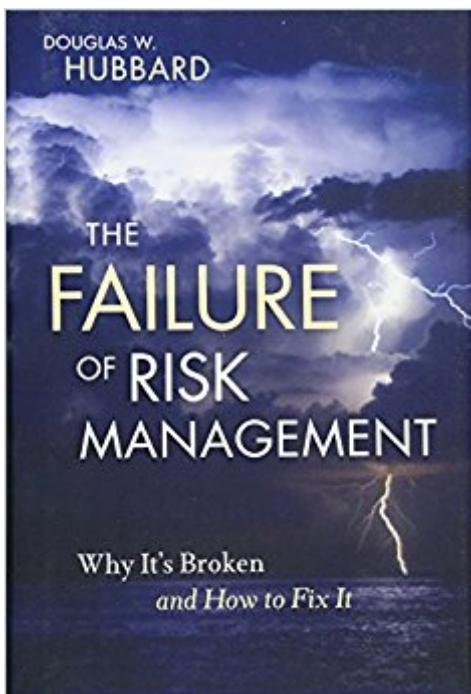


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The Failure Of Risk Management: Why It's Broken And How To Fix It



Synopsis

An essential guide to the calibrated risk analysis approach The Failure of Risk Management takes a close look at misused and misapplied basic analysis methods and shows how some of the most popular "risk management" methods are no better than astrology! Using examples from the 2008 credit crisis, natural disasters, outsourcing to China, engineering disasters, and more, Hubbard reveals critical flaws in risk management methods and shows how all of these problems can be fixed. The solutions involve combinations of scientifically proven and frequently used methods from nuclear power, exploratory oil, and other areas of business and government. Finally, Hubbard explains how new forms of collaboration across all industries and government can improve risk management in every field. Douglas W. Hubbard (Glen Ellyn, IL) is the inventor of Applied Information Economics (AIE) and the author of Wiley's How to Measure Anything: Finding the Value of Intangibles in Business (978-0-470-11012-6), the #1 bestseller in business math on . He has applied innovative risk assessment and risk management methods in government and corporations since 1994. "Doug Hubbard, a recognized expert among experts in the field of risk management, covers the entire spectrum of risk management in this invaluable guide. There are specific value-added take aways in each chapter that are sure to enrich all readers including IT, business management, students, and academics alike" •Peter Julian, former chief-information officer of the New York Metro Transit Authority. President of Alliance Group consulting "In his trademark style, Doug asks the tough questions on risk management. A must-read not only for analysts, but also for the executive who is making critical business decisions." •Jim Franklin, VP Enterprise Performance Management and General Manager, Crystal Ball Global Business Unit, Oracle Corporation.

Book Information

Hardcover: 304 pages

Publisher: Wiley; 1 edition (April 27, 2009)

Language: English

ISBN-10: 0470387955

ISBN-13: 978-0470387955

Product Dimensions: 6.3 x 1.1 x 9.3 inches

Shipping Weight: 1 pounds (View shipping rates and policies)

Average Customer Review: 4.2 out of 5 stars 79 customer reviews

Best Sellers Rank: #87,501 in Books (See Top 100 in Books) #24 in Books > Business &

Customer Reviews

"Ã¢â€ž shows how to identify and fix hidden problems in risk management. He uses real world examples to reveal serious problems in common quantitative and qualitative approaches to risk analysis." (Book News, August 2009)

The 2008 credit crisis, terrorism, Katrina, computer hackers, and air travel disasters all have something in common-the methods used to assess and manage these risks are fundamentally flawed. If risks cannot be properly evaluated, risk management itself becomes the biggest risk. The Failure of Risk Management shows you how to identify and fix these hidden problems in risk management. Ineffective risk management methods, often touted as "best practices," are passed from company to company like a bad virus with a long incubation period: there are no early indicators of ill effects until it's too late and catastrophe strikes. Exploring why risk management failsÃ¢â€ž the failure to measure and validate methods as a whole or in part; the use of components known not to work; and not using components that are known to workÃ¢â€ž The Failure of Risk Management shows you how to measure the performance of risk management in a meaningful way, identify where risk management is broken, and fix it. Respected expert and bestselling author Douglas Hubbard-creator of the critically praised Applied Information Economics (AIE)Ã¢â€ž uses real-world examples to reveal the serious problems in our current approaches to risk analysis. Hubbard skillfully illustrates how to use a calibrated risk analyses approach, and the many benefits that go along with it, along with checklists and practice examples to get you started. One of the first resources to apply risk management across all industries, The Failure of Risk Management provides you with the tools you need to hit the ground running with radically better risk management solutions. Here, you'll discover: The diversity of approaches to assess and mitigate risks Why many influential methods-both qualitative and quantitative don't work Why we shouldn't always trust assessments based on "experience" alone The fallacies that stop you from adopting better risk management methods How those who develop models of risks justify (in error) excluding the biggest risks Adding empirical science to risk management

A thorough assessment of current risk assessment methods and their shortcomings. Hubbard takes the reader through some historic events that showcase shortcomings in different fields in regards to

risk management. Rooting his points in both case studies and citations to a multitude of other research, Hubbard provides reasoning for the found flaws in how risk is handled today. A favorite component for all of Hubbard's work has always been the vast amount of background research, there is never a shortage of avenues for readers to look for further information. After providing this relatively comprehensive debunking of many widely used techniques, Hubbard offers some solutions involving a larger reliance on quantitative methods and the scientifically proven method of estimation calibration training.

I have been involved in business consulting, investment management, business valuation and corporate governance for most of the past 25 years, and I can say without hesitation that Doug Hubbard's book on The Failure of Risk Management is an outstanding and elucidating work. I have never been a risk manager per se, but I have frequently been deeply involved in risk assessment and risk management activities, so I do have firsthand experience in this topic. This book is an eye opener from the outset. In Part One of his book ("An Introduction to the Crisis") Hubbard begins with fundamental, obvious questions about risk management that everyone (not just risk managers!) should be asking. For example: How do you know that your risk management program is effective? Would anyone in your organization know if your risk management program didn't work? (...and how would they know - and define - that it wasn't working?). These are very simple, obvious questions, yet I have never heard them asked by management teams or even members of boards where I have served as director. Alas, there is a huge "placebo effect" in so much of what passes for risk management nowadays - perhaps that is why it is so popular. For example, consider the following: If risk management programs really do work, then it seems logical to assume that companies in a given industry with a (self proclaimed) "highly effective" risk management program would show greater shareholder returns, less earnings volatility, and better safety and regulatory compliance records than other companies in their peer group who lack such a program. Yet there appears to be no valid evidence that current risk management practices, taken as a whole, serve to improve overall corporate performance. The evidence just isn't there. In Part Two ("Why It's Broken"), Hubbard provides a thorough and convincing overview of the many shortcomings of modern risk management practices. As a self proclaimed "Quant," he strongly endorse quantitative analytics as the most effective approach to both measuring risk as well as the implementation of risk management programs. His approach is compelling and convincing; after all, if we can't measure accurately, how can we rely on our system of "assessing" (i.e., measuring)? It sounds pretty obvious, doesn't it? Without metrics, what tools do we have, other than generalizations, hunches,

intuition, and "gut feel"? Sure, certain qualitative techniques are helpful, but qualitative risk analytics is really effective (in my view) only for the most obvious risks, and therefore no better than having no risk management program at all. Indeed, Hubbard makes a compelling argument that ineffective risk management can be worse - possibly much worse - than having no risk management program at all. Part Two also includes concepts that Hubbard brilliantly applies to risk management practices. This includes certain characteristics of human nature, such as a proven tendency to be overconfident in our estimates (of risk, but also of other estimates), that must be acknowledged and addressed in order for risk management programs to work effectively. He also provides a practical method of adjusting or "calibrating" for such overconfidence. Similarly, there is a fascinating discussion on risk correlations and how risk events seldom materialize in isolation from one another. Consider (my own example) certain risk correlations in mortgage banking. Banks that invested in mortgage backed securities no doubt undertook some sort of risk analysis of these investments. They also had risk management systems in place for their mortgage lending business. But how many lenders tied these two risk programs together, and properly concluded that a collapse of one market would also result in the collapse of the other? Thus, it's not just a case of accurately assessing and management individual risks, but also in considering the extent to which there might be a "domino" or "cascading" effect among different risk factors. In reading Part Two (especially Chapters 6 and 9), it occurred to me that this book should be read by anyone and everyone involved in investing or lending money. As one might expect, Part Three of Hubbard's book ("How to Fix It") embraces a scientific and quantitative approach to improving risk management. Once you get to this point in the book, you will find it very difficult to disagree. Another important concept introduced by Hubbard is that of language and communication with respect to risk. As a potentially murky and subjective topic (if not downright Byzantine at times) risk management systems require clear and concise language and terminology to be effective. Thus, if two different managers in the same factory concur that the likelihood of a risk event materializing is "very likely," we should not assume that they both agree on the use of the term "very likely." One may feel that this means the odds are one in three, while the other feels the odds are one in ten. Hubbard is clearly on target when he proposes that risk managers apply scientific methods to risk management. His suggestions on how to do this are fairly simple and practical. Without such methodologies, risk managers are sailing through dense fog with an unreliable compass. You might even feel that you are making great headway, but if you can't measure where you are going, you will never know if you are really making any progress. Finally, one of the greatest benefits to me in reading this book has less to do with the specifics of risk management and a lot more to do with the way people think. Consider, for

example, why your sales team frequently falls short of their sales projections, or why so many portfolio managers buy stocks near their highs and sell near their lows. Or why risk management programs are so popular, and yet seldom work. Hubbard provides a brilliant and penetrating look into the human mind in the context of business decision making as a whole - not just with respect to risk. For me, this was an excellent "upside surprise" to this book. I finished reading this book several months ago, and I still think about it all the time. It has made a lasting and beneficial impression that I will never forget.

I work in the mineral exploration industry where managing risk is a daily aspect of life as we know that more than 95% of the time an exploration project will fail. Therefore, like others in my industry (which spends about \$10 Billion a year, globally) I am very interested in any insights that I can glean from the general risk-management literature that might help me and my business. This was the reason that I bought Douglas Hubbard's book and I was not disappointed in finding some gems that could help me. In particular, I found the discussion about calibrating expert judgment to be very enlightening and the concept that calibration is not domain-specific to be a very interesting insight. Hubbard's general approach to the philosophy of measurement I also found very helpful. When you work in a highly uncertain domain, it is very easy for people to totally reject any form of quantitative analysis. However, Hubbard makes the very profound comment that it is actually in areas of highest uncertainty that we get the most value (ie in terms of improving our business decision making) with the least amount of additional measurement. I have recommended this book to many others in my industry and have also now purchased Hubbard's early book.

When I attended a course on risk management for my masters degree in engineering management, I was very disappointed with the prescribed book. It contained very shallow principles on risk management and an overview of some approaches. It did not really equip me as a manager to know the history of risk management (how it developed and why); and where it is heading to. It also did not tell me the strengths and weaknesses of risk management models and approaches. Previously I have read "how to measure anything" from Hubbard and thought that a book about measurement taught me more about risk management than risk management books. Then I read this one that put everything together in a single book. Hubbard can be "evangelistic" in promoting his approach, but he provides an exceptional overview of the risk management landscape and how it evolved over the years. He also puts his head on a block and probably offends many authors in calling the weaknesses to their approaches to risk management (and in

some cases he even demonstrates the weaknesses with research findings or examples). He goes further by providing recommendations on how risk management could be tackled. I highly recommend this book for people interested in tackling risk management, or just wanting a general overview of risk management. I should warn that he is very single minded in promoting quantitative risk modelling, which is not suitable to complex domain issues (see the Cynefin framework). But what I do take home with me is that we are able more often to perform quantitative risk modelling than we think we can. And it is a superior way of managing risk when compared to qualitative methods (such as the infamous risk matrices)

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