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In fallout from crisis, rethinking risk and human judgment

By Lynnley Browning

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NEW YORK: Call in the philosophers, call the psychologists. The idea of risk, the most fundamental concept in the insurance industry, is undergoing its most rigorous analysis in decades.

As the financial crisis sweeps Wall Street and Europe, big insurers are scrambling to unearth flaws in their core assumptions about the chances for financial outcomes - and to devise new ways to cope with uncertainty and "slippery slopes," both for themselves and the companies that buy their products.

"With this crisis, everybody is re-evaluating the concept of risk management," said Richard Phillips, a professor of risk management and insurance at Georgia State University, which has a leading program for insurance studies.

The scrutiny goes beyond a dissection of the complex mathematical models created by financial engineering, particularly those behind credit default swaps, the \$63-trillion-dollar market of insurancelike products that nearly bankrupted American International Group, caused steep losses at MBIA and Ambac, and has upset banks from Seattle to Amsterdam.

Rather, the rethinking "is focusing on the overreliance on models," said Carol Fox of the Risk and Insurance Management Society, a trade group.

Because nearly all risk-management models failed to predict or protect against the crisis, Fox said, insurers will increasingly view risk "more as a function of behavior than of models."

Going forward, she said, insurers will use models "as a point of information, but it won't drive risk tolerance" or the appetite for making financial and other bets.

Although both rely on historical data, the actuarial models behind life, property and casualty insurance - the industry's stock in trade - are not the same as those behind complex derivatives.

So the rethinking means considering the role of financial models in a company's overall operations, and whether those models fail to consider, for example, the risk of collateral calls or write-downs on the company's balance sheet - both missed by AIG.

"People have been managing the wrong risks - they have been taking microrisks rather than macrorisks," said Peter Bernstein, a historian and the author of "Against the Odds: The Remarkable Story of Risk."

"They weren't thinking about how the degree of risk in the system might be changing. They weren't thinking beyond their own models. Risk management is about making choices, not preventing losses. I don't think chief risk officers were asking that question."

With the exception of AIG, whose highflying London unit, AIG Financial Products, dived deeply into the derivatives business, insurers have not suffered losses comparable to those on the rest of Wall Street, where the carnage includes the collapse of Bear Stearns and Lehman Brothers.

But in a world of blurring boundaries between banks and insurers in interconnected markets, in which insurers buy and sell derivatives and manage investments and retirement funds that dip into derivatives, insurers are only relatively insulated.

As go their biggest customers - large companies and national and municipal governments - so go the insurers.

Insurance executives say the one thing the financial crisis has made clear is that risk, and how one deals with it, can mean wildly different things to different companies, from gamble, hazard or chance to threat, possibility or opportunity.

It can be a bucket of nasty things to be avoided, or a daring play. Some companies - AIG, for example - found it too risky to avoid the big profits trading mortgage-backed securities in a soaring market, and dived in head first, while others determined that such bets would undermine their operational risk, or business functioning.

Despite the vagueness of the concept, the insurance industry in recent years spawned a cottage industry of specialists and consultants offering advice on every type of risk under the sun: credit risk, liquidity risk, market risk, legal risk, catastrophe risk, regulatory risk, political risk, compliance risk and reputational risk, to name a few.

It didn't help matters that until the crisis, the field enjoyed a halo of academic credibility.

"All these rocket scientists with Ph.D.s provided reassurance to decision makers and buyers," said Paul Bracken, a professor of political science at Yale University.

But Robert Merton, the Harvard Business School professor who received the Nobel in economic science in 1997 for inventing a new method to value derivative contracts, said: "It would be a mistake to think the essence of the problem is complex math models that were inadequate. A lot of it is straightforward things, like judgments made to accept ratings. We've got to get these financial engineers and quant types out of the banks and get sensible types in."

Still, there is the human factor. Merton, after all, not only developed the options pricing model that is the most widely used in risk management programs but also served on the board of Long-Term Capital Management, the giant hedge fund that imploded in 1998.

Another case in point: In recent years, risk management came to be viewed by many chief risk officers as complying with laws and regulations, in particular the Sarbanes-Oxley law, the landmark U.S. antifraud legislation passed in 2002 in the wake of corporate scandals.

That was a big mistake, according to many insurance and risk management specialists.

"Our definition of risk became confused with obeying the law," said Bill Sharon, chief executive of Sorms, a risk-management consulting firm. "We created an environment where we didn't know what we were doing, but it was legal and making profits."

Now, insurers are increasingly looking at risk management as a process applying not only to the activities of particular divisions but also to big-picture questions - a concept known as enterprise risk management.

John Phelps, the director of business risk solutions at Blue Cross Blue Shield of Florida, said that "the big rethink is, what happened to the 'e'?" - as in "enterprise."

After all, said Martin Grace, associate director of the Center for Risk Management and Insurance Research at Georgia State University, "you can have math models, but that doesn't tell you how to manage the firm."

Correction:

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