

# Factors that Determine the Functioning of Risk Management Systems

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**Abstract.** This work, based on empirical research, has identified determinants which condition the implementation and operation of risk management systems. For organizations looking to avoid failure in this regard, it is necessary to strengthen the positive impacts, and evade the identified barriers.

**Keywords:** risk management, implementation barriers, barriers to functioning, risk management system

## 1. Introduction

Recently, risk management is seen as a process to assist the organization in understanding and assessing the imminent dangers and in benefiting from emerging opportunities. In the literature, business circles and the press there are many debates on how to approach risk management, how to apply it, which factors determine its success, and which ones limit its effectiveness.

The beginnings of risk management are dated to the '60s, when Douglas Barlow at the Massey Ferguson Company said: "Management is managing the risk"<sup>1</sup>. Whereas holistic approach to risk management goes back to the early '70s, when Gustav Hamilton, representing Statsfoeretag – Swedish government agency managing public companies, introduced the so-called risk management circle describing interaction of all elements of risk management process ( assessment, control, financing and communication) in the Swedish companies belonging to the state. In the twenty-first century risk management reaches its peak form all over the world. However for Polish managers it is still a novelty. The main objective of risk management in the organization is: identification of sources of risk, risk assessment, development of an appropriate strategy for dealing with it.

Thus, risk management depends on the objectives assigned to it by the given organization. It protects against threats, but also provides assistance in business by optimizing the ability to take risks, pointing to the efficient use of insurance, assisting with value management, or optimizing the use of capital.

Risk management includes work organization, i.e. assignment of work, improvements, resources, and leadership, employee motivation as well as identification, estimation, monitoring and control of undertaken actions. It concerns an analysis of retrospective information and the information derived from the environment in order to accurate estimate of future states. So, it is a procedure aimed at formation of the structures, functions, processes, so that the organization could effectively respond to emerging risks, accurately identify threats and effectively eliminate them, and notice emerging opportunities. Risk management in the organization is a process, but it is also a system. Thus, its important element is the implementation and conscious management<sup>2</sup>. Many studies<sup>3</sup> have shown that its effectiveness is affected by both the right approach to the implementation and functioning as well as its continuous improvement. The

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<sup>1</sup> This view was derived from work by Shaw Jack *Managing All of Your Enterprise's Risks*, "Risk Management Magazine", Vol. 52 - Issue: 9, September 01, 2005.

<sup>2</sup> Description of the state of implementation of risk management process in Polish enterprises is presented in the works by I. Staniec, *Zarządzanie ryzykiem w Polsce na tle przedsiębiorstw z regionu Europy Środkowej i Wschodniej*, in: *Ryzyko zarządzania ryzykiem w przedsiębiorstwie*, ed. J. Bizon-Górecka, TNOiK, Bydgoszcz 2007, p. 149–158; *Zarządzanie ryzykiem operacyjnym*, ed. I. Staniec, J. Zawila-Niedźwiecki, p. 44-48.

<sup>3</sup> Important considerations on this subject are presented in the work by Alt K. S. (2002) *Managing reputation risk* The RMA Journal.

aim of the presented considerations is to identify positive and negative factors affecting the implementation and operation of risk management in the organization.

## 2. Purpose, scope and methodology of research

Under studies conducted in the years 2006-2009 attempts were made to assess the implementation and functioning of risk management systems in organizations of different sizes and from various sectors. In the studies, risk managers from 40 organizations, selected in an intentional manner based on snowball sampling, were subjected to a standardized interview. Standardization related to the following categories: implementation and ongoing operation of the risk management system within the organization.

Issues under studied categories were related to aspects supporting, i.e. positively affecting the organization and its risk management system, and to unfavourable aspects which negatively affect the organization and its risk management system. Results presented below are based on aggregated subjective perception of respondents.

The primary limitation of the selection of organizations was the functioning of the risk management system, which resulted from the need to obtain answers supported by specific knowledge and practical experience regarding analyzed issues. The sample group was composed of small, medium, and large organizations: trading, service providers, or belonging to the public sector – education, administration, as well as production companies.

Table 1 Sector versus the number of employees

The number of employees	Sector				Total
	administration	trade	production	services	
10-49	6	5	1	4	16
50-249	1	3	6	6	16
Over 249	3	2	3	0	8
Total	10	10	10	10	40

Source: own calculations

While selecting the sample, it was emphasized, that the size of the organization should not be determined by the sector, which is confirmed by appropriate statistical tests ( $p=0.166>0.05$ ).

## 3. Determinants of implementation of the risk management system

With regard to the positive determinants of implementation of risk management systems, the surveyed organizations indicated: increase in the value of the organization, increase in the credit rating, preparing the system of business continuity management, including crisis prevention and optimization of an insurance policy. The significance of the various determinants is shown in Figure 1. The results show, how important for representatives of organizations with certain experience is an appropriate planning which takes into account specific character of the organization of the system implementation process. This aspect confirms unequivocally that the success of the implementation is determined by good preparation and making employees aware of the expected values. The most important determinant according to the respondents is increasing the value of the organization. Expectations for the risk management systems are very large. Currently, risk management only allows for qualitative description of the relationship between risk factors and goals achievement, a specific indicator which can measure the added value of the functioning of risk management system is still to be found. Activity in the turbulent environment, making decisions under uncertainty, natural disasters and unexpected actions cause that organizations look for preventive measures which enable them to emerge from the crisis. Research shows that crisis management is more effective if based on risk management. Specifically for the organizations outside of the administrative sector it is important to raise the credit rating. After the last economic crisis it seems necessary for almost all financial

institutions<sup>4</sup> to have a risk management system. In addition, the environment and the continuous publication of many falls, confirm that an essential element for today's organizations is to have a business continuity management system. Risk management is a step towards preparing to develop the necessary practices and procedures for restoration of continuity in the case of any unplanned event. The smallest but essential significance for organizations has optimization of the insurance policy, which mainly helps to reduce fixed costs of operations. This also means that risk management increasingly ceases to be associated with protection against risks or insurance management.

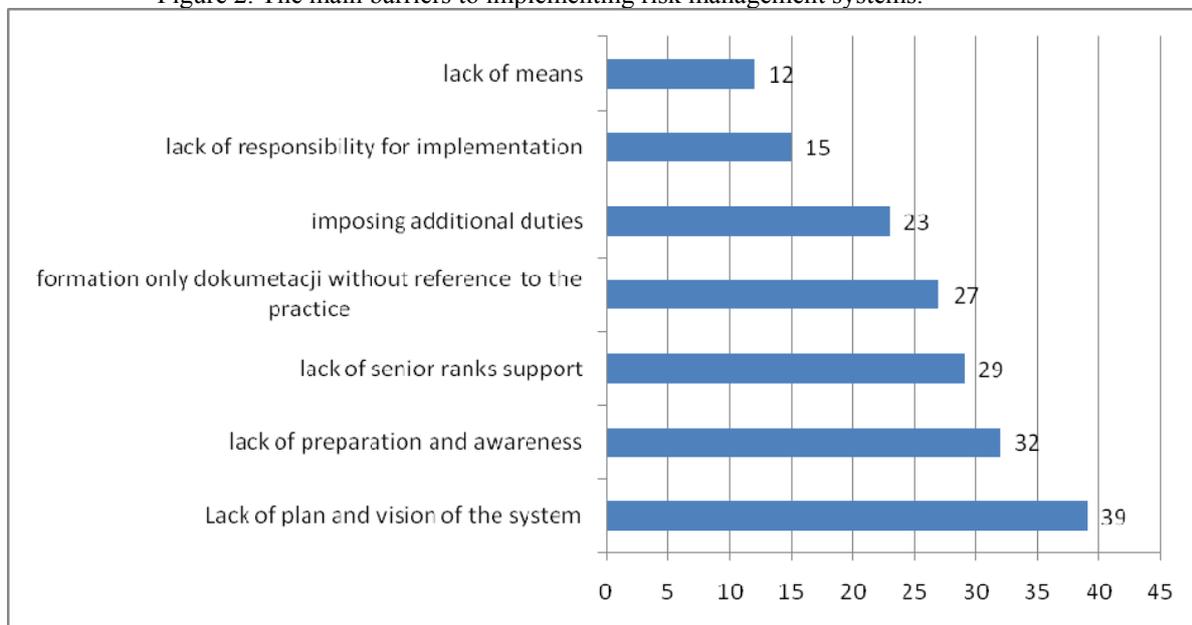
Figure 1 The significance of individual factors positively influencing the implementation of risk management system



Source: Own work

In the next stage of research there were identified factors which are significant barriers in implementing the risk management system. Study results are shown in Figure 2.

Figure 2. The main barriers to implementing risk management systems.



Source: Own work

The results of study on the root causes of problems in the implementation of risk management systems in organizations confirm on the one hand that most organizations associate these systems with their formal side – the documentation, on the other hand, that the lack of adequate preparation of staff, making them aware of the importance of this system is the basic problem accompanying implementation. Recognizing the

<sup>4</sup> On the attitude of the banks to risk management in organizations it was written in the work by Gilbert D., *Will Every Bank Eventually Have ERM?*, on line: [www.erisk.com](http://www.erisk.com), access on 14.05.2004

increasing understanding of the organization concerning the origin of problems associated with the importance of staff awareness, it is recommended to provide training. Those will inspire, bring about information of a need to create the system, unleash the creativity in employees and strengthen their involvement in a system designed to eliminate organizational weaknesses. An important sign is an indication of the difficulties associated with understanding and practical application of risk management. It can be concluded that the lack of understanding of the concept of risk management and the proper, tailored for the organization methods of monitoring the processes almost completely reduces the effectiveness of implementation of the risk management system as a tool to streamline management. In conclusion, we can say that the primary barrier to the proper functioning of the risk management system in organizations is the perceptual difficulty associated with inability by the employees to see the need for radical changes, i.e. the attachment to the status quo, opposition or neutrality of the board, unmotivated staff and limited resources<sup>5</sup>. We should further emphasize the role of inappropriate attitudes of management, who often avoid taking responsibility for implementation activities.

#### **4. Determinants of functioning of risk management systems**

Under the identification of the benefits associated with the functioning of risk management systems the following observations were made:

- shorter reaction time of management in case of crisis (20 organizations),
- less unforeseen events affecting the organization (32 organizations),
- greater emphasis in the organization on proper performance of the appropriate tasks (40 organizations),
- increased protection of the organization and its customers through management of resources, and above all maintaining reputation of the organization ( 35 organizations),
- optimizing the use of enterprise resources, i.e. ensuring greater accuracy of decisions and consequently, long-term development of the company (40 organizations),
- improved management standards (40 organizations),
- improved internal control (39 organizations).

The study results in this category confirm that organizations quickly see the benefits of using the risk management system. All organizations notice the correlation between having the risk management system and improvement in organizational governance and management standards. In addition to these essential, internal benefits coming from the risk management system, they indicate positive external ones, such as improved relationship with stakeholders, and especially the image of the organization.

The next step is to identify the negative aspects associated with the functioning of the risk management system. The study found that the functioning of the risk management system is adversely affected by:

- risk management in isolation from the company's strategy ( 39 organizations),
- forgetting about the existing organizational structure and management procedures (38 organizations),
- focusing on formal sides of risk management instead of on its objectives (25 organizations),
- failure to use external knowledge and omitting the risk that the organization is not aware of (12 organizations),
- lack of continuous and systematic approach to risk management (22 organizations).

While the findings relating to the benefits of a functioning risk management system should be regarded as fundamental elements to motivate more and better efforts to promote the system in an organization, the presented factors must be considered in terms of urgent needs which, if met, will become a condition for achieving tangible benefits for the whole economy. The primary reason for the failure in the functioning of the risk management system in an organization should be considered to be a lack of commitment or inadequate participation of workers in the system concept. The condition of this participation is to create your own effective solutions. The second in turn factor which disturbs the proper functioning of the system is failure to link it with the strategy of the organization. This result demonstrates vulnerabilities found in organizations regarding the management process. Equally important is adequate publicity of information

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<sup>5</sup> Ch. Kim and R. Mauborgne mention similar organizational barriers in implementing Blue Ocean strategy [Ch. W. Kim, R. Mauborgne, 2005, p. 215–216].

from the risk management system. Essential from the point of view of studied organizations are also further factors: forgetting about existing organizational structure and management procedures, focusing on the formal side of risk management and not on its objectives, and the lack of continuous and systematic approach to risk management. These aspects are on the one hand the classic cause of poorly functioning systems, on the other hand they are the result of common mistakes made during implementation. Documentation is still widely regarded as the most important feature of the management system. It is also a sign of lack of proper understanding of the nature of a process approach, where the main measure of effectiveness is the ability to achieve constantly updated and consistent with the strategic intentions of the organization goals of the processes covered by the system. It is therefore worthy in the process of implementing the risk management system to consider the development of simple analytical methods which will allow to determine precisely the degree of achieving agreed goals as the relation of achieved results to the adopted goals – in relation to the overall objectives of the organization and the individual processes. Besides the lack of participation in designing of the system, as a significant cause of this situation it should be indicated lack of sufficient knowledge in the organization about the process approach, which is the basis of the planning and conducting of the internal audits.

## 5. Conclusion

In recent years risk management increasingly shows in adaptation of new management paradigms. To some small extent this ensuing phenomenon is relevant to the trend towards novelty in concepts and methods of management, and their affirmation. However, there is a more important reason behind the acceptance of innovations in management, and it is increased awareness of the opportunities for development through the introduction of processes and changes in the organization which will enable the efficiency of the organization and increase openness to stakeholders. Essential for the proper functioning of the risk management system is to prepare the employee behavior and management commitment.

Avoidance of barriers means that it is clarified how not to act to destabilize the system. The factors which should be avoided during the implementation of the system include: the introduction of rapid organizational changes, the introduction of changes in staff, staff turnover, especially in managerial positions, i.e. process owners and employees engaged in an implementing team. To strengthen the positive perception of the risk management system, the performance evaluation should be done in the context of established standards. It should be neither too low nor deliberately inflated. It should be noted, however, that there is no single recipe for the correct implementation and operation of the risk management system in the organization, every time it needs various transformations depending on the existing conditions and continuous observations.

## 6. References

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