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The psychology of risk - Real estate/construction owners: Don’t be fooled, our minds can play tricks - by Frank Licata

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The psychology of risk is fascinating. The way our minds work, we think we’re being thoughtful and managing risk, but we can be fooled. Risk management professionals are aware of this and adapt.

Psychology causes business managers to focus on the frequency of loss rather than the severity. Company owners and managers have a way of brushing aside concern for the rare but severe event, except for some vague unease about it in the back of their minds. This is understandable; however it is a mistake that can be avoided.

Why does it happen?

First, there are some psychological phenomena that cause us to use faulty judgment. We judge the probability of an event happening in the future by how readily we can bring it to mind (the availability bias), or by how recently it has happened (the hindsight bias). The “bystander apathy effect” allows us to ignore our own concern if we’re in a group and no one else in the group seems concerned. There is also the “problem of induction.” With inductive reasoning we project into the future based on events we have observed in the past. If it hasn’t happened to us, we assume it won’t happen.

There are also some perverse incentives in operation. Your insurance broker’s incentives are oriented toward the frequent risk. Brokers need to have happy customers. They can’t get bogged down in what seems like irrelevant talk about distant events that hardly ever happen. They can’t be expected to critique the terms of their own product, except with respect to losses they know are bound to happen in the short term.

Really, frequent events are a cost of doing business. They are not even insurable on a basis that makes sense- it’s the dollar-trading fallacy. Somewhat frequent losses are the ones that receive the most attention from CEOs and CFOs. These are the losses that don’t occur every day, but do happen enough and cost enough to be a concern.

What about the truly severe events? These go unmanaged unless there is a focused risk management culture. This is where many companies are exposed. This is the area where events happen that bring companies to their knees.

Professional risk managers have always been concerned with severity vs. frequency. The severe, though rare, event is the more important.

In real estate and construction we’re talking about things like:

• Earthquake: rare but potentially catastrophic to property whether existing or under construction. In Boston, for example the probability of a magnitude 6 quake (enough to cause major property loss) is about 10% in a 500 year period. And even with new construction, be aware that quake related building codes are oriented to life safety more than future building functionality.

• Liability limits: here, don’t catch yourself saying “We’ve been in business for 20 years and have not had a claim over $100,000.” Is this a reason why you can dismiss the need to 20, 30, 50 million liability coverage (depending on your exposure)? Definitely not. If the high multi-million dollar claims were going happen every 20 years to every company, you’d find the insurance unaffordable. The issue is that our time horizon is too short; only aggregate data over many companies over many years will have any statistical meaning.

• The need for loss control: “We’ve been cutting corners forever and nothing has gone wrong!” Again, catastrophes are not every day events – our own experience alone is meaningless. The disasters that take down companies are rare and are most often preventable. The 2010 BP oil well blowout disaster is a case study. It has so far cost BP over $40 billion in direct costs alone, and was completely preventable. See here for the story: The BP Gulf Oil Spill: a Risk Management Debacle http://licatarisk.com/cms/the-bp-gulf-oil-spill-a-risk-management-debacle/

Understand the problem of severity vs frequency, the psychology and incentives behind it, and the way to manage it, and you’ll be in the top 20% of businesses. Have a risk management culture and obtain the risk management resources, either in-house or on a consulting basis.

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