Cognitive Bias and ERM
EnterpriseInsight™
White Paper

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OVERCOMING COGNITIVE BIASES TO IMPROVE ENTERPRISE RISK MANAGEMENT

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INTRODUCTION

Cognitive bias affects decision-making in all aspects of life but becomes especially problematic when managing enterprise risk. A chief risk officer or dedicated team's judgment of risk severity can negatively influence the validity and focus of risk assessment, monitoring, prevention, and reporting efforts.

It's imperative that an enterprise risk management (ERM) program plan incorporates and responds to cognitive biases. But is it possible to cut out the middleperson and eliminate bias altogether?

Technological solutions certainly roll back psychological and emotional influences in managing enterprise risk and compliance. An efficacious ERM solution can minimize bias with a pre-built enterprise framework and the ability to automate the risk management process.

The human mind can react to information either intuitively or reflectively. Intuition leads to heuristic techniques of using impressions, associations, and emotions to make snap judgments. Thinking reflectively is using context, data, and rational thinking to make decisions, which is the best approach for ERM.

Should risk officers act intuitively? They should certainly draw upon experience when identifying and evaluating risk. Going with gut feelings, however, can be a dangerous heuristic approach that is only sufficient enough for reaching immediate, short-term goals. Drawing conclusions without considering alternatives can lead to overestimating some key risks and underestimating or overlooking others.

WHAT IS COGNITIVE BIAS?

According to Christopher Dwyer of Psychology Today, "A cognitive bias refers to a 'systematic error' in the thinking process. Such biases are often connected to a heuristic, which is essentially a mental shortcut — heuristics allow one to make an inference without extensive deliberation and/or reflective judgment." These thought processes come from a person's background, education, fears, motivations, prejudices, friends and family, the media consumed, and more.

WHAT MAJOR BIASES MUST BE UNDERSTOOD TO EXECUTE A ROBUST ERM PROGRAM?

Biases can potentially harm an ERM program's effectiveness. "Individual behavior, emotions, personality traits, and life experiences influence our decision-making, and it is more complicated than simply analyzing numbers," says Joseph A. Iraci of The Risk Management Association. "Risk managers use a combination of quantitative and qualitative analyses when making decisions, but all decisions ultimately are a judgment call."

Here are 15 everyday heuristics and biases that can influence your risk manager's and ERM team's decision-making:

Framing Effect. How data is presented can affect decision making. A binary framing of positive or negative can lead to a foregone conclusion.

Ostrich Effect. People may avoid data if they dislike the information they are receiving, such as potential financial losses. This bias affects both risk managers and the C-suite, who may be reluctant to receive risk assessments that point to a negative outcome.

Not-Invented-Here Syndrome. Many organizations are unwilling to adopt an idea if it is not a "home-grown" innovation. This us-versus-them mentality leads to errors in group judgments, such as missing out on new opportunities or failing to recognize risks.

Overconfidence. A false sense of belief in our ability to judge probabilities and severities can lead to suppression of impact, likelihood, or both. This form of biased risk assessment results in risk suppression, ineffective prioritization, and a strong impact on strategic risks.

Gambler's Fallacy. Belief that future events are affected by how often an event has taken place in the past. For instance, a gambler may believe that "luck" is on their side and that they'll roll a six because the die hasn't come up with that number yet.

Optimism/Pessimism. Overestimating favorable and pleasing outcomes has many influences on risk culture, risk assessment, and risk response. It distorts and falsely inflates leadership's confidence in the risk culture and capabilities of a company. It undermines the identification of new and emerging risks, objective evaluation of existing risks, and it suppresses the risk response. By contrast, a pessimistic attitude can lead to overestimating the likelihood of negative outcomes. As Dwyer explains, "In either the case of optimism or pessimism, be aware that emotions can make thinking irrational."

WHAT MAJOR BIASES MUST BE UNDERSTOOD TO EXECUTE A ROBUST ERM PROGRAM?

Illusion of Control. An organization might have an erroneous idea of their ability to control risk. For example, an ERM program may attempt to mitigate environmental, social, and governance (ESG) risk by advising that greenhouse gas emission be reduced or that employee health and safety conditions be improved. These factors, however, can be affected by an area's changing labor practices, the negligence of a third-party vendor, or even random chance.

Confirmation. In the context of risk identification, we may only seek the views of people who confirm existing preconceptions or initial decisions and ignore contrary insights. This form of validation can fail to capture the full range of risks facing an organization.

Groupthink. Group members tend to minimize conflict and reach a consensus decision without critical evaluation of alternative viewpoints. In risk management this can create hot spots where risks are inaccurately prioritized, intentionally ignored, or repressed.

Availability. People are most likely to flag risks based on information that is most readily available. As a result, risk management processes are vulnerable to placing more emphasis on information that is easily available while downplaying information that isn't as accessible.

Endowment/Loss Aversion Effect. People may overvalue what they already have. Businesses with this thought process may feel more comfortable handling risks related to specific niches, markets, products, or services, and be inconsistent with others.

Anchoring. Decisions are often informed by the first thing a person sees or encounters. ERM can be affected by how risks were handled in the past or a program may focus just on risks it knows.

Status quo. People and groups, especially in large enterprises, resist change. Change is hard and requires work. Maintaining a status quo with risk management means not questioning what is already in existence on risk registers and expecting known or predictable outcomes.

Curse of Knowledge/Hindsight. Reconstructing the past with the benefit of hindsight means feeling that a risk was avoidable all along. Hindsight bias can result in deflecting blame and unnecessary changes in processes that can harm a business.

Dunning Kruger Effect. An organization that is not ready or able to evaluate risk may overestimate their ability, and vice versa can be true with experts underestimating their ability to manage. Crucial decisions regarding risk will be affected if a risk officer or risk management team unknowingly exaggerates or downplays their abilities due to a lack of support from the C-suite.

Organizations must identify, measure, and address these heuristics and biases. If you truly hope to overcome cognitive bias, however, you need an ERM system with risk analysis and quantification capabilities.

OVERCOMING BIAS WITH ERM

ERM solutions can help avoid the wrong decisions that result from biases. A key benefit is reducing psychological and emotional influences from the acquisition and processing of risk data.

A user-friendly, intuitive software can ensure the risk management process is continuous by aggregating risks, automating risk assessments, and tracking risk treatment actions. This advancement in risk management can provide cost effective and valuable insight into risk environments and emerging risks. ERM solutions also enable multiple risk identification processes and audit and compliance policy management.

Every organization has unique operating structures, workflows, and biases. Your risk management and ERM program need to accommodate these concerns and excel despite them. With an ERM solution you can maintain a real-time or near-time focus on risks and risk mitigation so you can limit the potential to miss or ignore a critical risk due to biases.

CONCLUSION

Consistent application of ERM requires expert knowledge of both risk management standards and the biases that affect the human mind. The most important method to mitigate bias is first to recognize that biases exist and then to implement established and proven strategies to neutralize them. An ERM solution can help implement these best practices to ensure more objective risk and compliance management.

ABOUT MITRATECH

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With Mitratech's proven portfolio of end-to-end solutions, organizations worldwide are able to implement best practices and standardize processes across all lines of business to manage risk and ensure business continuity.

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