It is better to know what could happen as a result of an unwanted event, rather than to occur the event and afterwards to take the necessary measures. Unfortunately for operational risk in insurance domain, there are few statistics, therefore it is difficult to prevent the result for a series of events. In respect of operational risk management, there could be settled the distribution of losses as it follows: expected losses have a bigger frequency and a lower severity, meanwhile stress losses have a lower frequency but are more severe. This means that, at least for the expected events, there could be settled a set of procedures for preventing, controlling and mitigation them.

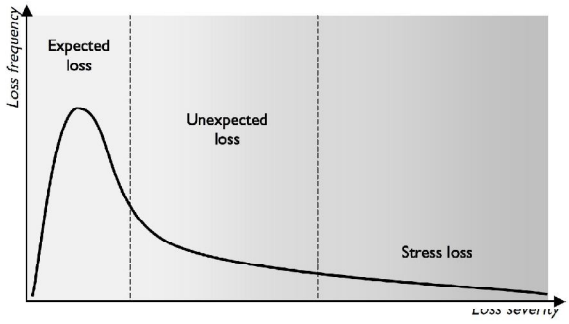

Fig. 1. Loss distribution of operational loss events
Source: Guidelines on Operational Risk Management, Oesterreichische Nationalbank in cooperation with the Financial Market Authority

The causes of operational risk due to human factor are:
- Operations errors, meaning that current activities are conducted in an erroneous way, leading to possible loss of income and loss of portfolio;
- Faults in internal audit and control activity. Taking into consideration the fact that internal audit and control are reporting directly to administrative management, a lack of communication or reporting wrong data to the management, could lead to impossibility of the executive management to take the best decisions in order to keep the company in business.
- Internal fraud, corruption acts.
- Risks aroused from employees movement.We must take into consideration that, by law, in insurance domain, heads of departments and executive management must have specific experience in insurance. Therefore, the sudden leave of an employee without having a replacement person, will cause distress in the company.

In order to avoid and mitigate the above mentioned events, the company management should implement an incentives program and to agree a disincentives procedure adequate to the risk management strategy. Only using a balanced policy reward/punishment, the company will manage to stimulate performance and to sanction the inefficiency and to discourage and tentative of illegal activity in company.

IV. TYPES OF INCENTIVES AND DISINCENTIVES

People are receptive to different types of incentives. This depends of their life style, of their material situation, if they are men or women, if they have children or not. Far from the beginning, incentives are split between cash and non-cash awards. In a case study, Awards Selection Study Phase I:Preliminary Insights From Managers, prepared for:Forum for People Performance Management and Measurement, Department of Integrated Marketing Communications, Northwestern University, prepared by:Dr. Jimmy Peltier, University of Wisconsin-Whitewater, Dr. Don Schultz, Northwestern University, Dr. Martin Block, there were analyzed both methods to award employees: cash and non-cash incentives, from the point of view of the managers.

The result was that non-cash rewards are more efficient for the employees, as shown in the picture below.

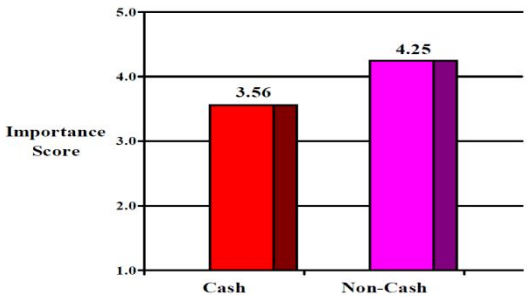

Fig. 2. Importance of cash and non-cash programs in organizations
Source: Awards Selection Study Phase I: Preliminary Insights From Managers

In order to understand better which type of incentive should be used by a company, it is important to see which incentives are preferred to others. In the same study mentioned above, that was realizedusing a survey with 235 managers, who declared that they were “users of reward and recognition services.”, each of them reported a different level of effectiveness in using one or another type of incentive.

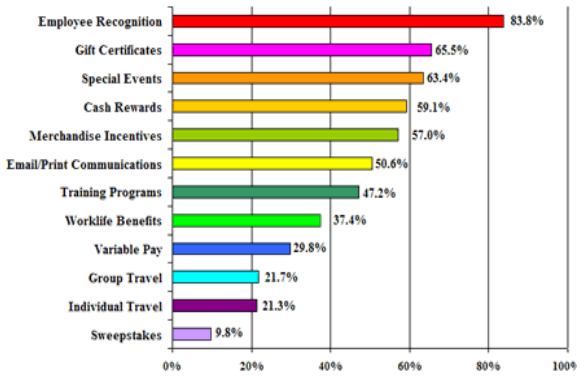

Fig. 3. Types of motivational incentives used by managers
Source: Awards Selection Study Phase I: Preliminary Insights From Managers

As we may see in the figure above, cash rewards, are on the fourth place with 59.1%.

The most used method by managers is employee recognition.

There are also used gift certificates, merchandise incentives, special events for employees, training programs, work life benefits, variable pay, group travel, individual travel, sweepstakes tickets.

Incentives could be awarded either individual or for the entire team effort.

There are use also unconventional incentives to employees, in order to stimulate their creativity, like unlimited holiday, spa tickets, rewarding green – the employees are receiving a bonus if they are going to work by bike, bus or walking.

From the employees point of view choosing one or another type of incentive depends of more variables: activity domain, the uniformity of the cultural values of the employees and the department where they work.

Applying disincentives in the company, will discourage employees to do any activities which are not in accordance with the organization rules. In the first place, most important is to have such disincentives on the paper, because nobody will desire to have applied on their own wage. Most of the disincentives are rather financial than non-financial, because, unlike incentives who were preferred in both forms cash and non-cash, nobody wishes to go to work for less money or for free. Other disincentive is not to receive the benefits awarded as motivation or for performance.

V. UNDERSTANDING WHY THERE IS NEED TO APPLY DIFFERENT INCENTIVES TYPES IN THE SAME COMPANY

One major thing to see when thinking at an incentive program for employees is to look over the uniformity of their social culture and biases. There must be taken into consideration the cultural specific of each employee. The set of cultural values and habits carried by each employee is the core part of the professional attitude and will have major influence in every person development. In cultural theory of Ellis &Wildavsky, 1990, there were identified four different types of understanding the real world: fatalists, hierarchists, individualists, and egalitarians.

Fatalists tend to think that everything will go wrong without having the possibility to control the results. For them, most important is the job security. For this type of employees, cash rewards will be on the top incentives preferred.

Hierarchists are the careful people, weighing risks and benefits. So, they will try to maximize the benefits for their work. They will accept a balanced package of incentives and they will calculate any change in their career.

Individualists are the persons seeking for a benefit in every good or bad thing happened. They will accept any kind of incentive, as long as exist and they will not hesitate to change the job if they receive a sensitive better offer.

*Egalitarians*are persons believing in personal values, in the fact that all people are more or less the same and they could bring the same value to the company. They will accept all kind of incentives, as long as they are receiving recognition for their efforts. They will look for jobs where everybody is awarded for its work.

From the same questionnaire mentioned above, resulted that cash incentives are more efficient for sales department, manufacturing staff and call center employees. It seems that employees working with a plan, need a palpable compensation and a motivation to produce more. For other employees working in other departments, the higher rating was obtained by non-cash incentives. In order to see which incentive is more efficient for the organization, there has been used in the study, a scale from 1, meaning 1 = cash is more important, to 5 equal tocash is less important. When we link the incentives with organization objectives, there could be observed below, the importance of cash in achieving company's goals. For instance, reinforcing organizational values an culture, there are more efficient cash incentives.

Organizational Objective	Cash Superior	Cash Better	Equal	Non-Cash Better	Non-Cash Superior	Mean Score
Reinforcing Organizational Values/Culture	2.2	7.9	29.8	36.4	23.7	3.71
Creating Positive Internal Communications/Buzz	5.2	13.0	27.0	26.5	28.3	3.60
Improving Teamwork	1.8	13.7	30.0	33.0	21.6	3.59
Increasing Customer Satisfaction	2.6	14.8	37.1	27.5	17.9	3.43
Motivating Specific Behaviors/Tasks	7.4	17.3	24.7	29.9	20.8	3.39
Increasing Retention/Loyalty	7.5	17.1	27.2	32.9	15.4	3.32
Improving Product Quality	2.7	21.2	42.0	23.0	11.1	3.19
Increasing Profitability/ROI	3.7	20.1	47.0	24.2	5.0	3.07
Improving Customer Acquisition/Referral	7.7	25.0	42.3	15.9	9.1	2.94
Increasing Sales	16.2	34.7	31.1	11.3	6.8	2.58

Fig. 4. Superiority of Cash vs. Non-Cash for Organizational Objectives
Source: Awards Selection Study Phase I: Preliminary Insights From Managers

From the table above, we may observe that a score greater than 3.25 means that non-cash programs are more efficient.

A total score less than 2.75 suggests that non – cash are not effective.

A score of 3 implies the fact that both cash and non-cash are effective, being equal.

The table shows that for Reinforcing Organizational Values, Creating Positive Internal Communications, Improving Teamwork, Increasing Customer Satisfaction, Motivating Specific Behaviors/Tasksand Increasing Retention/Loyalty. together, Non-Cash programs are seen as being more effective for goals regarding daily operations and those aimed to develop better customer relations.

In a case study realized in 2014, on 256 respondents from different organizations, where they should answer why companies offer benefits, the main reasons were the employees retention and easier recruiting.

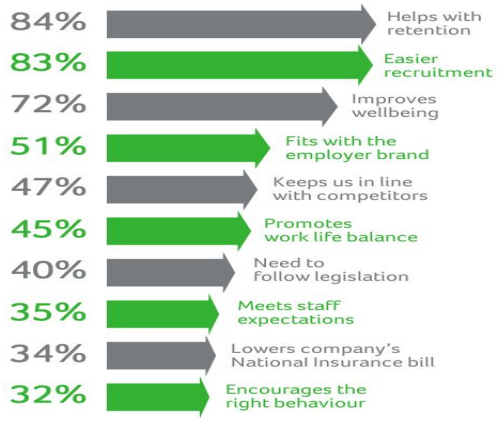

Fig. 5. Reasons for which managers offer incentives to employees
Source The Benefits Research 2014

Overall, companies using incentives/disincentives policies for employees will solve at least two problems: the business will meet performance indicators and will manage to mitigate a series of problems related to operational risk caused by employees fault. It is true, that form the figure 4, most incentives are serving for company performance, although on the first place is one of the risk management problem: staff retention. There are also identified being used in risk management process the followings: easier recruitment, need to follow legislation, meet staff expectations, encourage right behavior. We observe that, last one, with a high percentage of 32%, has a major contribution in preventing fraud and other illegal activities against the company and the staff.

VI. COMPANY TASKS REGARDING INCENTIVES PROGRAMES

In order to settle best strategies and programs for the company's employees, there must be settled a compensations committee. The committee will discuss with the top management the incentives programs appropriate for the company, according to the specific of every department. The Committee will evaluate periodically the Company's financial and non-financial target comparing to the results obtained in reality.

The Committee will present reports regarding employees performance and will determine and approve appropriate incentives for each employees.

The company must also adopt a policy of total transparency towards staff. People will be more motivated, will feel that they are involved in the entire process of achieving the company's goals.

Beside this, the company must act fairly towards all employees and to award properly good behavior and performance and to apply penalties to those inefficient employees.

CONCLUSIONS

Correlating data from Fig 2. and Fig. 3, with those from Fig. 5, we may conclude that, applying incentives/disincentives programs, may not be a great financial expense for the company, taking into consideration that losses aroused from operational risk events could register greater values. As a principle of risk management says, there must be analyzed possible gains versus possible losses and to take that action which will bring in the end more value to the company.

Incentives programs are not the only method to control and mitigate operational risk. There are more methods, highlighted in the figure below, that I shall approach in my future research.

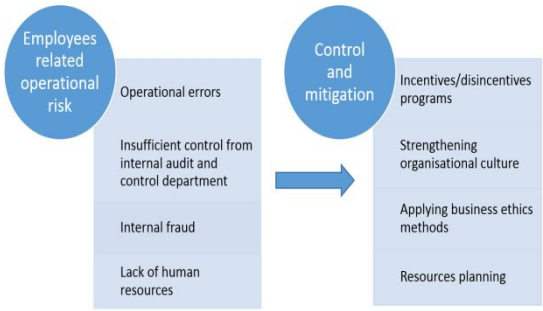

Fig. 6. Methods to control and mitigate operational risk related to personnel
Source: author

REFERENCES

[1] Dr. Jimmy Peltier, University of Wisconsin-Whitewater, Dr. Don Schultz, Northwestern University, Dr. Martin Block, Northwestern University, "Awards Selection Study Phase I: Preliminary Insights From Managers", Forum for People Performance Management and Measurement, Department of Integrated Marketing Communications Northwestern University, December 2005.
[2] Michael Thompson, Richard J. Ellis, Aaron B. Wildavsky, "Cultural theory", Westview Press, 1990.
[3] Oesterreichische Nationalbank in cooperation with the Financial Market Authority, Guidelines on Operational Risk Management - Control and provision for processes individuals systems and breakdowns, 2006
[4] http://eur-lex.europa.eu/homepage.html
[5] http://www.employeebenefits.co.uk/the-benefits-research-2014/
[6] http://medicash.org/blog/posts/5-unusual-employee-benefits/

★★★