

## **Dropped Babies and Risk Mitigation**

What is an acceptable number of dropped babies in a hospital delivery unit? This macabre question leads to a classic issue of risk management.

Obviously, the answer to the question seems to be zero. It does happen, though – newborns are wet and slippery and may sometimes emerge unexpectedly quickly. But there is a conceptual and practical distinction between saying that the number must be zero, and the number must be as small as possible.

If a hospital is determined that it is utterly unacceptable whatsoever, they will devote and divert resources so that it cannot happen – but this allocation of resources will have knock-on consequences. Perhaps another department is thereby understaffed, or the cost of this resource allocation is so high that money that could have been used for life-saving treatments elsewhere is lost, with a net adverse outcome.

If, instead, the hospital takes all the steps it is reasonable to take, including consideration of resource allocation, then the number of dropped babies may not be zero, but there will be a net benefit in lives saved.

What is being analogized here is the distinction between risk elimination and risk management or mitigation. They are not the same thing, neither conceptually nor commercially.

The point is that, setting aside babies (carefully, onto appropriate surfaces...) and the calculus of human lives, the cost of risk elimination may be greater than the cost of risk mitigation together with expected loss. Clearly, if risk mitigation costs \$10mm and a reasonable estimate of expected loss post-mitigation is \$15mm, that is better than risk elimination that costs \$25mm in additional operational costs and \$20mm in opportunity cost (of profitable transactions forgone).

However, everything we know about how humans perceive risk (from Allais through to Kahneman and Tversky) tells us that such calculations will often not be found convincing. It may well be easier for management or shareholders to accept an observed cost of \$25mm than an observed cost of \$10mm and a risk (shudder) of \$15mm, because, well, risk, even without considering economic costs or profits.

I exclude from consideration some of those risks inherent in the P&L generation. A proprietary trading firm may well be in the business of taking risks. But many risks are



optional risks, as often encountered in say private wealth management (PWM) – “do we accept clients from this country?” or “should we offer margin lending in this sector?” Yes, these optional risks contribute to P&L but they are usually not core to the PWM business.

Economic or opportunity costs are difficult to take account of as they are invisible or virtual. The only visible exception, it seems, is when traders and hedge fund managers are benchmarked against competitors in the same markets or strategic domain. A financial company operating in its (claimed) unique sector (“we’re the only midsize bank catering to energy customers in our state”, etc.) may not see or know how its elimination of risk incurred an economic or opportunity loss.

So the CEO and Chief Risk Officer have two relevant and related problems when considering risk policy and risk appetite. The first is that, psychologically and qualitatively, people prefer no risk to managed risk – which in the abstract is a reasonable enough position, after all - and second, that as you move from the abstract to the real, even when the (quantitatively derived) economics favor managed risk, gut psychology may still lead to a preference for no risk.

Stephen R. Gould, CEO

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