SOCIETY OF ACTUARIES

ERM Symposium
April 2009

KL1-Group (Risk) Therapy - Cultural Theory and the Current Market Crisis

David Ingram

Moderator
Max Rudolph

Group (Risk) Therapy

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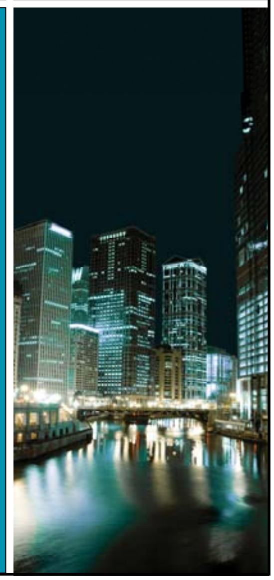
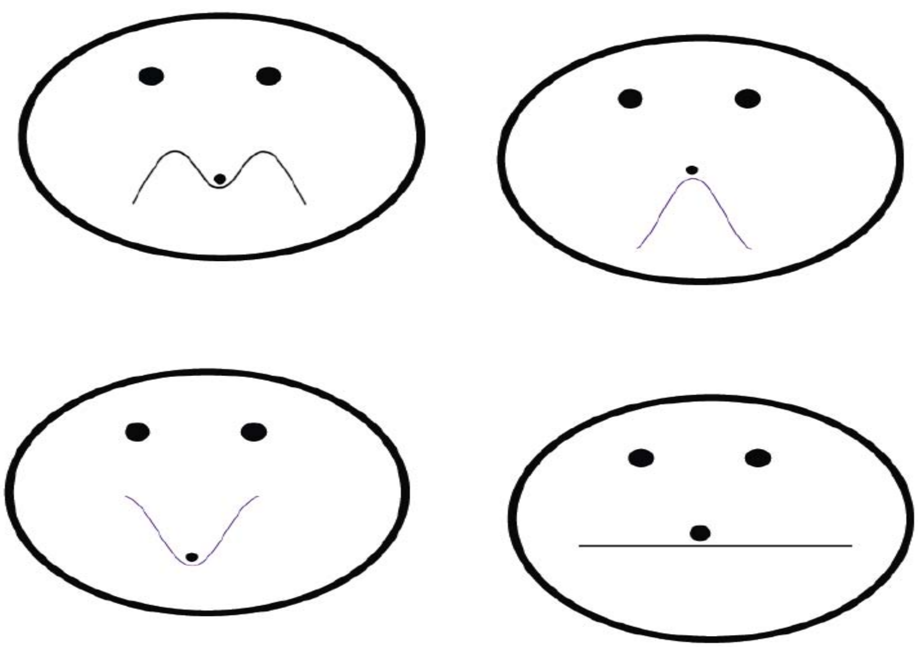
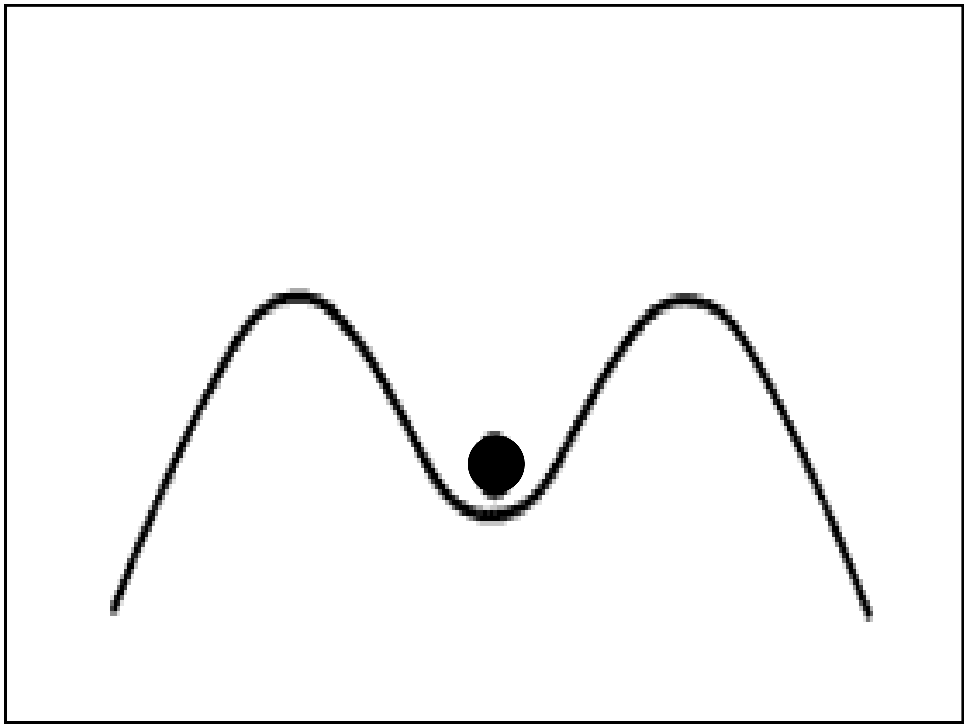
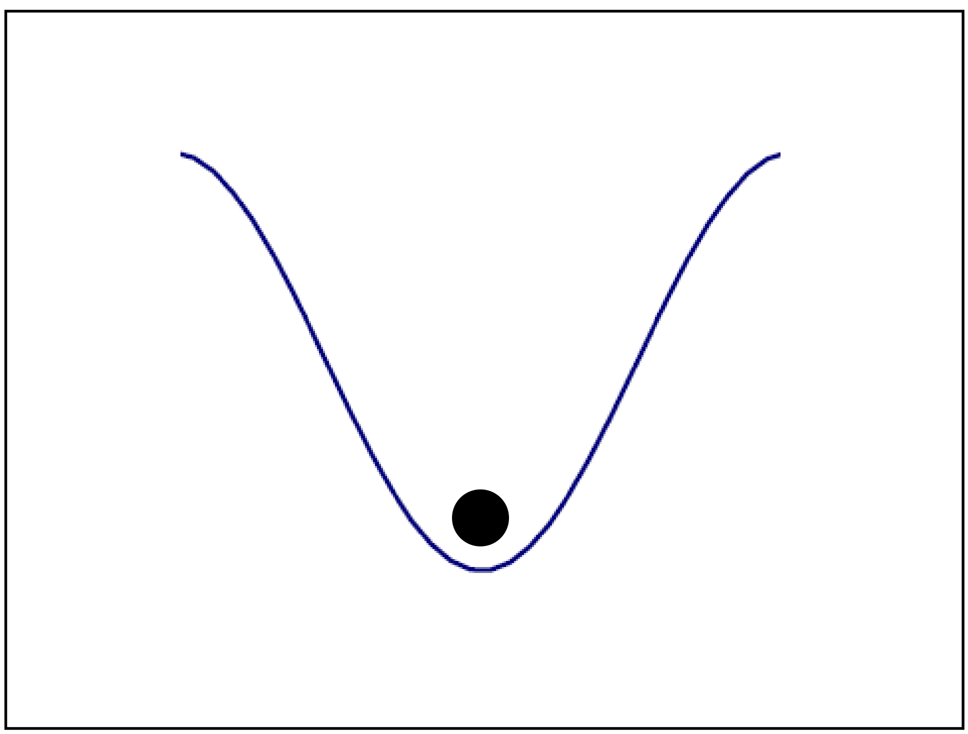
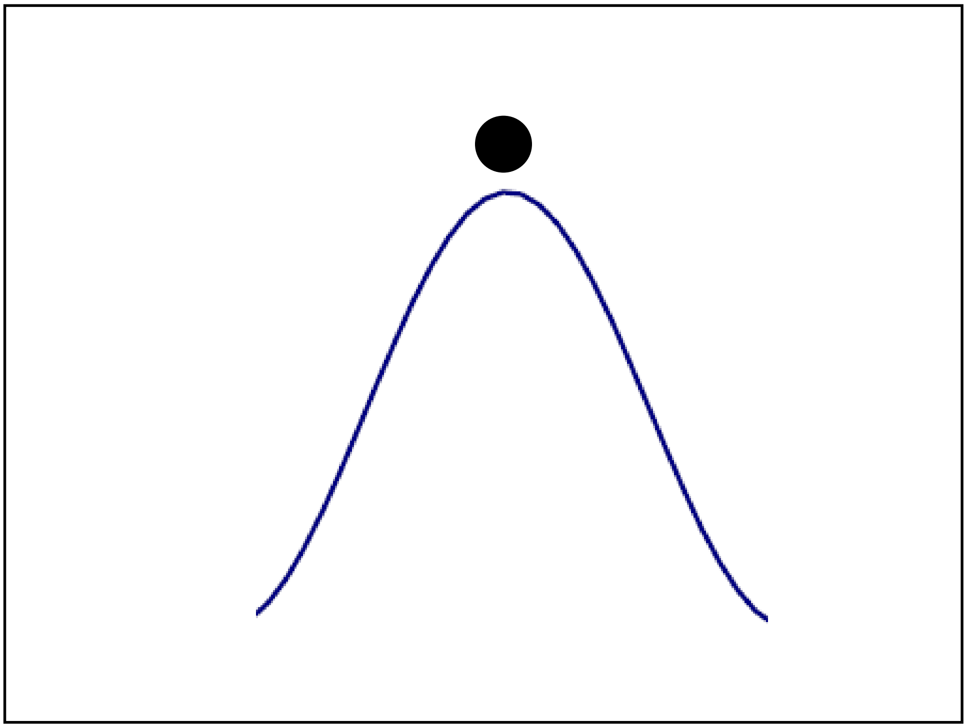
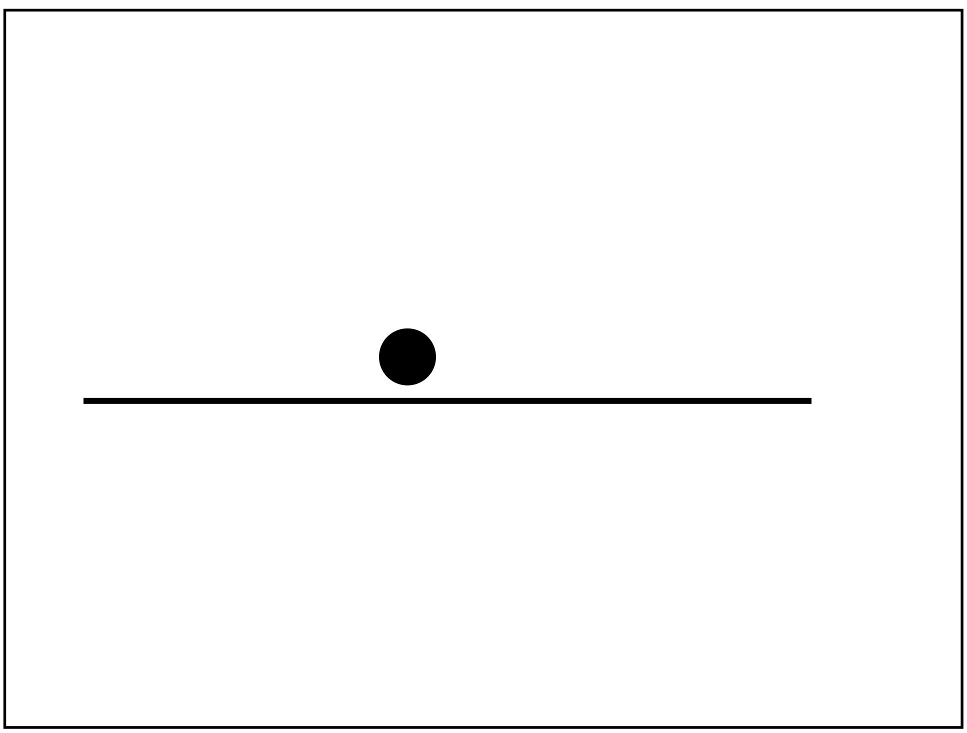


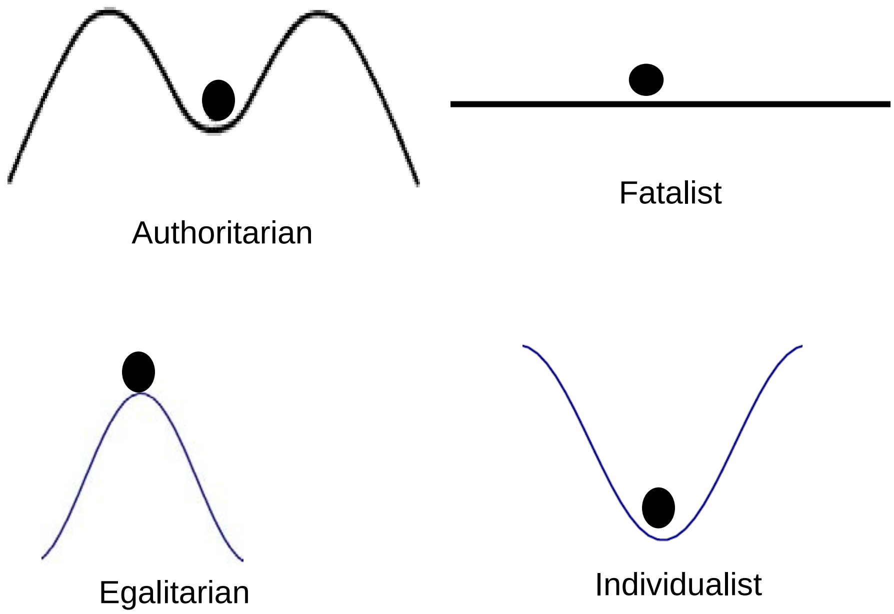




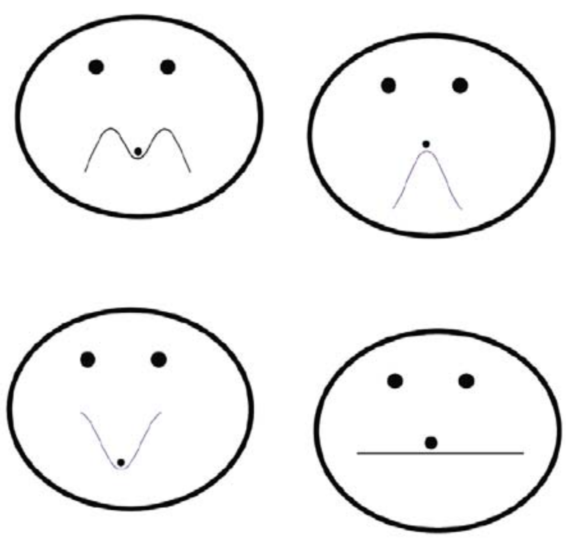








ERM Committee



Group (Risk) Therapy

An Introduction to Cultural Theory
Keynote Presentation
2009 ERM Symposium

David Ingram, CERA, FRM, PRM
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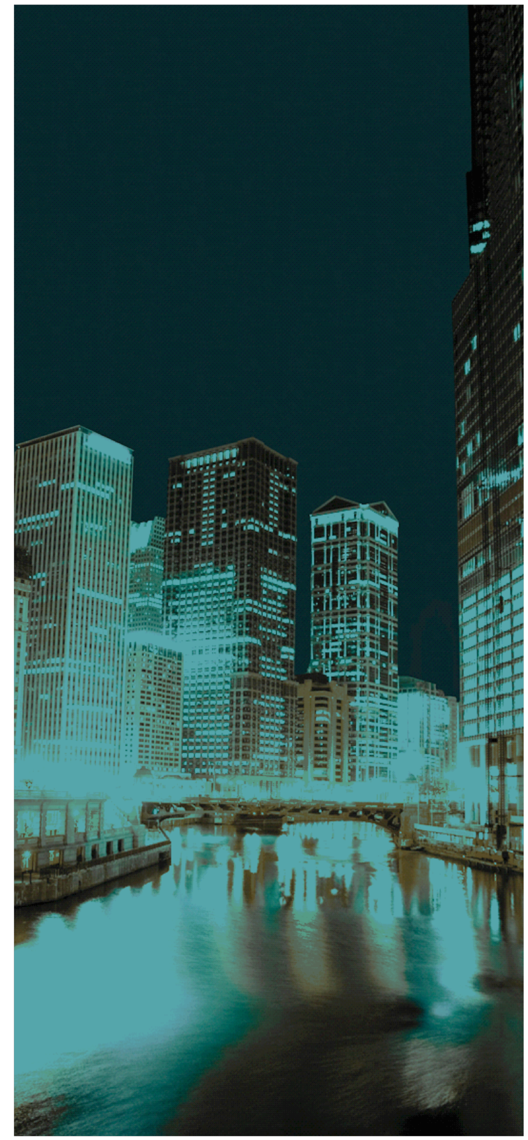


Group (Risk) Therapy

An Introduction to Cultural Theory

Keynote speech presented at the

2009 Enterprise Risk Management Symposium, Chicago

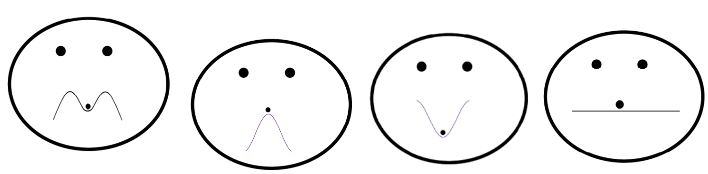
David Ingram, CERA, FRM, PRM

Have any of you ever heard the "official" story of Risk Management at a firm? I have, dozens of times. Those stories often include Org charts, policy statements, committee charters and binders of reports. All nice and neat.

Reality is usually not quite so neat. All of the positions in the org chart are not necessarily filled by people who know how to do their job, if the positions are even all filled. Policy statements are written, filed and forgotten. Committee meetings are cancelled or the time is taken up with discussion of topics other than risk management. Key numbers on the reports were not available on time and are estimated or left unchanged from the prior report.

But the worst thing is that there are just too many people, important people, who do not understand risk management, who passively or actively resist risk management or who directly oppose risk management.

Are any of those people present in your firm?



Well, those people are the subject of my talk. For this talk, I will have 4 assistants. They would not let me take their pictures, so I drew their faces. Let me introduce them. Arthur is a big fan of ERM. Edgar thinks that ERM is scary and that it encourages dangerous behavior. Ingrid sees ERM as a business prevention program and Francine just tunes out when she hears someone talking about ERM.

These four people represent 4 Archetypes of risk perception developed by anthropologists in the 1980's and 1990's. Their approach to explaining the ways that people choose to form groups within a society is called Cultural Theory. Cultural Theory says that the way that people think of risk is not just "a" key driver, but that it is "the" key driver for group organization.

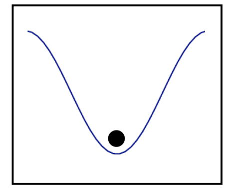
I have no idea if they are right in general. But it does make sense to me that perception of risk is important to the success of an ERM effort.

But let me back track and mention two other theories of risk perception that have been widely used. The first is utility theory of classical economics. Under Utility Theory, there is only ONE risk view. The second view of risk perception is found within behavioral finance. They talk about TWO risk views in Behavioral Finance.

Cultural Theory suggests that there is not one or even two ways that people approach risk, but at least four:

1. Individualists – They believe that the world is self correcting (or mean reverting in math terms) Risk is not a major concern to Individualists. They believe in unfettered capitalism – self-regulating markets. They see raw materials as infinite – limited only by man's ingenuity. That individual effort and imagination will create more for everyone (rising tide lifts all boats – growing the pie before you divide it). Their view of risk can be

represented by the picture at right. If you push the ball to one side or another by taking a risk, the ball will shortly come back to where it started.

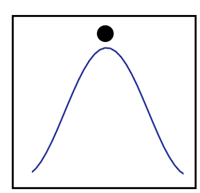


Things Individualists might say:

a. Those who have more ability should be paid more
b. We should give firms the chance to prosper
c. Life sorts out those who try harder from those who don't

Individualists are not very good customers for risk management products like insurance. They tend to think that insurance is a waste of money. Social security is a bad deal, since they will not even get their money back that they put into the Social Security fund. They would prefer individual investment accounts. Individualists tend to have strong and informal personal networks and have a weak feeling of responsibility for the consequences of their actions. Individualists believe in unbounded growth of the system. Individualists are not concerned when there is disagreement among their group. The best ideas will prove themselves anyway.

2. Egalitarians – believe that the world is in a delicate balance. Any major change could result in disaster. Egalitarians focus on fairness and dividing the pie. Egalitarians are frugal. They believe that resources are finite and we must be careful how we use them. Their view of risk can be represented by the picture at right. Any risk that moves the ball could knock the ball from its perch and to disaster.

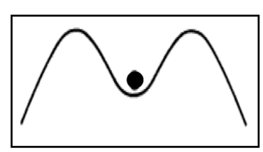


Things Egalitarians might say:

a. If people were treated more equally there would be less trouble
b. The government should make sure everyone has a good standard of living
c. Those who get ahead should be taxed more to support the less fortunate

Egalitarians tend to be good customers for insurance, since they see plenty of risk everywhere. But they tend to favor social insurance. Social Security is a very good program and the program should be brought into financial balance by increasing the social security tax on the wealthy. Egalitarians tend to have strong and informal relationships and strong feelings of accountability for the consequences of their actions. Unions and professional organizations are often Egalitarian. Egalitarians do not see the need for output of the system to grow. Egalitarian groups tend to be inward looking. Egalitarians are doctrinaire and uncompromising. They spend a higher proportion of their time criticizing the other groups. When Egalitarians find disagreement within their group, the tendency is to split the group.

3. Authoritarians – believe that risk taking is ok if it is controlled by experts. There is a need for rules and laws to keep risk taking under control. Their view is represented by the picture at right. The ball can be pushed only so far without going over the edge to disaster. They are also referred to as Hierarchists.

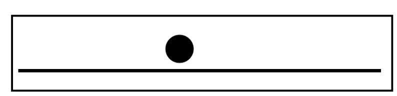


Things Authoritarians might say:

a. One of the problems with people is that they challenge authority
b. I value regular routines and being on time
c. Before making an important decision, I always research what the experts recommend

Authoritarians will usually buy a carefully determined amount of insurance. They believe that the government is able to deliver many social services like Social Security at a much lower cost than private industry and the government can keep things under control better. Authoritarians tend to have weak and formal relationships and a high degree of concern for consequences. Authoritarians believe in controlled growth. Controlled by them of course. At a level that is determined to be best by the experts.

4. Fatalists – believe that the world is unpredictable and uncontrollable. Fatalists are those folks who will not conform to the rules of the Hierarchists, who cannot muster the fervor to become members of an Egalitarian group and who do not have the ambition to strike out on their own as an Individualist. They are outsiders and seldom control things. They believe that risk cannot be controlled so no need to try. They think of things like hedging and insurance as bets that either you win or you lose – not as Risk Management. Their view can be represented by the picture at right. Who knows where the ball will end up if you push it by taking a risk?



Things Fatalists might say:

a. Cooperating with others rarely works
b. I am often treated unfairly

c. Even if you work hard you never know if that will help you do better

Fatalists will tend to buy low premium, high benefit insurance like travel insurance or ADB or Dread Disease. Fatalists believe that Social Security will not be there to pay benefits by the time that they retire so there is no need to waste time talking about it now. Fatalists tend to have weak relationships and low concern for consequences. Fatalists have no particular concept of whether growth is needed or not. I am guessing that Fatalists may make up the majority of the human race but a small minority of those who are in charge of anything.

I want to assure you that I did not wake up this morning, suddenly remembering that I had a speech to give and make this up. This idea was first described by Mary Douglas in 1984 and expanded in a 1990 book titled "Cultural Theory" that is still in print. Cultural theory has been used extensively in the context of public policy risk management decision making to help to navigate conflicting agendas over environmental and aesthetical objections to public and large private initiatives. It has not to date been used in finance or insurance. So you are the first to be hearing about the potential applications of this theory in a new field.

Now lets talk about the people within firms and how they might fit with this. You all will usually find every one of these four groupings within most firms. One stereotypical alignment would be:

Individualists in Sales/Underwriting/Trading. They tend to be paid with a high proportion of incentives or bonuses. They prefer to get paid for what value that they bring to the firm. They will frequently argue with the nit pickers and bean counters about how good the deals that they do will be for the company.

Fatalists in Operations and IT. Their priorities are frequently changed without their knowledge. Many firms tend to value the flexibility of Fatalists who do not expect things to stay steady and predictable anyway. Fatalists in a firm are quite happy with a job where they do not know in advance what they will be doing from day to day. You probably want a Fatalist on your help desk.

Egalitarians in traditional risk management (Compliance, Internal Audit, ALM, Insurance buyers, some underwriting shops) who seek after zero losses as well as some CFO's, Legal, traditional actuarial functions. Egalitarians will tend to keep to themselves within the firm and have few connections with the other areas. They tend to think that the company is going into decline, but that their department is run well and things would be much better if people just listened to their group more.

Authoritarians - in most companies CFO's and the new ERM area. When there is an Authoritarian CEO or powerful senior administrative officer who is an Authoritarian, the firm will usually have a very organized planning system with regular update to short and long term plans. The emphasis of Authoritarians in management will be to set goals and measure progress against those goals.

ERM is clearly an Authoritarian risk perception. The ideas of risk limits, risk policies, balancing risks and optimizing risk portfolios are all purely Authoritarian ideas! Risk Tolerance or Appetite is perfectly represented by the Authoritarian M picture. The Org charts, policy statements, committee charters and binders of reports that I mentioned are all Authoritarian ideas.

FIRST INSIGHT – Authoritarian ERM will conflict with all the other risk views! If CFO is Egalitarian then ERM will be seen to facilitate excessive risk taking. If CFO is Individualist (more common now) then ERM will be seen as constraint on quarterly income. Only Authoritarian CFO will support ERM. Same holds for other C suite folks. The discussion about whether the CRO should report to the CFO or the CEO is an offshoot of this insight. If you presume that the CFO will not be Authoritarian, then making the CRO report to the CFO will likely highly diminish the CROs effectiveness. However, if the CFO is Authoritarian, the CRO will have powerful support there.

SECOND INSIGHT – traditional risk management folks with Egalitarian point of view will not easily be converted to supporting ERM! They will all see a conflict between their traditional zero risk goal and the risk tolerance approach of ERM.

The better CRO's have realized this at some level and have adapted their pitch to suit their audience. Over the years at this conference, we have heard many CRO's and consultants talk about how the main risk management job is to be partners to the businesses and to help to do business. This is Authoritarian ERM playing up to Individualist business leaders.

Now let us talk about some insights that Cultural Theory provides regarding the financial crisis.

In Cultural Theory terms what happened to create the crisis was that Individualists were given control over too much of the world's resources. Meanwhile, Authoritarians and Egalitarians degree of control over Individualists was almost totally eliminated. (Fatalists usually do not control anything for long)

Hyman Minsky accurately describes what happens to Individualist systems – they go from investment to speculation to Ponzi to collapse. When Individualists control fewer resources, take for example the 1987 stock market crash, It did not have major impact outside of the highly Individualist financial markets to hurt the "real" economy. When Individualists control moderate amount of resources, their cycle of financial instability ends in a mild recession. With too much resources in the hands of Individualists, a major recession.

But why did that happen? Why did Individualists get so much of the resources? As Minsky observed; "Stability is ultimately destabilizing"

Cultural Theory (the 1990 book that is) makes two important observations that help to explain what happened.

1. Each of the four views of risk are correct some of the time. (But not all at the same time – so in any period of time 3 out of 4 are incorrect.)
2. With each passing period during which their world risk view is not validated, some people shift their view to the one that has been validated by events.

THIRD INSIGHT – Allegiances to these four risk views shift over time.

Now wrapping up the discussion of the financial crisis. Favorable financial times led more and more people to shift their view to Individualist. The normal Individualist cycle of investment to speculation to Ponzi to crash happened.

So now what?

The adverse events of the financial crisis are clearly contrary to the Individualist mean reverting idea of risk and will cause many people to shift away from an Individualist view of risk. What comes next will be something like…

(a) There will be fewer Individualists controlling fewer resources under tighter controls
(b) There will be more fatalists and Egalitarians (Crisis seems to validate either of their views)
(c) Egalitrians will want to eliminate bonus and take many fewer risks, make more limitations, seek to preserve – stick to your knitting is an Egalitarian approach.
(d) Fatalists controlled companies will do less planning; be more reactive – they see no need for planning since the future is so uncertain. On the other hand Fatalists are better at adjusting to changes since they are less wed to a single idea of the future.
(e) Authoritarians making major power plays (the Authoritarian response to anything) and pushing for more rules and regulation and for the adoption of ERM.

(f) The folks we are asking to fix things – the financial regulators – are the experts that authoritarian systems favor. However, they are smart enough to realize that to some extent, Fatalist solutions – reactive solutions – are needed now. Since that is counter to their training and position, they may not be very good at that.

(g) ERM programs will shift from playing to Individualists to playing to Fatalists and Egalitarians – a very different pitch

But some of you are still not convinced that this concept makes any sense. If every year, 3 out of four of the groups do not have their view validated by what happens, how can a set up like this possible survive?

The explanation is ties to one of my favorite quotes:

> Daniel Patrick Moynahan once said "Everyone is entitled to his own opinion but not his own facts." I love that quote.

But, according to Cultural Theory, Moynahan was exactly wrong!

There are just too many facts. Nobody can pay attention to all of the facts. Everyone selectively concentrates on the important facts. That process is called filtering. And the four styles of risk perceptions are major filters for most people. So Moynahan was exactly wrong! This filtering causes people to notice more of the facts that reinforce their view and to filter out the facts that contradict their view. So they do have their own facts.

So this is **INSIGHT 4** – and the most important in my opinion. People do have their own facts. And those with the strongest filters are able to maintain their views for longer in the face of non-validating experience.

And in fact, reality obliges each group by sometimes validating their view.

> **Stage 0 Risk Environment** - Everything IS mean reverting – validating the individualists. There appears to be no risk. Risk levels are far below capacity to absorb losses, especially factoring in the benign environment. So any risks can be safely added to the portfolio.
>
> **Stage 1 Risk Environment** - Risks behave normally – fluctuating within the expected ranges – validating the Authoritarians. The amount of risk in the environment is within the "usual " range. A model of an adverse situation (like 1/200) losses is a useful standard – but no one would expect losses to ever actually get that large. It is good in this environment to fully utilize risk taking capacity.
>
> **Stage 2 Risk Environment** - Reality is very sensitive and small changes to result in disaster – validating the Egalitarians. This is a tipping point environment. Resources to absorb losses are very similar in magnitude to the amount of possible losses. Best strategy in Stage 2 is to carefully unwind risk positions before things blow up.
>
> **Stage 3 Risk Environment** - Sometimes the future is just totally unpredictable – validating the Fatalists. Losses have occurred and resources may not be great enough to absorb future losses. Survival is the most

important objective and you must be on the lookout for any opportunities to save the company.

So my final take away is that to be fully effective in all environments. ERM should not seek to "WIN" everyone over to its Authoritarian point of view. The objective should not be to have everyone working from the same facts.

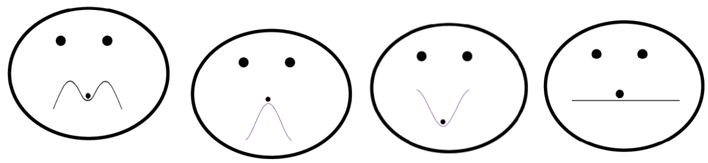
If you did "win" and force everyone to adopt the Authoritarian ERM view, then

You would miss the opportunities that the individualists see

You would not have the flexibility to react to the changes in the environment of the Fatalists.

You would miss the importance of that fatal misstep that the egalitarians would point out.

So I would suggest that you invite this group to be the ERM committee.



And learn to value the continual challenges and differing sets of facts that they will bring to the ERM discussions.

Key Insights

FIRST INSIGHT – Authoritarian ERM will conflict with all the other risk views!

SECOND INSIGHT – traditional risk management folks with Egalitarian point of view will not easily be converted to supporting ERM!

THIRD INSIGHT – Allegiances to these four risk views shift over time.

FOURTH INSIGHT –People do have their own facts.

FIFTH INSIGHT – Invite all four risk views into the ERM discussion and learn to value the continual challenges and differing sets of facts that they will bring to the ERM discussions.

For further Reading on Cultural Theory:

Organising and Disorganising (2008) by Michael Thompson

http://www.amazon.com/gp/product/0955768144

Cultural Theory (1990) by Michael Thompson, Richard J. Ellis, Aaron Wildavsky

http://www.amazon.com/Cultural-Political-Cultures-Michael-Thompson/dp/0813378648/ref=sr_1_5?ie=UTF8&s=books&qid=1241284258&sr=1-5

Thanks to Michael Thompson for his encouragement in this effort to take CT into this new area where it seems to fit quite well.