



The Institute of  
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and Management

# MANAGER UPDATE

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# Creating value for the customer

Much marketing research concentrates on the link with company financial performance, specifically interpreted as shareholder value. Faster market penetration, shorter sales cycles, and decreased sales costs improve net cashflow, which underpins the measurement of shareholder value. Closer customer relationships enhance this. The valuation of brand equity is a component of intangible asset value, and finding ways of measuring and enhancing it also links directly to shareholder value.



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Rightly or wrongly, one of the most enduring criticisms of marketing has been the perceived inability of managers to measure and assess marketing expenditure in relation to marketing performance.

For most marketing managers, the traditional analysis of sales, market share and profitability coupled with the evaluation of sales force, advertising and distribution efficiency is hardly one of the attractions of the job.

This problem is decreasing today because of the extensive research being carried out on the development of marketing metrics designed to help managers evaluate the various aspects of their role.

## Market orientation and performance

McNaughton, Osborne, Morgan and Kutwaroo<sup>1</sup>, looking at performance from the organisational perspective, have explained the links between market orientation, marketing assets, customer value and wealth creation for the firm. They consolidated work from various strands in marketing to build an all-encompassing model, which is based on

- developing a market orientation;
- focusing on customers;
- focusing on competitors.

It also emphasises the dissemination of market intelligence and teamwork.

One of the omissions in early research on market orientation was the link between market orientation and business performance. Many researchers were criticised for this apparent gap in their work.

McNaughton *et al.* suggested that this connection may well be found in the study of market-based assets and their effect on customer value strategies. This largely focuses on the impact of market-based assets (and in particular intellectual capital and relational capital) on cashflow.

Intellectual assets are developed through

- investment in the customer;
- knowledge of the competitor;
- knowledge of the environment.

Relational capital is forged, for example, through

- relationship building;
- the development of brands, image, reputation and so on.

These create value in themselves.

- They are difficult to imitate.
- They help to build barriers against the competition.
- They are the basis for developing customer value.

This leads us naturally to a customer value strategy that examines the costs and benefits of attracting and retaining customers.

For example, a customer acquisition strategy should be focused on increasing incoming cash through the efficient management of

customers as they move from the awareness stage of a product or service to the purchase stage, and then on to becoming established and faithful customers.

It is also necessary to shorten the sales cycle and reduce sales costs while efficiently managing inventory and maximising the benefits from innovations.

McNaughton *et al.* stated that customer value strategies usually lead to satisfied customers, and this, happily for the firm, generally leads to brand loyalty.

With respect to customer retention, it is important to remember that incoming cash is acquired from customers who are prepared to

- pay price premiums;
- respond to cross-selling;
- purchase more frequently.

The marketing costs of sales and acquisition expenses are thus reduced, as are those incurred in servicing loyal customers.

In summary, this all has a positive overall effect on the business :

*Quicker and more extensive market penetration, shorter sales cycles, and decreased marketing and sales costs enhance the cash flow of a market-oriented firm. This may be recognised in higher valuations, which ultimately translate into higher share prices and wealth creation for the owners of the firm.<sup>1</sup>*

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## Customer value and profitability

Work on customer value and profitability is also a prominent feature of business-to-business markets.

Jacobs, Johnston and Kotchetova<sup>2</sup> have studied various strands of research. They highlighted the difference between the marketing approach, which has traditionally focused on market assets, and the cost accounting approach, which has tended to concentrate on revenues.

They highlighted the need for reliable customer revenue and customer account figures, coupled with an understanding of the future customer costs of, for example, warranties and even litigation.

Most of the methods of assessing customer profitability fall into one of two categories.

In the retrospective view, the historical profitability of customers is calculated. For marketing purposes, this is often the stream of past repeat purchases of current customers. Jacobs, Johnston and Kotchetova are strong advocates of the historical data approach :

- It helps in the assessment of the success of a marketing strategy.
- It aids understanding of the link between customer-related cost and performance.
- It assists in the determination of whether customer profitability has had an impact on shareholder value.

They also believe that examining the cause and effect of previous actions is useful when making decisions about the future.

The second approach, the prospective view, attempts to examine the future value of customers. Much of the literature that the authors analysed supports the future-oriented approach for business-to-business and consumer markets. The emphasis here is on the links between

- customer expectations;
- satisfaction;
- quality;
- price;
- customer plans to make repeat purchases.

The value of this research is that it combines a historical net present value model with prospective profitability.

The authors suggested that managers need to consider a number of key factors.

They started with total customer value, in other words, the net present value of future profits from

- retaining every customer;
- future expansion of the customer pool.

This notion of customer value depends on

- customers' previous experiences;
- customers' feelings of satisfaction;
- customers' ability to communicate to other potential customers their delight with a product or service, hence potentially increasing the company's market share.

The authors concluded that prospective measures are critical in marketing because they encourage the culture and practice of forward planning in the business.

Companies should develop plans that not only provide a focus for marketing activities, but also link customer value to the efficient management of resources and the subsequent contribution to shareholder value.

*It is informative that a customer may have been relatively unprofitable in the past; however it is more informative that creative and informative intervention may turn that relationship around and make it beneficial to both the buyer and the seller.<sup>2</sup>*

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## Costs of relational exchange

Much research is devoted to the process of developing relationships and understanding the results of successful relationships in terms of cooperation, trust and commitment.

However, there are few studies that examine the costs of collaborative relationships between buyers and sellers. Cannon and Homburg<sup>3</sup> have examined how this joint or shared management affects the customer's costs. Where costs are lower, they examine the potential for future business from the customer.

In the early stages of the research, they found that there were four factors that affect costs and thus future purchase intentions.

## Supplier communications

Here, the focus is on communication frequency and information sharing.

The authors suggested that where there is frequent contact with respect to routine issues such as product availability, order handling and delivery, there is also less uncertainty. As a result, customers do not really feel the need to stock up 'just in case' there is an interruption in delivery.

In addition, frequent communication leads to a better understanding of how customers use products, which allows suppliers to give advice on operational improvements and product development.

Where suppliers are also prepared to share information and discuss potential changes in products or distribution, the customer can modify its own plans in order to minimise employee productivity costs, plant use costs and scheduling costs.

## Customer accommodation

To what extent are suppliers prepared to accommodate a customer's changing needs ?

More importantly, can suppliers be flexible ? Are they prepared to relax rules for customers ? Can they respond to the unexpected ? Can the supplier adapt to meet fluctuations in customer demand so that the customer does not need to carry excess inventory ?

One can easily forget that customers, and not just service and product suppliers, are interested in the long-term development of relationships.

Customers value those partners that, as the relationship develops and the companies develop a firmer bond, are prepared to make more significant adaptations in

- information management;
- accounting;
- technical support;
- customisation of products;

to suit their needs. These adaptations may have an impact on both costs and the ultimate price to the end customer.

## The offering

A high level of product quality usually leads to customer confidence, so that there is less need to incur costs in rework, downtime and scrap. There is also less uncertainty, and fewer transaction costs are incurred in cross-checking.

However, Cannon and Homburg believe that location is still a key strategic decision for suppliers.

The closer a supplier's business is to its customer, the less chance there is of problems occurring in transit. Fewer administration costs are incurred in coordinating the delivery, and there is less need to carry emergency stocks.

## Cost management

Traditionally, competitive tendering has been a significant feature of business-to-business relationships, and the market exercises control over suppliers and their prices in this way.

Although competitive tendering may help to maintain the cost of products, materials and components, other costs are incurred in managing the process. The direct cost benefits therefore need to be compared with the increased administration and transaction costs involved in managing an assortment of suppliers.

Where a network of relationships with suppliers is maintained, customers need to assess any consequent variations in products and the effect on ultimate product quality.

Cannon and Homburg tested their model extensively, and their results have significant implications for managers.

In business-to-business exchanges, price is often solely relied on as the key differentiator and basis for competition. The authors' research showed that rather than focusing on price sensitivities, suppliers need to position their offering as one that brings cost benefits to their potential partners.

A marketing strategy based on this approach implies a need for a fundamental shift in custom and practice.

For example, the sales force should concentrate on relationship development rather than one-off sales. There are implications for training : a focus on the technical excellence of the product needs to be supplemented with information about customers' needs, their operations and the cost structures.

The sales staff's compensation packages will also need to be reviewed. Rewards are effective motivators, and most organisations currently compensate people principally for short-term sales gains.

Relationship management, on the other hand, requires a long-term and teamwork approach if the supplier's contribution to decreasing customer costs is to be emphasised and ultimately rewarded by increased customer business and/or loyalty.

Finally, communication plays a prominent role in decreasing costs. The two parties need to implement a communication system that ensures that the information necessary for

each partner to perform its role effectively is regularly shared by individuals and teams across both businesses.

## Brand equity

Understanding brand equity is another key task for marketing and brand managers. There is a great deal of ongoing research in this area.

Capon, Berthon, Hulbert and Pitt<sup>4</sup> have suggested that managers are confused by the various definitions of brand equity. For them, brand equity has two main attributes : it provides value to

- the customer;
- the organisation.

Yoo and Donthu<sup>5</sup> have also acknowledged that there are many definitions of brand equity. The development of measures to assess brand equity has been hampered by a lack of agreement over its precise definition.

Researchers and managers can use an array of tests to determine brand equity that examine

- price premiums;
- the value of the brand name;
- customer perceptions;
- financial values;
- future earnings;
- cashflow.

Yoo and Donthu looked at customer-based brand equity. They examined customers' responses to branded and unbranded products that had equivalent features and attributes and similar levels of marketing support. Their aim was to develop one measure of brand equity that could be used widely for various products and across cultures.

They decided to base their research on the definition provided by Aaker<sup>6,7</sup>, who stated that brand equity is composed of brand assets and liabilities with four dimensions :

- loyalty;
- awareness;
- quality;
- brand associations.

Their extensive research resulted in one ten-item measure that examined branding from the customer's perspective when the value of the branded product exceeded that of its non-branded counterpart.

This single measure can help managers to understand how the following affect brand equity :

- the customer's knowledge of the brand;
- the customer's shopping experience;
- marketing strategies;
- environmental factors.

The measure can also assist in managerial decision making by showing how customers develop their preferences, for example for different brand extensions.

Over time, managers can use the measure to assess how their brand equity changes. They can then monitor these changes against their marketing strategies to develop an understanding of which strategies actually work.

Although this research makes an important contribution to the measurement of brand equity, it is still one-dimensional. More information is needed on what Capon *et al.*<sup>4</sup> called organisational brand equity.

They suggested that organisational brand equity depends on cashflow to brands from two sources :

- customer acquisition;
- retention.

Three broad groups of measures were identified :

- financial market methods;
- brand earnings;
- price premiums.

A measure of organisational brand equity would be a useful complement to the measure of customer-based equity.

As marketing changes and evolves, managers must extend their skills and competencies in assessing the contribution that they make to the future success of their organisation.

Instead of being caught up in historical measures and short-term decision making, marketers must collect reliable data and information, and proactively help to shape the future of the business.

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# E-learning : towards a blended approach

The use of computer-based training, or e-learning, is growing fast, but does it really work ? A huge investment is being made in online education, but will this go the same way as the ill fated dot.coms ? Is it just a cheap alternative to face-to-face learning, or is it more effective ? What are the advantages and disadvantages ? Is there a happy medium that blends the two approaches together, building on their respective strengths ?

Although there is strong evidence of the progress of e-learning at both the corporate and academic levels, it is probably not happening quite as fast as was originally expected<sup>1</sup>. The practice of e-learning may be advancing more quickly than our understanding of it.

Even so, there is now a greater understanding of

- the costs and potential benefits of e-learning;
- the nature of the e-learning process;
- the ways in which e-learning is best provided.

It is increasingly recognised that a blended approach that combines face-to-face learning and online learning may be the most effective method of delivering e-learning.

There is also a more fundamental debate about the correct model of learning.

For example, is learning about the transfer of knowledge from teacher (or website) to student, or is it about the creation of a learning community of teachers and students within which participants create their own knowledge and meaning ?

For e-learning to be successful, providers must address not only issues of content and technology, but also questions about student support and the learning process.

## E-learning

### What is e-learning ?

For some writers, such as Rosenberg<sup>2</sup>, e-learning is about networked learning and the use of the Internet. (See *Table 1* overleaf for a glossary of e-learning terms.)

Others take a broader view. The American Society for Training and Development, for example, sees e-learning as a wider set of applications and processes<sup>3</sup>, including

- web-based learning;
- virtual classrooms;
- digital collaboration.

It may include the delivery of content via

- Internet;
- intranet;
- extranet;
- audiotape;
- videotape;
- satellite broadcast;
- interactive TV;
- CD-ROM.

### What are the benefits of e-learning ?

The key benefit of e-learning for the individual is that it personalises learning, potentially allowing each student to move at his or her own pace. It can also cater for students' differing needs and learning styles.

There are also benefits for the providing organisation, as summarised by Rosenberg<sup>2</sup> :



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Table 1 Glossary of e-learning terms

Term	Definition
Asynchronous training	Training where the interaction between teachers and students takes place intermittently rather than simultaneously; examples are links to web content, email, newsgroups, discussion groups
E-learning	A wide set of applications and processes that include web-based learning, virtual classrooms and digital collaboration; other examples are the delivery of content via the Internet, intranets, extranets, audiotape, videotape, satellite broadcasts, interactive television and CD-ROM
Integrated learning system (ILS)	A complete software, hardware and network system used for instruction
Learning management system (LMS)	An infrastructure platform through which learning content is delivered and managed
Learning object	A modular building block of e-learning content
Learning platform	An internal or external site that is often organised around specific topics; it contains technologies that enable users to submit and retrieve information
Learning portal	A website that offers learners or organisations consolidated access to learning and training resources from multiple sources
Learning service provider (LSP)	A specialist application service provider (ASP) that offers learning management and training delivery software on a hosted or rental basis
Synchronous learning	A realtime, instructor-led online learning event during which all the participants are logged on at the same time and are in direct communication with each other

- lower costs;
- enhanced business responsiveness;
- consistent or customised messages, depending on need;
- more timely and dependable content;
- learning that can be done 24 hours a day, seven days a week;
- no user 'ramp-up' time, because of access to e-learning becoming a non-issue;
- the building of a community;
- scalability;
- leveraging of the corporate investment in the Web;
- the provision of an increasingly valuable customer service.

The cost savings of e-learning can potentially be considerable.

Leonard<sup>4</sup> has noted that computer-mediated learning (that is, the use of a computer in

learning, whether networked or not) is characterised by initial large fixed costs for developing training material and building the infrastructure. There are also small variable costs, such as those of adding another student at the margin. The ROeL (return on electronic learning) of shifting to a computer mediated environment is thus in the region of three figures. This results from significant economies of scale in training delivery.

Although such benefits can be considerable, Rosenberg<sup>2</sup> argued that, to achieve them, an organisation needs to devise an e-learning strategy that is founded upon a sound business case.

To develop such a strategy, the organisation must

- address the way in which it manages knowledge;
- coordinate e-learning with the rest of its learning efforts in a learning architecture;
- develop its technological infrastructure;
- review its learning culture, management



ownership and change management competencies;

- reinvent the training organisation to support the growth of e-learning.

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## Electronic communication and social identity

### Computer-mediated communication

To evaluate the benefits of e-learning, one must also take into account the nature of computer-mediated communication (CMC) and its consequences for individual behaviour.

One view, the cues filtered out theory, argues that text-based computer-mediated communication lacks physical and social cues. It may therefore promote uninhibited behaviours and equalise relationships by reducing social barriers and differences. Less positively, socio-emotional bonds may be more difficult to develop online.

Another view, social information processing theory, argues that cyberspace can be a hyper-personal and intense place, because

- there is a lack of immediate feedback from others;
- the minimal text-based cues can be overvalued.

The anonymity may thus amplify differences in electronic discourse.

A third view, the social identity and deindividuation effect (SIDE) model, holds that, although computer-mediated communication limits the number of interpersonal cues, it does provide some cues about social identity. Consequently, social or group identity replaces individual identity in computer-mediated communication. Existing social boundaries are reinforced, and conformity to normative behaviour increases.

### Electronic discourse and gender

Electronic discourse has elements of both written language and speech. Like speech, it can be almost interactive, and there may be

informality of vocabulary and sentence construction. On the other hand, the discourse may be edited and formatted like written language.

Thomson and Murachver<sup>5</sup> researched the question of whether the gender differences of everyday face-to-face communication were also present in electronic discourse.

The answer seems to be that they are. In a study of e-mails, the authors found that it was possible to identify the gender of the participant to an accuracy of 94%.

The female e-mailers had the following characteristics :

- They made significantly more reference to emotion.
- They gave more personal information.
- They used more intensive adverbs.
- Their emails contained a higher mean frequency of questions, self-effacing comments, compliments, apologies and subjective conjunctions.

The male writers displayed the following characteristics :

- They were more likely to convey opinions.
- Their emails contained more insults.
- They wrote more.

Although there were only small gender differences in the 12 language features identified, e-mail messages could still be accurately classified by gender.

This research demonstrated the following :

- People use gender-preferential language in informal electronic discourse.
- Participants can correctly identify gender on the basis of linguistic style.

Electronic discourse provides cues about social identity, and the extent to which cues are used depends on the social context of communication.

The more informal and social the discourse is, and the less it is being engaged in to exchange information or complete a set task, the greater is the salience of gender as a social identity category.

This not only raises the possibility of gender-typed behaviour and discrimination, but also perhaps demonstrates that computer-mediated communication is not quite the great equaliser it has been supposed to be.

*Claims that the anonymity provided through CMC will free people of their social roles appears to have ignored the incredible propensity and ability of humans to construct social realities.<sup>5</sup>*

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## Developing E-learning programmes

Academic discussions of e-learning commonly identify two models of teaching and learning :

- the constructivist model;
- the behaviourist model.

In the constructivist model, according to Salmon<sup>6</sup>, knowledge is

- informal;
- tacit;
- continually developing.

This approach seeks to develop a community of tutors and students within which participants create knowledge for themselves.

The role of the tutor is to engage his or her students to help him or her to construct knowledge that is applicable in new and varying situations. The goal of the approach is to facilitate learning, rather than to transmit content, as in the behaviourist model.

According to Salmon, this model is more typical of UK programmes, while most US designers use a behaviourist model.

Carr-Chellman and Duchastel<sup>7</sup> believed that both models can work, but that constructivist approaches may steadily gain ground as the need for more interactive learning increases.

However, the creation of constructivist online courses may challenge the economies of scale within universities that are mostly interested in the Web as a revenue generator.

E-learning or computer-mediated communication is very suited to the constructivist approach.

Salmon reviewed the experience of Open University Business School. The main

advantages of computer-mediated communication 'will come through the communication, co-operation and collaborative aspects of online working'. However, a key point is that, while technology offers the 'affordance', or opportunity, of social interaction, it does not in itself create it. Hence the role of the tutor as facilitator is vital, as well as the programme design.

For all kinds of computer-mediated communication, Salmon developed a five-step model for teaching and learning<sup>8</sup>. The model, which was derived from action research, identifies the key tasks and skills that a learner must achieve and develop, and the increasing interactivity and collaboration that is supported by the tutor (or e-moderator) :

1. *Access and motivation* : Individuals set up and gain access to the computer-mediated communication system. E-moderators (tutors, mentors, teachers and/or instructors) welcome and encourage the participants.
2. *Online socialisation* : Participants establish their online identities, and find others with whom to interact. They learn to send and receive messages. The role of the e-moderator is to help the participants familiarise themselves with the system, and to provide bridges between cultural, social and learning environments.
3. *Information exchange* : Participants give information relevant to the course to each other. They master the skills of searching, and personalising software. The skills that e-moderators need at this point are those of facilitating tasks and supporting the use of learning materials.
4. *Knowledge construction* : At this stage, interaction becomes more collaborative, and participants master the skills of conferencing. E-moderators must facilitate the process, as communication depends on the establishment of common understandings.
5. *Development* : Participants look for more benefits from the system to help them to achieve personal goals, explore how to integrate computer-mediated communication into other forms of learning, and reflect on the learning processes. They develop skills in providing links outside closed conferences, and the e-moderators support and respond.

As Carr-Chellman and Duchastel cautioned, online education is a specific medium with its own design considerations. For example, an existing paper-based or face-to-face programme cannot simply be transferred to a computer-mediated communication or e-learning context.

E-learning may enhance the learning experience and facilitate student engagement through interactivity and collaboration. The problem is though, as both Goodfellow<sup>9</sup> and Laurillard<sup>10</sup> have remarked, that e-learning tends to increase the workload of both students and tutors. It is easy for an ever-increasing bulk of material to be given to already overwhelmed students, and this could impact upon dropout rates.

Laurillard noted that if 20% of the material for a course is changed to e-learning materials, this can increase the academic staff time required by 40%, and more than double the production staff time.

In effective programme design, the balance between computer and non-computer-based elements, and between interactive exercises and communicative, collaborative work online, must be correct.

One other problem with the collaborative method is that its structure and timetabling can reduce the flexibility that students value in e-learning. Collaborative activities need to be reduced towards the end of a course as students become more independent and require more control of their schedules.

Another key aspect of programme design is that computer-mediated communication based activity must be integrated into the assessment strategy for the course. This may pose problems, as online assessment may be more subjective and difficult to monitor than conventional marking methods.

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## Classroom learning versus e-learning

Weingartner's recent review of asynchronous distance learning courses<sup>11</sup> supported the argument that there is no significant difference between classroom courses and asynchronous courses.

If dropout rates are not taken into account, asynchronous courses are at least as good as classroom-based courses at achieving learning objectives. A blended approach may be even more effective.

It is also necessary to consider the learner's experience. Sweeney and Ingram<sup>12</sup> examined the perceptions of students and tutors completing a marketing course at an Australian university. They compared three learning environments :

- traditional face-to-face tutorials;
- asynchronous electronic bulletin board tutorials;
- synchronous electronic chatroom tutorials.

There were several key findings :

- Face-to-face tutorials were preferred overall by all students because they provided a higher level of feedback and expert opinion from the tutor.
- Overall participation was similar across tutorial types, but differed when ethnicity was taken into account. Asian students were more likely to participate in bulletin boards and chatroom sessions than Australian students. The reverse was true for face-to-face tutorials.
- Web-based tutorials provided a more equitable and comfortable environment in which all the students could participate. They were more student-oriented in their learning approach, and allowed students to take more responsibility for their own opinions. The face-to-face tutorial characteristics of politeness, structure and formality were removed, and this encouraged more direct, in-depth and critical responses.
- Chatroom sessions were seen as being the most enjoyable tutorials, but also the most superficial and potentially unfocused.
- Bulletin boards were the most effective and formal of the web-based tutorial approaches. They were seen as the fairest environment, in that they provided the best opportunity for deep thinking and collaboration with respect to student peers. On the downside, there could be a lack of continuity of ideas.
- Participation in web-based tutorials required extra time on the part of both students and staff.

Sweeney and Ingram argued that bulletin boards and chatrooms can be used as adjuncts to face-to-face tutorials, so that the advantages of all three methods are combined. Their research supported

arguments in favour of a blended learning approach, although they did not use the term.

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## Selection for e-learning programmes

The issue of dropout rates and selection for e-learning programmes is important, because student dropout rates are likely to increase when learners are physically separated from their tutor and other students.

Osborn<sup>13</sup> sought to identify a method of assessing the ability of a student to complete a distance learning course.

For her, the three most important factors that determine whether a student will complete an e-learning course are

- the study environment;
- motivation;
- computer confidence.

The need for motivation and commitment, a designated place to learn that is relatively free from interruption, and regular times for study and an ability to manage time is not surprising.

It is easier to overlook the issue of whether an individual can use computers to learn. Managers and organisations must address this point when developing e-learning approaches.

Young<sup>14</sup> found that if technology is to be successfully integrated into the classroom, students must be able to use the technology confidently and effectively. Those students with low self-efficacy beliefs are more likely to cease their efforts prematurely, fail at the task, and retain or reduce their expectations about their personal competencies.

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## Critical thinking in an e-learning environment

The nature and quality of critical, reflective discourse within a text-based educational environment needs to be considered.

Garrison, Anderson, and Archer<sup>15</sup> have argued as follows :

*The adoption of computer-mediated communication (CMC) in higher education*

*has far outpaced our understanding of how this medium should best be used to promote higher-order learning.*

Although their research considered only asynchronous communication in one specific context, it added weight to the argument that it is important to

- understand the nature and limitations of various approaches to learning;
- understand how to combine them in the most appropriate ways to achieve particular learning objectives.

The authors developed a model of practical inquiry that identifies the process of critical thinking through which individuals attain deep and meaningful understanding and acquire content-specific abilities, skills and dispositions.

Individuals construct and confirm meaning through sustained reflection and discourse in a critical community of inquiry. The extent to which they have achieved this is defined as cognitive presence.

The model is cyclical and has four phases, each of which is characterised by a descriptor :

1. *Trigger* : This is the initiation phase of critical inquiry. Example triggers are an issue, a dilemma or a problem-posing event. The descriptor for this phase is *evocative*, and the nature of the process is induction.
2. *Exploration* : This stage involves both individual reflection and discourse with others in a social context. It is characterised by searching for relevant information and ideas, and brainstorming, questioning and exchanging information. The descriptor is *inquisitive*, and the nature of the process is divergence.
3. *Integration* : This phase is characterised by a tentative conversion or connection of relevant ideas that are capable of providing insight into the dilemma, and by the construction of meaning. The descriptor is *tentative*, and the nature of the process is convergence.
4. *Resolution* : This is the resolution of the dilemma or problem by the process of critically assessing concepts and actions. The descriptor is *committed*, and the nature of the process is deduction.

Table 2 Content analysis

Category	Frequency, %
Trigger	8
Exploration	42
Integration	13
Resolution	4
Other	33

Content analysis of three one-week exchanges from two computer conferencing courses found the relative frequencies for each category of practical inquiry shown in Table 2.

Participants made great use of the communications medium to explore issues and to exchange ideas.

However, the key issue was that of why the frequency of responses for integration and resolution were so low. The authors identified three possible reasons :

- instructional design and facilitation;
- the limitations of the practical inquiry model;
- the medium.

Although further research is required, these findings are consistent with other research and practice, which suggest that electronic communication may be less suited to activities such as decision making.

This research also supports arguments for a blended approach. Developments in technology-facilitating synchronous e-learning will no doubt significantly enhance the e-learning possibilities.

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# Entrepreneurship in the large corporation

How can large companies become entrepreneurial? Bureaucracy and executive mindsets usually constrain efforts to take advantage of breakthrough innovations. The exploitation of pioneering technologies may be essential for many corporations as once leading-edge markets become mature. However, this is not necessarily true for all companies, as some markets are not as threatened by breakthrough technologies, and in this case the initiation of radical change may prove counterproductive.

Many studies over the last two decades have sought to address the critical strategic issue of how large, mature organisations can embrace significant radical change. Popular management books such as Moss-Kanter's *When Giants Learn to Dance*<sup>1</sup> have described inspiring examples of how big-name companies have successfully reinvented themselves.

However, even when the willingness to change and adopt new technology exists, the dominant logic of an organisation, its senior executives, and the heritage of past investments often prevent the strategy from being effectively implemented.

Gautam Ahuja and Curba Morris Lampert<sup>2</sup> have recently studied the ability of incumbent firms to create breakthrough innovations, which are best defined as basic inventions on which subsequent technological innovations are built. The authors believe that this subject is important for two reasons:

- Light is cast on innovation in general.
- Breakthrough inventions can often help companies to attain competitive advantage and increase returns.

Breakthrough technologies tend to be developed by challengers or new entrants to an industry rather than the incumbents. Ahuja and Lampert stated that to sustain market position, an incumbent firm must

- meet customer demands for high-quality outputs in an efficient and consistent way;

- have a source of competitive advantage over its rivals;
- possess an organised structure to enable it to deliver.

However, these prerequisites, although optimised to market conditions, can prevent breakthrough inventions from being developed because they focus the company's attention on existing, mature and familiar technologies that may no longer be appropriate for its future.



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## The learning traps

Established firms can sometimes fall into a series of learning traps:

- **Familiarity trap**: By failing to experiment with unfamiliar or novel technologies, the firm limits its repertoire and ability to solve problems. 'The irritant of new, imperfectly understood streams of knowledge can foster pearls of insight and encompass both old and new knowledge' (reference 2, p 527).
- **Maturity trap**: In focusing on successful, tried and tested technologies, companies can miss the opportunity of operating at an earlier stage in the development of a technology that may offer greater opportunities for path-breaking solutions.
- **Propinquity trap**: Searching for technological solutions close to existing ones and relying on historical precedent may well conserve organisational energy and



resources. However, it can also limit an organisation's ability to come up with the kind of radical inventions that can arise when new areas are explored.

These traps may all seem similar, but Ahuja and Lampert provided some useful distinctions :

- The familiarity trap is likely to affect companies that focus on a single technology, even if that technology is perceived to be leading-edge and the approaches that the company brings to it are original.
- The maturity trap can affect a company that explores many technologies, even if its approach to the technologies is original. The technologies will typically be in mature areas.
- The propinquity trap can affect companies that have an involvement in several leading-edge technologies but use a non-innovative approach.

To avoid these traps, companies must engage with novel, emerging and pioneering technologies. To be effective though, they must conduct these forms of organisational experiments in moderation. Otherwise, there will be a risk of sapping company resources and creating internal confusion.

Ahuja and Lampert tested these propositions by analysing patent data in the chemical industry.

They found that investment in novel and emerging technologies is generally associated with subsequent breakthrough inventions. However, if pushed to excess, this process will lead to a decreasing likelihood of invention.

Interestingly, the authors found no apparent diminishing return as a result of exploring pioneering technologies. They believed that this is because the implications of pioneering technologies may be different from those of novel and emerging technologies, which tend to impose excessive demands and information overload upon the organisation.

*Thus it is not so much the possibility of information overload that is problematic but simply that the attempted solution may yield no results. In such a circumstance, although excessive experimentation with pioneering technologies will have significant costs, these costs may not be eventually reflected in a decline in break-*

*through invention; instead, they would appear as larger resource outlays or monetary costs. (Reference 2, p 539.)*

Why do firms adopt differing entrepreneurial strategies ?

Ahuja and Lampert wrote of a virtuous circle of corporate entrepreneurship, in which the use of pioneering technologies leads to breakthrough inventions that in turn generate more money and enable the next cycle of entrepreneurship and experimentation to take place.

The possession of organisational slack (which complexity theorists call redundant resources) is an essential precondition for successful innovation. It is not only cash-rich corporations that can afford this type of strategy though. Many breakthrough innovations are created by small groups of dedicated individuals who may be working in adverse circumstances. Even when the organisational will is there, not all large well resourced organisations are good at allocating resources effectively.

The virtuous circle of corporate entrepreneurship is an interesting concept in relation to business success, but there may still be a strong element of chance. Not all organisations that pursue novel, emerging or pioneering technologies generate breakthrough inventions, and even quite innovative firms can experience long periods of frustration.

On the other hand, many organisations acquire breakthrough inventions through simple good fortune or the purchase of other companies that then launch them on a trajectory that would otherwise have been impossible. One example is the growth of Glaxo on the back of the ulcer drug Zantac.

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## Managing in the white space

Incumbent companies in mature industries are often hampered by management systems that severely constrain breakthrough innovations. This may simply be due to layers of bureaucracy and the length of the approvals process in the company.

This is a problem that prompted Gary Hamel to argue that if companies are to be competitive, they must create internal markets for innovation that are modelled on Silicon Valley<sup>3</sup>.

Mark Maletz and Nitin Nohria<sup>4</sup> have described the challenge of corporate entrepreneurship as 'managing in the white space', an area that they define as follows :

*a large, but mostly unoccupied territory in every company where rules are vague, authority is fuzzy, budgets are non-existent, and strategies unclear – and where, as a consequence, entrepreneurial activity that helps re-invent and renew an organization takes place.*

'Black space' activities, on the other hand, are company operations that are formally sanctioned by senior executives and incorporated into plans and budgets. Traditional management textbooks tend to assume that most activity within an organisation occurs within the black space.

Some may even think it subversive to suggest that activity that has not been legitimised by formal management approval not only exists but is an essential method of developing new business models and ideas.

As a result of their research, Maletz and Nohria believed that managers should 'shift to the white space' if one of three conditions exists :

1. There is exceptional uncertainty over a recognisable business opportunity.
2. Organisational politics, such as turf wars between various parts of the organisation, are preventing or delaying a timely and effective exploitation of the opportunity.
3. The company's existing operations are still performing well, and may be disrupted or undermined by the formal diversion of resources to exploit the novel opportunities.

White space activities could refer to just about any new form of product, technology, process or channel to market. However, many of the examples described by Maletz and Nohria relate to the challenges posed by e-business models to established businesses.

Some of the examples involved clandestine activity on a huge scale. One executive at a large bank developed a virtual trust business that managed assets in excess of \$1 billion without formal recognition from top management or explicit financial controls.

Maletz and Nohria identified three challenges faced by managers in mastering desirable white space activities :

■ **Establishing legitimacy** : To operate at all, managers in white space projects must acquire some legitimacy. As this is not going to come through official sanction, it must be earned through leveraging the reputations of individuals and demonstrating that the activity is consistent with the organisation's mission, even if the activity is not officially recognised.

■ **Mobilising resources** : Effective white space managers develop the ability to beg, borrow and steal the financial and human resources that they need to support the activity. In the virtual trust organisation, the manager responsible apparently persuaded managers from other units to allow her to 'borrow' 70 full-time employees.

■ **Building momentum** : Speed and surprise seem to be key to building momentum behind white space projects. It can be useful to win over potential opponents from black space operations by sharing credit for the success of the activities.

According to Maletz and Nohria, senior managers should nurture and support these initiatives whilst monitoring their progress carefully. Eventually, they should decide to wind up the activity or move it to black space. However, management support should not equate to corporate generosity.

In this respect, the authors' conclusions differ from those of Ahuja and Lampert :

*White space initiatives shouldn't be starved of resource, but they shouldn't be overfed either. When 'white space' managers are forced to sell their ideas to the organisation to obtain resources, only the most persuasive ideas, supported by the most credible managers, will take off. Keeping funding tight also makes it easier to help white space activities that are clearly failing. (Reference 4, p 110.)*

## The business case against revolution

This can all be an exhausting and risky business.

Many companies have successfully reinvented themselves, for example Hewlett-Packard and Nokia. Other incumbent organisations have been unable to embrace

radical change or adopt new, successful recipes, for instance Xerox and Marks & Spencer.

Some companies have implemented dramatic changes only to succumb to poor timing or misjudged strategic moves, for example Marconi. However, other companies have managed to achieve long-run success not through adopting revolutionary strategies, but by making incremental improvements in business practices.

For many people, Swiss food multinational Nestlé epitomises the continental model of capitalism. It is a 134 year old company that employs 230 000 people in 500 factories and 17 R&D facilities around the world.

Nestlé makes no secret of the fact that its primary objective is long-term sustainable and profitable development of the business rather than the creation of short-term shareholder value.

CEO Peter Brabeck believes<sup>5</sup> that the doctrine of business reinvention is little different from old-style Marxism or the student radicalism of the late 1960s. For him, radical revolutionary change is a symptom of organisational malaise, not a way to ensure the organisation's survival :

*You cannot under-estimate the dramatic impact of abrupt change, the distraction it causes in running the business, the fear it provokes in people, the demand it makes on management's time. (Reference 5, p 114.)*

However, Nestlé operates in a mature industry satisfying the most basic of needs : food. Despite changes in eating habits and fashions, consumer tastes in the industry remain conservative. Brand values count for a lot, and customer loyalties often go back for generations. Nestlé's markets are therefore rarely threatened by the type of dramatic changes posed by breakthrough technologies in, for example, the IT sector.

Brabeck sees technology as more of a tool than as a driver of Nestlé's business strategy. He places great emphasis on customer relationships around the world, and on the trust that he believes Nestlé has established, and identifies these as key factors in the company's success.

He believes that a radical reinvention of the business might confuse customers and diminish these levels of trust.

However, he recognises that a major challenge for Nestlé is to avoid complacency and exceed what some see as the company's unremarkable growth and performance targets.

His views remind us that not all businesses operate in high-growth, technology-intensive markets. In spite of what articles in management journals and business books would have us believe, e-business still accounts for a relatively small proportion of the value generated in mature economies.

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# Operational risk

Risk management has become a hot topic as both shareholders and regulators believe it merits more rigorous attention. Companies are having to find new and more credible ways of managing and reporting risks of all kinds. Banks in particular are having to look at new techniques and seek comparable standards. The Basle Accord has evolved in two stages, reflecting how thinking and practice in risk management have developed.

A recent review<sup>1</sup> of cost management issues in banks and financial institutions suggested that they had fallen behind with the introduction of some new approaches to cost management.

However, it is the issue of regulation that is worrying more financial institutions at the moment.

In the area of risk management, banks are being challenged on several fronts. In the UK, for example, the Turnbull report<sup>2</sup> has stated that all listed PLCs must assess their risk management capabilities.

At the international level, the draft New Basle Capital Accord has been published<sup>3</sup>. This regulatory pronouncement, commonly known as Basle 2, is discussed in detail in this article, with particular emphasis on the hot topic of operational risk<sup>4,5</sup>.

How does a bank prevent the type of acute operational disaster that brought down Barings Bank from occurring? With great difficulty it seems, and certainly not without good management control. The Basle regulators are trying, through regulatory measures, to stop such disasters from happening in the future.

There is an initiative to include operational risks, such as the breakdown of systems or the occurrence of other unforeseen events, in the basket of risks to be covered under Basle 2.

Basle 2 defines operational risk as

*the risk of direct or indirect loss resulting from inadequate or failed internal*

*processes, people and systems or from external events.*

This includes legal risk, but not strategic and reputational risks.

Capital allocation against operational risk is a hotly debated topic that is under negotiation between the Basle regulators and the banks.

A key feature of the New Basle Capital Accord when it comes into effect in 2005 will be that international banks will, for the first time, be required by regulators to set aside capital against operational risk. They will be asked to set aside around 20% of their regulatory funds against unforeseen disasters.



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## The New Basle Capital Accord

### 1988 Basle Accord

When it came into force in 1988, the first Basle Accord was seen as a breakthrough in regulation. For the first time, regulators from a number of countries had set a truly global standard for capital adequacy in relation to banking operations.

However, that accord only explicitly covered credit risk. It required international banks from the G10 countries to hold minimum total capital equal to 8% of risk-adjusted assets. (The Group of 10 consists of 11 countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK and the USA.)

At least half of this must be met by Tier 1 capital (equity capital and disclosed reserves). (The calculation for risk-adjusted assets involves assigning both on-balance-sheet and off-balance-sheet items to risk categories that weight them, by factors of 0%, 20%, 50% and 100%, according to the perceived riskiness of the asset.) Tier 2 capital (other hybrid debt/capital instruments) can also be used in the calculation.

In 1996, an amendment to the accord introduced Tier 3 capital to cover market risk exposures. The main objective of the amendment was to allow banks to use their own internal models to determine the required capital charge for market risk.

The accord's focus on risk was thus geared towards credit risk and market risk. Operational risk was not specifically mentioned. However, interest in this area has grown as a result of banking collapses, such as that of Barings Bank, that resulted from operational risk failures.

One serious drawback of the 1988 Basle Accord was that it took an inflexible 'one size fits all' approach<sup>6</sup>. Many observers also saw it as outdated, believing that its broad-brush approach to credit risk may have given banks the incentive to take on more risk without necessarily holding the commensurate amount of capital. Many institutions found ways of holding off-balance-sheet assets that increased their risks, and were not covered under the accord.

### New Basle Capital Accord

The New Basle Capital Accord is intended to create capital requirements that are more closely in line with modern credit risks<sup>7,8</sup>.

It is based on a number of discussion documents issued by the Basle regulators that focused increasing attention on the need for adequate management of operational risks. As shown in *Table 1*, Basle 2 is designed to be

more flexible and risk sensitive than its predecessor.

Its structure, which is based on three mutually reinforcing pillars, is intended to contribute to safety and soundness in the financial system :

- **Pillar 1 : Minimum capital requirement :** This is still set at 8% of risk-weighted assets, but a revised credit risk measurement is proposed, and a measure for operational risk is included. The market risk requirements are unchanged.
- **Pillar 2 : Supervisory review process :** Supervisors will be required to ensure that each bank has in place sound internal processes for assessing the adequacy of its capital on the basis of a thorough evaluation of its risks.
- **Pillar 3 : Market discipline :** Market discipline will be bolstered through enhanced disclosure by banks, including disclosure of the way in which the bank calculates its capital adequacy and disclosure of its risk assessment methods.

The new accord thus sets the scene for banks to move their risk management and measurement techniques into the 21st century.

For the first time, operational risk will feature directly in the assessment of capital adequacy, together with the review undertaken by the supervisors.

The new framework will probably bring about other changes :

- Banks may pursue different types of business. Some predict that there will be a shift away from retail activities towards corporate and investment banking.
- There will be an impact on bank product range pricing. Many banks may have to raise their cost base because of the extra administrative load.

Table 1 Comparison of 1988 Basle Accord and New Basle Capital Accord

1988 Basle Accord	New Basle Capital Accord
Focus on a single measure	More emphasis on banks' own internal methodologies, supervisory review and market discipline
One size fits all	Flexibility, menu of approaches, incentives for better risk management
Broad-brush structure	More risk sensitivity

[Source : Reference 3.]



- Some banks will be able to use their own internal risk management techniques to calculate the capital they require, rather than prescribed regulatory formulas. However, this will entail the amassing and processing of a mound of historical loss data.

Is this the beginning of a new universe of risk-capital allocation ? It probably is.

More capital will be required for most retail banking activities (residential mortgages being the main exception), where the historical probability of losses is higher. Some estimate that the capital appetite of retail banking activities will increase two-fold to three-fold under the new regime.

Corporate and investment banking are expected to attract lower risk-capital weightings, with banks that are geared towards investment-grade corporations being required to hold less capital to back these businesses.

This reversal in the relative benefits of consumer banking and investment banking is clouded by plans to introduce a separate and crudely calculated capital charge to cover banks' operational risks. Concern has been expressed that smaller, less sophisticated banks are going to be penalised by a very significant charge for operational risk.

Regulators hope that the New Basle Capital Accord will be approved and published by the end of 2001 after a short consultation period, and that it will take effect in 2005.

The revised accord is expected to

- enhance the security of the world financial system by aligning regulatory capital requirements with the underlying risks;
- provide banks and their supervisors with several options for the assessment of capital adequacy.

Greater emphasis has been placed on banks' own assessment of the risks to which they are exposed and the calculation of regulatory capital charges.

Inevitably, there have been criticisms of the accord.

Some say that the new rules governing the amount of capital that international banks must hold fail to meet necessary standards for the regulation of the global banking industry<sup>9</sup>.

The financial regulatory committees of Europe, the USA, Japan and Latin America (which consist of academics who specialise in regulation) believe the following about the proposed new accord :

- It will leave banks short of capital to cover their risk exposures.
- The number and complexity of the revised rules will make it harder to establish uniform supervision of the accord across the world.
- There is a lack of enforcement mechanisms. Additional capital measures to evaluate stability and systems, such as the prompt corrective action used by US authorities to enforce capital standards, are recommended.
- There are too few incentives for banks to make the disclosures needed by the regulators. Banks should be required to issue subordinated debt. This would create a group of bondholders whose returns would be linked to risk reduction. They would be able to hold management to account.

## Current operational risk practice

Banks are generally in one of three phases with respect to operational risk management practices<sup>10</sup> :

- realisation;
- basic implementation;
- advanced integration.

Most financial firms have passed through the first phase, realisation. They have seen that there is a problem. They realise that operational risk is a major issue, and have embarked upon developing operational risk management frameworks.

Financial firms that are in the second phase, basic implementation, are already

- implementing one-off initiatives;
- experimenting with self-assessment;
- employing risk indicators on an isolated level;
- using various management tools;
- using management information systems in an individual business line;
- perhaps doing some high-level modelling of certain areas of risk.

Advanced integration involves the following :

- Integrated or holistic operational risk programs are in place, including multiuser systems that allow people to input and access data throughout the firm, conduct various types of analysis to support the efficiency of the business overall, and reduce the cost of operational risk and loss. Programs and systems are fully integrated and distributed.
- There is continuous risk assessment and mitigation throughout the firm. Risk capital is used to help managers understand the impact on the capital structure of the firm. Blended risk finance (insurance, reinsurance, self-insurance, capital markets, finite risk, or financial insurance coverages) is a reality.
- A management framework is in place, or is being created, for dealing with the risks of complexity, for example integration risk, merger and acquisition risk, and the risk of dealing with cultural changes.

The majority of financial institutions are currently in the first or second phase. Only a few are in the process of adopting an advanced integration approach.

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## The measurement of operational risk

Regulators recognise the difficulties of measuring indirect losses. Nevertheless, because few banks provide for expected operational risk loss, a certain amount of capital is considered necessary to cover expected loss as well as unexpected loss.

The draft New Basle Capital Accord proposes three approaches for calculating the operational risk capital charge :

- *approach 1* : the basic indicator approach;
- *approach 2* : the standardised approach;
- *approach 3* : the internal measurement approach.

While banks would be able to use any of the approaches, the regulators do not seem to expect G10 internationally active banks to use approach 1, and there will be qualifying criteria that relate to operational risk

management for banks that want to use approach 2 and approach 3.

In simple terms, the more complex the approach is, the lower the charge will be.

- *Approach 1 (basic indicator)* : This is a very simple approach in which the charge equals gross revenue multiplied by a factor (alpha). It is estimated that this approach is most likely to be used by non-G10 banks. It requires no work by a bank, and there are no qualitative qualifying criteria.
- *Approach 2 (standardised)* : The bank is divided into standard business lines, and each business line has a standard risk indicator. The charge to be made corresponds with the standard risk indicator multiplied by a factor (beta), and the total charge is the sum of business line charges. There is no requirement to collect loss data.
- *Approach 3 (internal measurement)* : The bank is divided into standard business lines, as in approach 2, but there is an additional dimension : risk types. For each business line/risk type, a bank will have to provide an exposure indicator (*EI*), probability of loss event (*PE*), and loss given event (*LGE*). *EL* is the expected loss. Then  $EL = EI \times PE \times LGE$ , and the charge for operational risk corresponds to the expected loss multiplied by a factor (gamma).

The real benefits are achieved with approach 3, the internal measurement approach.

The bank can use its own internal loss data to show the regulators that, as a result of sound risk management, it should benefit from a further reduced charge. However, this reduction is subject to a floor for at least the first two years<sup>11</sup>.

The charge calibration issue is still in the early stages. Regulators estimate that banks set aside 20% of capital for operational risk, and preliminary estimates suggest that the application of this figure gives an alpha of 30% and some sense of the range of betas.

However, regulators are not going firm on these figures until more research has been undertaken. There has therefore been no indication of the calibrations of the gammas so far.



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## Criticisms of the New Basle Capital Accord

There have been other criticisms of the New Basle Capital Accord.

World bankers have criticised the minimum capital reserve requirements for banks as being 'overly conservative and costly' <sup>12</sup>.

The Institute of International Finance (IIF) is a global association of international financial institutions with more than 320 members.

It has stated that while it supports the broad direction and intent of the accord, it is concerned about whether regulators, as well as banks, are ready to implement the complex and expensive guidelines.

It has also expressed concern about some emerging-market banks. They could fall outside the accord's net because they could be at a competitive advantage if their own regulators were not prepared to set the same minimum standards in their own countries.

## Definition of operational risk

Major concerns have been expressed about the definition of operational risk as 'the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events'.

Many dispute the inclusion of indirect loss in the definition as it is so hard to quantify. Some believe that strategic and reputational risks should be added to the definition.

## Charges

Much concern has been expressed about the level of charges<sup>13</sup>.

The most significant concern about the charge for operational risk is that in the most basic approach, approach 1, the charge is set according to the bank's gross income. This raises an interesting question : what sense is there in creating an incentive that rewards banks for reducing their income ?

The proposal offers three approaches for measuring operational risk, all of which can be argued to be either flawed or too complex.

## Data

Another major problem is that of insufficient data. There is usually plenty of data on expected losses, such as predictable levels of credit card abuse, failed trades and petty fraud, but this is not typically the case for all types of loss.

This raises another interesting question : should the charge cover not only expected losses but also other 'extreme' events ? How many extreme events, such as terrorist atrocities or large losses made by a rogue trader, have occurred in the last decade ? Such events are fortunately relatively rare in most countries. How statistically relevant are past extreme events ?

Data collection and pooling is taking place, and there some commercial databases.

The NetRisk database is based on data collected in 1993 by the former US bank Bankers Trust (now owned by Deutsche Bank). Further data is being added to it by the MORE consortium (which comprises 12 big banks) and by PricewaterhouseCoopers, the accounting firm.

A ten year online database is maintained by Zurich IC Squared, a subsidiary of Zurich Insurance. The source of its early data is also Bankers Trust though. Supervisors find themselves using the same data too.

## Risk classification

There is concern that some operational risk will be double counted as a credit event and a market event, for example bad documentation that leads to credit failure.

There is also a debate about where to put reputational risk. A blow to reputation (which can be caused by operational risk failure) can also sink a bank.

## Insurance

In a debate with the insurance industry, lobby groups are presenting bank regulators with ideas for lightening the capital charge that banks must bear for operational risk. Some operational risks, such as professional liability and computer fraud, are already insured, and it seems that regulators agree that this merits some offset against a capital charge. If insurers can concoct insurance cover for a wider range of risks, then the capital offset will presumably also be larger.

On the fringes, there are ideas to let the market itself impose discipline on the banks, at least as far as operational risk is concerned. Catastrophe bonds linked to earthquake and storm risk have been sold to investors, as has contingent capital in the form of callable equity. However, most insurers believe that a capital markets solution for operational risk is a distant goal.

### Postponement of new rules

Because of concerns such as these, the Basle committee has decided to postpone the introduction of new rules on the amount of capital that banks must hold from 2004 to 2005.

One important reason for this postponement is that first drafts on important issues such as the treatment of retail exposures, securitisation and equity holdings have yet to be published.

The scope of the new capital charge for operational risk (that is, losses from inadequate staff, systems or other unexpected causes) has yet to be determined. Little detail has been provided about the information that banks will have to disclose to encourage market disciplines on their lending.

It will not be easy to meet the new deadlines. There is now more time for additional criticisms to be aired. For example, there is the fear that the new accord will provide incentives for banks to underestimate the riskiness of lending, which would potentially leave them undercapitalised.

Enforcement will also be difficult unless there is uniform supervision across the globe to a standard that will require a substantial upgrade in the quality of regulation.

### Scope of accords

Some have even questioned whether detailed prescription is the best way to promote bank stability.

The draft New Basle Capital Accord is already a complex document of more than 500 pages in comparison with its 40 page 1988 predecessor. This increase in scope reflects the need for closer calibration of credit risk and the need to encompass other types of risk.

Further detail will surely be needed as new loopholes emerge and the banking industry

continues to evolve. Looking even further into the future, it is very likely that the drafts will be even bigger, more complex and even harder to finalise for Basle 3.

The challenge for the industry, regulators and governments is to find a better way of promoting bank stability that is less reliant on very detailed rules. How can this be done ?

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### An alternative approach

One alternative approach that is reportedly being developed by leaders in the industry<sup>14</sup> is the Qualitative Scorecard Approach (QSA).

At a high level, QSA is based on an operational risk scorecard that provides risk scores by business lines and by risk categories. Capital is then calculated by combining risk scores with exposure indicators and regulatory parameters.

The scorecard is based around a series of questions that cover a number of issues, including the scope of the control environment and risk indicators. Questions can be designed to address the perceived major drivers of risk, and they should be as quantitative as possible to facilitate validation.

One advantage of this approach is that questions can be quickly adapted to reflect changing risk environments (for example recent e-business initiatives) or emerging areas of operational loss.

Other significant advantages include the fact that this approach is risk sensitive and forward looking, with the primary driver being the internal control environment. The approach is also generally applicable, and it provides a transparent approach to the calculation of capital.

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| <p>2 <b>'Internal control. Guidance for directors on the Combined Code'</b><br/>Turnbull, N (Ed.)/Internal Control Working Party (1999) Institute of Chartered Accountants in England &amp; Wales</p> <p>3 <b>'New Basle Capital Accord. Consultative document'</b><br/>Basle Committee on Banking Supervision (2001)</p> <p>4 <b>'Operational risk for financial services – a review of the literature'</b><br/>Blacker, K <i>International Journal of Project and Business Risk Management</i> (1999)</p> <p>5 <b>'What is operational risk and why is it important ?'</b><br/>Smallman, C <i>Risk Management</i> Vol 2 No 3 (2000) 7–14</p> <p>6 <b>'Bank capital regulation in contemporary banking theory : a review of the literature'</b><br/>Santos, J A C, Working Paper 30 (2000) Bank for International Settlements</p> <p>7 <b>'Operational risk management'</b><br/>Basle Committee on Banking Supervision (1998)</p> | <p>8 <b>'Framework for internal control systems in banking organisations'</b><br/>Basle Committee on Banking Supervision (1998)</p> <p>9 <b>'Basle rules criticised'</b><br/>Willman, J <i>Financial Times</i> (18 June 2001)</p> <p>10 <b>'Bank operational risk management : a board-level issue'</b><br/>Hoffman, D <i>Accounting and Finance</i> Vol 14 (Winter 2000)</p> <p>11 <b>'Lack of methodology in the madness'</b><br/>Stewart, J <i>The Banker</i> Vol 151 No 902 (2001) 8</p> <p>12 <b>'Basle Accord too conservative'</b><br/><i>South China Morning Post</i> (2 June 2001)</p> <p>13 <b>'Capital cushion fight'</b><br/><i>The Economist</i> (USA) (9 June 2001)</p> <p>14 <b>'Operational risk concerns intensify'</b><br/>Johnson, B <i>Australian Banking and Finance</i> Vol 10 (30 April 2001)</p> |
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# MANAGER UPDATE

This Faculty publication is produced in parallel with the Braybrooke Press publication of the same name. Accordingly, references in the text to issues of *Manager Update* prior to April 1997 relate to the Braybrooke edition.

*Manager Update* helps the general manager keep abreast of the latest articles in specialist management journals. The most useful ideas in the fields of strategy and organisation, marketing, accounting and finance, and human resources management are carefully selected from a wide range of publications with the busy general manager in mind. Experts in each field explain and discuss the relevance, practicality and usefulness of the key new concepts and ideas, thus enabling the senior executive to keep really up-to-date.

The articles represent the personal views of the

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The Faculty committee intends that *Manager Update* will act as an aide-memoire for members, provide new ideas, and encourage good practice, but cannot accept responsibility for their accuracy or completeness. Responses from the membership will be a very important part of the successful development of the series. Comments please, to Chris Jackson on 020 7920 8486 (or by e-mail to [chris.jackson@icaew.co.uk](mailto:chris.jackson@icaew.co.uk)).

*Manager Update* is compiled and edited by Professor Keith MacMillan, Academic Dean and Deputy Principal of Henley Management College.

## Feedback

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Issue 5 :	May 1998	Issue 16 :	February 2001
Issue 6 :	September 1998	Issue 17 :	May 2001
Issue 7 :	November 1998	Issue 18 :	August 2001
Issue 8 :	February 1999	Issue 19 :	November 2001
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