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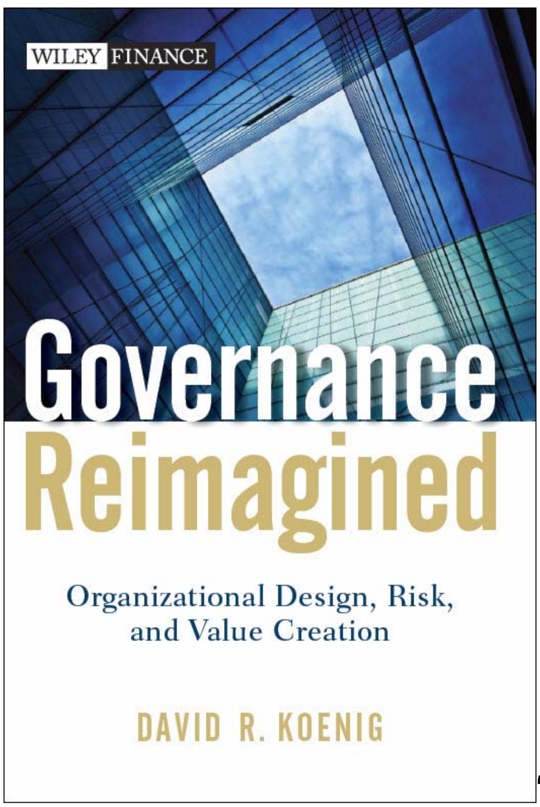
Risk Management Is Freedom: An Interview With Author David Koenig - Compliancex

Beth Connolly



"Many people in risk management are defensive about risk, or they fear it. I seek to give organizations a better understanding of risk so they can handle it confidently and better achieve their goals," said David Koenig, author of the new book *Governance Reimagined: Organizational Design, Risk, and*

Value Creation (Wiley Finance, 2012.) I spoke to David recently to discuss his book, his career in corporate governance, and what his vision of distributive governance means for compliance professionals.

Koenig explained that proper risk management is essential to a company's success. "My professional career has been about the pricing of risk: an understanding of what risk does to the perceived value of things and how it affects an organization's ability to achieve its goals," Koenig explained. "The better you understand risk, the more confidently you focus on your objective."

In his career, the Minnesota-based Koenig has built risk management departments, launched new for-profit and non-profit ventures, and managed diverse and complex financial portfolios. *Governance Reimagined*, his first book, is a culmination of this experience and the research he's done over the course of his 25-year career.

The book details a concept Koenig created called "risk capital as commons." A"commons" is a resource that is both desireable and accessible to a defined group of people. Historically, common resources are taken advantage of by the few and therefore destroyed for the many. For example, air is a commons in that all humans need it to survive; yet, before environmental sanctions, factories were not punished for polluting the air with waste, lowering its value for everyone. Commons management is a classic risk management conundrum.

Koenig's concept, which won a prize in an international management innovation competition, is to treat the capacity to take risk, or risk capital, as being commonly owned among all members of an organization. Rather than a traditional “top-down” vision of risk management, in which one individual or a select group within an organization attempt to control risk by policing other members, Koenig proposes a system of distributive and networked governance, in which a small piece of risk is owned by subsets of the organization.

Risk Management Is Freedom

“The more you understand risk, the more free you feel to make decisions,” Koenig said. In *Governance Reimagined*, Koenig suggests that governance means granting individuals the freedom to make decisions within set parameters, which enables creativity and innovation. If an individual in an organization is overly governed, creativity is impeded. In organizations, creativity includes network creativity, which is the ability to generate ideas and be responsive to emerging risk by working with others.

“For compliance professionals, this is a really interesting model,” Koenig said. “It’s a whole new way of thinking about the role compliance plays in organizations.” In a distributive and networked governance scenario, compliance officers are responsible for ensuring that employees comply with guidelines set by the organization when their freedom to take risk has been granted to them.

“I look at organizations as a portfolio of ideas,” said Koenig. “In some ways, they are like a venture capitalist making small investments in ideas in the company. Let them flourish, continue to invest in them. To allow them to flourish, you must set parameters." Compliance professionals are then tasked with making sure groups stay within the parameters that have been established.

In other words, rather than being seen as the cops or the bad guys, compliance officers become the ones empowering the organization to be more creative and more productive by ensuring the people who allocate the risk capital that they can trust those who receive it. "Too often, corporate compliance and risk management professionals are put into a box of control. They are thought of as people who stop things from happening," said Koenig. In the distributive and networked governance model, compliance people are enabled. "I never liked being the cop when I worked in risk management. I preferred to help people understand risks," Koenig added.

Underestimating the Power of Fear

Though his book deals with complex concepts, Koenig said he's tried to make challenging information accessible. (He did warn against reading the book right before you go to bed.) As an example, he illustrated the concept of a binomial tree using a metaphor of New York City streets. "If you've ever had somebody try to explain to you how to price an option using a binomial tree, most people lay out a bunch of equations, and they've lost 98% of their audience in under a minute," he explained. "I try to use an example. Picture midtown streets, a grid pattern. Think of yourself starting a walk across midtown on the west side and flip a coin. Heads, you walk one block east and one north.Tails, one block downtown. Whatever happens at a corner will be of value. It could be negative (you get mugged) or positive (you sample some good falafel, or you hear a street musician.) You keep doing it till you get to the east side. Then you add up the value of that walk, and decide how much you would pay for it if it had been promised to you with certainty. Then, you consider all the possibilities that could have happened and mathematically bring that back to an expected value of something that you have the option of doing."

Apart from the psychological reality of the human mind, this is how a binomial tree might be constructed. The reality is rather different. "We make a judgment based on our emotions," Koenig said. "If I introduced to you all the great things that might happen, you'd probably be willing to pay a high price for the adventure. But if I included the possibilities of getting shot or robbed, you might not be willing to take the trip regardless of the good things that might happen."

To that point, Koenig said that most organizations dramatically underestimate the effect that fear has on their customers' psychological decision-making process. No matter how many positive outcomes are presented, if a customer believes that there is a chance of a really bad thing happening by associating with your organization, that may outweigh all of the possible positive outcomes. "The perception of fear is probably the single least appreciated factor in determining how much something is worth to people," Koenig said. "It's greatly underappreciated by businesses. Most of them don't understand how people respond to a potential for large negative risks."

Therefore, any organization that is trying to attract employees, customers, or investors, needs to be able to deal with any fear that's out there of something really bad happening, or to pay a very high price for not doing so. For example, in the case of Knight Capital trading glitch and massive loss, they and companies like them need to convince customers and potential customers that that kind of loss will never happen again.

Koenig says he's not aware of any businesses that are currently implementing the full distributive and networked governance model, as it is very new. But, there are some that utilize various parts of it. It is the complete application of this governance model, with the view of risk capital as a commons that is outlined in the book. His vision of a successful company is one that adopts this model and ultimately in which the value it creates is aligned with the values of its owners.

"In the end, value is created when we are able to fulfill our values as well as those who are in our organization's network," Koenig said.

Beth Connolly is Editor-in-Chief of the Wall Street Job Report and the Compliance Exchange. She blogs creatively at When Nutmeg

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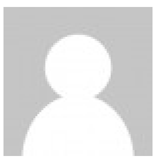
About The Author



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Beth Connolly is Head Editor, Writer, and Marketing Coordinator at the Compliance Exchange and the Wall Street Job Report. She tweets @Bethconnolly and shares her love of the good writing life at her blog, When Nutmeg Met Basil. A graduate of Middlebury College in Vermont, she works in Manhattan and calls Astoria home.