The Failure of Risk Management
The Failure of Risk Management:
Why It's Broken and How to Fix It

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WILEY
I dedicate this book to my entire support staff: my wife, Janet, and our children, Evan, Madeleine, and Steven.
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Preface

I started writing this book in early 2008, well before the most serious period of the financial crisis. The original plan was to turn in my manuscript in December but, as the economic crisis developed, the publisher saw that a book about the failure of risk management might become more relevant to many readers. So, at my editor's urging, instead of writing a 50,000-word manuscript due by December, I wrote an 80,000-word manuscript by the end of October.

Although the financial crisis becomes an important backdrop for a book about risk management, I still wanted to write a much broader book than a reaction to the most recent disaster. This book should be just as relevant after the next big natural disaster, major product safety recall, or catastrophic industrial accident. Better yet, I hope readers see this book as a resource they need before those events occur. Risk management that simply reacts to yesterday's news is not risk management at all.

I addressed risk in my first book, *How to Measure Anything: Finding the Value of Intangibles in Business*. Risk struck me as one of those items that is consistently perceived as an intangible by management. In a way, they are right. A risk that something could occur—the probability of some future event—is not tangible in the same way as progress on a construction project or the output of a power plant. But it is every bit as measurable. Two entire chapters in the first book focused just on the measurement of uncertainty and risks.

Unfortunately, risk management based on actual measurements of risks is not the predominant approach in most industries. I see solutions for managing the risks of some very important problems that are in fact no better than astrology. And this is not a controversial position I'm taking. The flaws in these methods are widely known to the researchers who study them. The
message has simply not been communicated to the larger audience of managers.

In 1994, I developed a method I called Applied Information Economics, in part for the same reason that I wrote this and the previous book. I have watched consultants come up with a lot of half-baked schemes for assessing risks, measuring performance, and prioritizing portfolios with no apparent foundation in statistics or decision science. Arbitrary scoring schemes have virtually taken over some aspects of formalized decision-making processes in management. In other areas, some methods that do have a sound scientific and mathematical basis are consistently misunderstood and misapplied.

Of all the good, solid academic research and texts on risk analysis, risk management, and decision science, none seem to be directly addressing the problem of the apparently unchecked spread of pseudoscience in this field. In finance, Nassim Taleb's popular books, Fooled by Randomness and The Black Swan, have pointed out the existence of serious problems. But in those cases, there was not much practical advice for risk managers and very little information about assessing risks outside of finance. There is a need to point out these problems to a wide audience for a variety of different risks.

This book is somewhat more confrontational than my first one. No doubt, some proponents of widely used methods—some of which have been codified in international standards—might feel offended by some of the positions I am taking in this book. As such, I've taken care that each of the key claims I make about the weaknesses of some methods is supported by the thorough research of others, and not just my own opinion. The research is overwhelmingly conclusive—much of what has been done in risk management, when measured objectively, has added no value to the issue of managing risks. It may actually have made things worse.

Although the solution to better risk management is, for most, better quantitative analysis, a specialized mathematical text on the analysis and management of risks would not reach a wide enough audience. The numerous such texts already published haven't seemed to penetrate the management market, and I have no reason to believe that mine would fare any better. The approach I take here is to provide my readers with just enough technical information that they can make a 180-degree turn in risk management. They can stop using the equivalent of astrology in risk
management and at least start down the path of the better methods. For risk
managers, mastering those methods will become part of a longer career and
a study that goes beyond this book. This is more like a first book in
astronomy for recovering astrologers—we have to debunk the old and
introduce the new.

Douglas W. Hubbard