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The psychology of risk - by Frank Licata

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The psychology of risk is fascinating. 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 managers to focus on the frequency of loss rather than the severity. They 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?

We judge the probability of an event happening 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. 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.

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.

Liability limits: “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)? 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/

Make sure you have the professional help to let your company overcome the psychology of risk!

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