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Editorial

Accounting for the cost of risk management in a risk capital as commons framework

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In the governance and management of risk, we are called upon to help our organisations make the most effective use of scarce risk capital, even in difficult times. In this work, we have become adept at identifying potential risks of loss, deferred liabilities and externalities created by our organisation's actions or decisions. But, it is also incumbent upon us to turn the analysis around and look critically at our processes and mindset — asking about potential losses and externalities from the work of risk management and seeking our most positive impact.

Begin here: without risk-taking, there is no need for risk management. The genesis of our jobs is the activity of risk taking. It seems logical, therefore, that our work should be focused on enabling the taking of risk, better. There is much more to be gained for all involved by moving to a positive mindset regarding risk taking. To do this, it is required that we understand and appreciate how systems like organisations create value along with the direct and indirect costs we may impose by inefficiently regulating such systems.

Taking good care of the precious commodity, risk capital, is a collective job of all members of our organisation. Capital, therefore, is a commons and, like any other commons, it can be abused, polluted or depleted without the right framework for its management. In general, when we deal with a 'commons problem' like this, there are two approaches that can be taken: management by an external authority that imposes governing rules or self-management of the commons by its owners.

Garrett Hardin famously looked at how the commons are ruined and abused — *The Tragedy of the Commons*. By his work, it seems a hopeless task to preserve things like the environment or even a nice lake near a subdivision unless there is external regulatory intervention. In her Nobel prize-winning work, however, Elinor Ostrom found that the commons can indeed be managed more successfully and efficiently when all interested parties recognise collective ownership, engage in self-monitoring, enforce boundaries and use both positive and negative feedback.

Organisations — systems like those for whom we are employed to govern or manage risk — have the potential to create more than the sum of their parts — to create value. This is precisely the focus of complexity economics. When combined with Ostrom's ideas about successful management of the commons, an understanding of complexity enables risk managers and risk governors to create a framework where risk capital is treated as a commons — one that improves the risk-taking of those who do it best and by leveraging the power of organisations.

I often resort to using the value equation (the present value of future returns) to illustrate the expected returns of an activity, organisation, financial vehicle, etc., over time. The value returned from such risk taking is a function of three things: the first being expected returns minus costs going forward. The second factor is the duration over which those returns are expected to be realised and the third is the perceived risk that those expectations will not be met — that whoever was counting on our organisation will be disappointed.

To some degree, we focus our work on the resiliency of our collective set of risk takers — the horizon over which expected future returns can be realised. Our role as risk governors and risk managers, however, tends to be focused more on two elements of the first factor — expected losses and loss avoidance. Loss avoidance, though, is a known bias in behavioural economics and it may impose a cost on our organisations that we don't fully appreciate.

By being focused on loss avoidance, not only do we set ourselves up for failure — there will be unexpected losses; we may be unnecessarily creating an externality from risk management. The fear of large losses demands as compensation sometimes irrational multiples of upside potential, relative to the perceived downside. In essence, we may be saying 'no' to worthwhile risk taking because of this bias. The result is that we could be inhibiting the innovation that comes from agents working together in systems. In other words, the benefit of successful risk taking may be unrealised because of risk management biases and decisions, which is a cost that our activities would impose.

Since it is impossible to measure the cost of our saying 'no', and risk-taking is essential to creating value, it becomes necessarily our job to facilitate the most effective ways of saying 'yes' — the most effective ways to use risk capital. We need to be advocates for better risk taking and doing so in a commons framework allows us more completely to focus on all three elements of the value equation, to a positive effect. Viewing and managing risk capital as a commons is an essential step for us to ensure that this commons is neither abused nor depleted.

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