Complexity, Governance & Risk

by **Pat Hoverstadt** *

All commerce, all markets, are based on exchange and on the principle that we value things differently. If I want a pint of beer more than £2.50 and the pub wants £2.50 more than the pint of beer, we have a deal – we are dealing using the same currencies – the pint and the pound, but the two parties value them differently. We value them differently because our two situations - our environments are different and with those differences come different needs and different values, even different ethical considerations. Time was when we could run our lives, organisations and whole economies on this basis, capitalising on these differentials in value across the boundaries of different environments and could import goods and export risks without much worry. And this works well as long as the environment is fragmented.

The big winners in this situation are those who benefit on both sides of the equation, we win when we import a good and we win when we export our problems or our risks and if we can do both at the same time, we score twice. Where the transaction is transparent so that both parties can see what is going on – can see who is ending up with what, and if our waste and risks are welcomed by the counterparty, then this is all right and proper. Unfortunately because all trades involve risk, there is an incentive to hide the nature of the transaction in order to hide the fact that what is sometimes being traded is risk. And of course, if you can disguise a risk as an asset, you can win three times on a trade – once when you import the "good" once when you offload the risk and yet again when you get paid for handing on the risk to a party who thought they were getting their hands on a good.

So, think of a large organisation, any organisation: private sector, public sector, third sector, it doesn't matter. This will have some sort of value exchange with a series of stakeholders in its environment. These different stakeholders live in slightly different domains within the environment. So for example, local considerations aren't quite the same as national ones and each level that our notional organisation deals with will have different needs, expectations and values.

What happens when we fail to recognise these differences, or to ignore them, or worse still to deliberately set out to exploit them? Our organisation can do a deal which is perceived as delivering a 'good' at one level, but seen as damaging at another. When we do a deal to create a good for ourselves in one domain of the environment and ignore the consequences in another domain, we are usually exporting problems or risk. And sometimes we genuinely do export the risk for someone else to pick up the tab. Often though, we don't manage to completely

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dissociate ourselves from the risk, we just end up exporting it to somewhere where we can no longer see it. Either situation is dangerous, though who it is dangerous for differs of course. And so, whether we do deals for the larger system at the expense of local interests or whether we do local deals at the expense of the larger system, we are creating either operational risks or strategic risks and sometimes the risks are ones we can no longer see or manage.

Does the recreational drug user sniffing a line of coke consider the violence and anarchy in Colombia that their habit helps to maintain? It is hard not to be at least aware of it. But what of my local authority which pleased a range of stakeholders including developers and central government when it allowed unrestricted development in our village, but outraged the local population who saw their village and community being destroyed? We see it as good that we can buy clothes cheaply, but would rather not know about conditions in the sweat shops that produce these cheap clothes. The convenience of being able to make calls almost anywhere using mobile phones is seen as a good almost everywhere – except perhaps in the areas of Africa where wars are fought by child soldiers over the rare mineral deposits on which our mobile telephony depends. Structurally these problems are all the same - a failure to recognise in the way deals are struck in particular environmental domain the costs these deals will have in other domains in the environment.

Such cases are not the exceptions, they are the norm because it is inevitable that large complex organisations will be exchanging different types of value with different parts of its environment, and that these parts will have different needs, and therefore different values. The reconciliation of these differences – of this variety – is a set of ethical dilemmas, but structurally, it is a problem of governance, since managing risk – both operational and strategic is one of the primary functions of governance.

So what's new? What has changed? Why is it now that chickens are coming home to roost? Two things: first our organisations have become bigger and more complex, they operate across more nested levels of the environment, so there are more of these problems to try to reconcile and secondly, the environments are now becoming more clearly connected. Even if we don't notice that our organisation is causing damage in one area in order to create a good in another, odds are now that someone will spot it and make the connection. The world has shrunk dramatically and the way we govern organisations has failed to keep pace. The reason the chickens are coming home to roost now, is because the bit of the environment they were dumped in is increasingly well connected to the home roost, so the chickens have a multitude of ways to find their way back to us.

This is an inevitable consequence of globalisation. Now I'm not arguing against globalisation per se, just that part of the reason globalisation has worked is because it allows the import of goods and the export of risks – often unwittingly or in culpabliss. If we want to carry on the globalisation agenda, then we need new governance rules to enable it to run.

So, what would this look like?

Good governance implies more than complying with regulation. In fact – and here's a conundrum - the more governance focuses on compliance, the worse it becomes.

It must also ensure transparency in transactions. I must be able to see what I'm getting in a transaction, what I'm not getting and where the risks lie. At the moment, this is not the case and obfuscation is endemic – the sub-prime fiasco, where bankers succeeded in deluding themselves that risks were in fact assets is but one of many examples. Nearly 30 years ago, Stafford Beer was pointing out that the insurance industry splits risk from the investment that is supposed to cover that risk, at the earliest opportunity and handles the two as if they are totally unrelated. And the result of this sort of disaggregation and lack of transparency is that when I insure my house, I cannot get what I want and what I pay for is not what I value. What I want is insurance in case my house and contents are destroyed. What I actually pay for in my premium is the cost of other people's carelessness, the new carpet when they spill a pot of paint, the laptop they trod on. None of this is visible to me, but overwhelmingly, I pay for risks that are not actually mine, which I would never insure against if I had choice and if the deal was transparent. And the systemic consequences are huge, whole industries have arisen to deny transparency so that risks can be exported un-noticed.

So the governance structure needs to make transparent the way an organisation conducts its business with different environments, where it is exporting risks or waste and just how and where it is really creating value. But of course, because we are dealing with different types of interaction with different stakeholders in different parts of the environment, good governance has also to operate at multiple levels. In fact, it has to operate at every level the organisation operates. If it isn't present and active at every level, we have rogue operations in our organisation.

Not surprisingly, Stafford Beer's Viable System Model provides a framework that fulfils these criteria: recursively structured, so it functions at every level and providing transparency about both how (and what) operations deliver and how they relate to their environments. This is in stark contrast to conventional models – emphasising as they do a single level of management, focusing on compliance and largely ignoring whole classes of operational relationships with stakeholders. The conventional model could have been designed (and perhaps was?) to ensure culpabliss.
