Ethics of Risk Management in the Information Age

Name

Institution

# Ethics of Risk Management

The title of the video is “Ethics of Risk management in the Information Age”. The chief moderator is Mike Hoffman while Boatright is the key speaker.

Hoffman qualifies the significance of the topic by highlighting important statistics pertaining to the issue. Specifically, Hoffman quotes issues such as an unemployment rate of 10%, a decline in GDP, an increase in homelessness, and a decline in world trade (Hoffman, 2014). Failure of financial institutions to manage risk is one of the principal causes of the economic crisis facing the global economy. Enterprise risk management (ERM) is widely used by many companies in the 500. It requires sophisticated information technology and computer programs, and would be impossible without these. Its onset in 1995 was facilitated by the alignment of several forces including information technology.

Ethics of risk management has been neglected in the literature. Boatright highlights three principal reasons why this may be the case. The first is the belief that risk management is purely technical. A second reason is that it is viewed as an unalloyed good. ERM evolved out of statistics, which empowered individuals and institutions such as banks to acquire a more tangible outlook on the future. A more definitive period for ERM was the 1970s when the risk began to be assessed for advisory purposes. The need for risk assessment arose due to the changing nature of banking which introduced greater risk. The role of risk management is not to avoid risk entirely, but to optimize the risk/reward trade-off. 1995 shaped the risk management field by highlighting the diverse and integrated nature of risks.

Enterprise risk management is comprehensive, integrated and high level, requiring the involvement of top-level management. Boatright argues that ERM has risen due to a shift from rule-based to risk-based regulation, and due to the onset of new financial instruments. Risk-based regulation involves the development of their own models that are used for decision-making purposes. Regulation is based on this models and is proportional to the level of risk. Such a system has advantages such as providing flexibility to banks in choosing their level of risk.

ERM has several advantages. For starters, it can provide firms with a comparative advantage. Investors do not like volatility, and where a firm is able to manage its risks, it is able to reduce its volatility thereby improving its comparative advantage relative to other companies. Others include the development of novel methods of measuring risk (VaR) and development of new financial instruments for risk management. These benefits have been facilitated by advances in information technology. VaR refers to value at risk. It is an expression of the maximum amount in a portfolio that can be lost on a given day over a period of time (Hoffman, 2014). It has the advantage that it provides a single number, thus, can be used for quick analysis. Moreover, it can be applied to all kinds of transactions. The model has however been criticized since it provides a false sense of security, thus encouraging excessive risk-taking. It also ignores low-probability events, whereas those might actually be high-impact. In this manner, ERM may have contributed to the financial recession.

Ethical issues related to ERM arise from the transfer of mispriced risk. The question is whether traders should just be left to pay the price of their mistake, where they are unable to price the risk appropriately. For instance, some investors may not be very sophisticated. Boatright concludes that ERM is a good idea, but that there shouldn’t be an overreliance on it.

# References

Hoffman, M. (Director). (2014). *Ethics of Risk Management in the Information Age* [Motion Picture].