NICO Asset Managers

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INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy

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Topic 243: Risk Management

Last week we continued the topic on risk management. We discussed the five crucial steps for effective risk management. We stated that in a competitive business environment, companies must always implement techniques in order to manage risks effectively. This week we will look at risk management failures. While understanding the role of risk management is important, it is also important to understand the ways in which risk management failures may arise. The following are the most common failures in risk management:

1. Failure to Report Risks

One of the most common reasons why risk management fails is because the people responsible for managing risks simply do not report them. Failure to report risks is very dangerous because risks have a tendency to grow over time, especially in financial organizations. However, effective risk reporting ultimately depends on an institution's culture and incentives. People are more likely to report risks if it is considered as everyone's responsibility. Employees are also more likely to take risks more seriously if they are given incentives.

2. Poor Communication

Communication failures have played a significant role in many risk management crises. The role of risk management is to provide accurate and timely information to the board, but this requires effective communication. In some cases, information may reach the board too late or distorted. A risk manager may also overstate or underestimate the risks to the board, and this may cause serious problems.

3. Poor Leadership

One of the major roles of leaders of an organization is to identify the challenges it faces and come up with effective strategies to overcome them. However, a leadership failure can undermine even the strongest risk management capabilities. It is crucial to always ensure that leadership takes risk management very seriously.

4. Failure to Measure or Monitor Risks

Failures also arise when risk assessment activities are not identifying key risks effectively, efficiently and promptly. In a well-functioning risk management system all risks should be identified, monitored and managed on a continuous basis however there is a common tendency to ignore risks, especially if those responsible are unable to measure them. This can be detrimental to the organization.

5. Relying on Historical Data

Risk management modelling often requires the use of information from the past in order to forecast the probability that a risk will materialize. Businesses and environments change over time and so do their risks. It is always crucial for an organization not to overly rely on past experiences when managing risks.

As shown above, risk management failures can cause serious consequences for the organization. Therefore, understanding the risks inherent in the company's business is essential in avoiding these failures. Subsequently, all employees whose activities can pose considerable risk to the organization must be adequately trained, carefully selected and continuously evaluated. Organizations must establish a common culture for risk awareness, and comprehensive measures for measuring, monitoring and managing risks.

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