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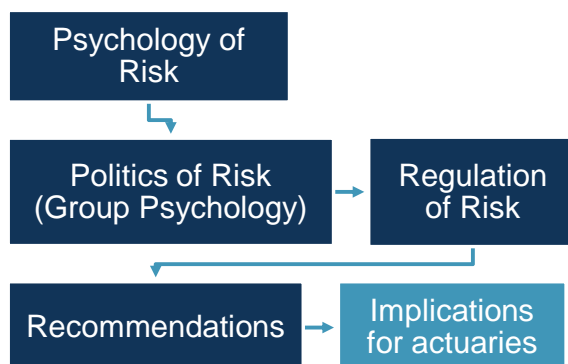
# The Politics, Psychology and Regulation of Risk

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02 January 2015



## Overview



- Actuaries – assess risk from a logical and rational perspective – typically based on theories that assume individuals act rationally.
- However, we are not rational robots. We are human!
- Alternative (classical) assumption – all individuals are subject to the same ‘*human condition*’.



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## Psychology of Risk - Existing Literature

The existing literature can be categorised into four main areas...

- Behavioural finance.
  - Smorgasbord of cognitive anomalies that arise from heuristics and biases.
  - Does not explain how and why the heuristics and biases arise.
- Risk Intelligence.
  - Embryonic field.
- Merits of psychological traits.
  - Contradictory conclusions.
- Assessment techniques.
  - No link with IQ (Ceci & Liker) & poor 'expert' forecasting (Tetlock).



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## The Classical Concept of the '*Human Condition*'

- Maslow, Freud, Sophocles, Jung, Fromm, Nietzsche, Heidegger, Keats, Adam Smith, Machiavelli, Socrates, Lao Tzu & other classical authors.
- The *Human Condition* is constrained
  - Socrates, Maslow, Lippmann
  - Numerous constraints on the psyche – so a proportionate degree of humility is always necessary, otherwise '*pseudodoxia*' (distorted logic) arises.
- We are human – we all have an *Ego*
  - Erich Fromm, Anna Freud.
  - The 'self' as distinct from other selves. NOT talking about ego as meaning an exaggerated self-importance or appropriate self-esteem.
  - The *Ego* offers use of defence mechanisms when it is in difficulty
    - which distort 'reality' to handle difficulties and setbacks



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## The Classical Concept of the ‘*Human Condition*’

- Life is a hill and progress is always an uphill battle
  - Hesiod, Democritus, Aeschylus, Euripides, Saint-Exupery
  - The hill is initially very steep but it flattens on ascent. The regressive forces pushing us down the hill are typically stronger than the progressive forces pushing us up the hill.
  - “*Civilisations are created from what is required of people, not from what is provided for them.*”
  - Our progressive force is what we require of ourselves. What we get and what is provided for us is only good if it helps us require more of ourselves. Progress, moving up the hill, is always an uncomfortable and difficult experience. The reward for moving uphill, to higher levels of the *human condition*, is that future ascent becomes less difficult.
  - The *ego* is mostly a regressive force as it can distort the reality of the hill and distort what is required of us. Overcoming the ego is necessary for significant ascent.
  - Difference with modern societal viewpoints.



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## The Classical Concept of the ‘*Human Condition*’

- Division of the *psyche* into ‘*Thought*’ and ‘*Logical and Rational Thinking*’
  - Einstein, Tesla, Anaxagoras, Tolstoy, Taoism...
  - “*The intuitive mind is a sacred gift and the rational mind is a faithful servant. We have created a society that honours the servant and has forgotten the gift*” – A. Einstein
  - Optimal alignment = a humility of the *Ego*, which balances:
    - Confidence, optimism, courage and patience in an individual's own thought (‘*E*’), and
    - Ego-critical and pessimistic forms of rational and logical thinking (‘*Go*’).
  - To reach the *psychological potential* of the *human condition* - the *psyche* must be operating in this manner, and the degree that it reaches its *psychological potential* depends on the level of vitality in the *psyche*.



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## The Importance of Thought

*"Thought is something limitless and independent, and it has been mixed with no thing but is alone by itself. For if it were not by itself but had been mixed with some other thing, it would share in all things, if it had been mixed with any. For in everything there is present a portion of everything, as I have said earlier. And what was mingled with it would have prevented it from having power over anything in the way in which it does, being in fact alone by itself. For it is the finest of all things and the purest, and it possesses all knowledge about everything, and it has the greatest strength. And thought has power over all those things, both great and small, which possess soul. And thought has power over the whole revolution, so that it revolved in the first place." - Anaxagoras (teacher of Pericles, Euripides and Phidias)*

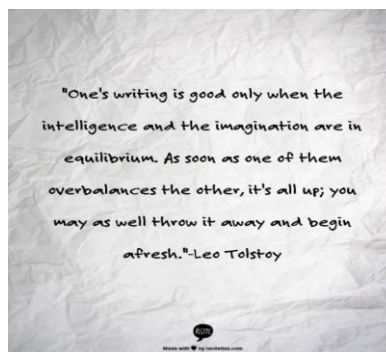
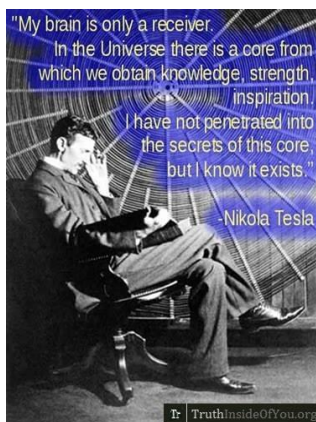
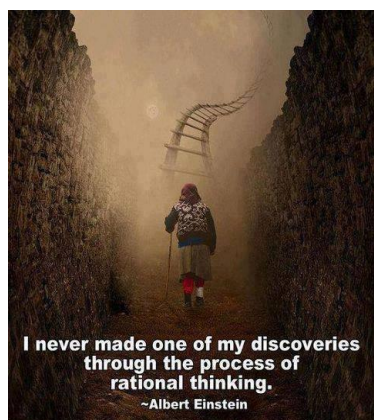


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## The Importance of Thought



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## The Dynamics of Accessing Thought

The greater the depth of thought, the greater the potential it is considered to have to “*taste the Pierian spring*” – Alexander Pope. In Greek Mythology, the Pierian Spring was considered the fountain of all knowledge and to be able to inspire whoever drinks from it. But the shallow waters of the spring were considered to intoxicate the brain – “*There shallow draughts intoxicate the brain, and drinking largely sobers us again*” – Alexander Pope. Only deeper drinking from the depths of the spring was considered to bring forth the Muses!

“*When they stop to think, they begin to fear*” – Pericles (fear prevents access to knowledge)



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## The Dynamics of Accessing Thought

### Just think: The challenges of the disengaged mind

Timothy D. Wilson<sup>1,2</sup>, David A. Reinhard<sup>1</sup>, Erin C. Westgate<sup>1</sup>, Daniel T. Gilbert<sup>2</sup>, Nicole Ellerbeck<sup>1</sup>, Cheryl Hahn<sup>1</sup>, Casey L. Brown<sup>1</sup>, Adi Shaked<sup>1</sup>

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ABSTRACT

EDITOR'S SUMMARY

#### Don't leave me alone with my thoughts

Nowadays, we enjoy any number of inexpensive and readily accessible stimuli, be they books, videos, or social media. We need never be alone, with no one to talk to and nothing to do. Wilson *et al.* explored the state of being alone with one's thoughts and found that it appears to be an unpleasant experience. In fact, many of the people studied, particularly the men, chose to give themselves a mild electric shock rather than be deprived of external sensory stimuli.

<http://www.sciencemag.org/content/345/6192/75>



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## The Three Types of Mind

- Hesiod – *“That man is best who reasons for himself, considering the future. Also good is he who takes another’s good advice. But he who neither thinks for himself nor learns from others, is a failure as a man”.*
- Machiavelli – *“There are three classes of minds: one which comprehends by itself; another which appreciates what others comprehend; and a third which neither comprehends by itself nor by the showing of others; the first is the most excellent, the second is good, and the third is useless.”*
- Thomas A. Edison - *“Five percent of the people think; ten percent of the people think they think; and the other eighty-five percent would rather die than think.”*
- There are many other similar thoughts among classical writers...



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## Freedom and the ‘Human Condition’

- People who move down the human condition effectively lose some of their capacity for choice (Fromm) – the steepness of the hill becomes an increasingly difficult constraint to overcome - they are less ‘free’ than those higher up the human condition.
- People who move up the human condition find it less difficult to be progressive as to be regressive – *“biophilia”* (Fromm) – their constraints effectively become much lower.
- *“There is no freedom without responsibility”* – J. S. Mill
- Escape from Freedom (Fromm).



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## Implications for the Psychology of Risk

- Those who have risen higher up the *human condition* are operating at higher levels of their *psychological potential* and consequently have more psychological capacity than those at lower levels of the human condition.
- Consequently, individuals who have risen up the *human condition* are likely to have greater potential for progressive risk management and progressive risk taking.
- Those at lower levels of the human condition are more constrained in their capacities and hence are subject to psychological risks, for example:
  - ‘*Ego Risk*’ – the risk that arises from the alternative realities created by the individual’s ego.
  - ‘*Reason Risk*’ – the risk that arises from putting only ‘reason’ (the faithful servant) in charge rather than having ‘*thought*’ in charge with the help of reason.



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## Assessing & Quantifying Psychological Risk

- *Risk Personality Questionnaire* – funded by Society of Actuaries in Ireland.
- It enables quantification of an individual’s ‘*Potentiality-Coefficient*’, a measure of the extent to which the individual is reaching their *psychological potential*, along with other measures which assess the degree to which they are accessing their own thought and adequately using their logical and rational thinking.
- Enables quantification of ‘*Ego Risk*’, ‘*Reason Risk*’ and other psychological risks.
- Has a feedback mechanism which offers advice for those wishing to improve the extent to which they are reaching their *psychological potential*.
- Tested using focus groups and statistically tested for reliability and validity.
- Other applications – assessing herd behaviour (lack of thought)
- More info: <https://web.actuaries.ie/events/past>



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## Risk Personality Questionnaire – Example

- *Sample Question: Which statement do you agree with most? (Honestly)*
  - *There is no freedom without responsibility.*
  - *I accept my responsibilities prudently.*
  - *It'd be great to have a few less responsibilities so that I could enjoy life more.*
  - *I'd love to win the lottery and be completely free.*
- Explanation:
  - John Stuart Mill, Antoine de Saint-Exupery
  - answers designed to be socially acceptable or socially admirable
  - anti-gaming techniques
    - ego defence mechanism & group ego defence mechanisms
  - answer one, scores 3, two scores 2, three scores 1, four scores 0



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## Political Risk - Aggregating the *Human Condition*

- Politics is the art of the possible. What is possible is limited by constraints. The constraints generated by the aggregation of the *human condition* create *Political Risk*.
- *Social Pietas* – associations necessary. Man is a political animal. Necessity to adjust.
- 'Might is Right' versus 'Right is Right'
- Optimum group dynamics requires *participation* beyond immediate self-interest
  - Idiotes get ruled by tyrants
- Emergence of the '*group ego*' and group ego defence mechanisms
- Consequently, all progressive policies need to overcome the following constraints:
  - Don't shock the system / protect the '*group ego*'
  - Protect the establishment / protect the strongest members of the group
  - Don't upset the balance of power / '*Might*' is '*Right*'



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## Assessing Political Risk in a Group

- *Political risk* can be considered to relate to the difficulty or otherwise in overcoming the previous constraints – how difficult is it to make '*Right*' to be '*Right*' in a group.
- A 'low risk' political environment is one where it is relatively easy to overcome the political economic constraints. – an unhealthy group ego.
- A 'high risk' political environment is one where it is relatively difficult to overcome the political economic constraints – a healthy group ego.
- If some individuals are not willing or cannot rule themselves, they are effectively asking somebody else to rule them => *Idiote risk* and *Tyrant risk*
- *Troll risk* – coming from the '*barbarian*' latent within the human condition – humans in their '*barbaric*' state are an enemy to anyone better than themselves.



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## Assessing & Quantifying Political Risk

- Group Risk Personality Questionnaire – funded by the Society of Actuaries in Ireland
- Enables quantification of the degree to which a group is operating at its combined *psychological potential* – i.e. the extent to which a group is greater or less than the sum of its parts.
- Why is the Group RPQ necessary?
- The Group RPQ calculates and compares a group's '*Group-Potentiality-Coefficient*' with the sum of each individual member's '*Individual-Potentiality-Coefficient*'.
- The Group RPQ enables feedback highlighting opportunities to improve the combined psychological functioning of the group.



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## Group Risk Personality Questionnaire - Example

- *Sample Question – Individual Question & Group Question*

*The group invested a significant amount into a particular investment – albeit less than its peer group. The investment has performed very poorly, losing >50% of its value. Which do you most agree with?*

- A) *The group did well to invest less than their peer group.*
- B) *The group made a very bad investment.*

- This question aims to test the degree of health of the group ego. The group / individuals have made a very poor investment and are given a choice to either see this reality or to see a sweetened reality.
- Answer one for both the individual and group questions would score 0 and answer two would score 3.



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## Regulation of Risk – Challenges

- Some of the challenges arising from the *Human Condition*
  - Insufficient thought - overcoming the dangers from low level narratives
  - Creating a progressive environment
    - setting adequate regulatory principles (Adam Smith)
    - setting adequate standards of professionalism
  - Assessing and managing ego risk and other psychological risks
  - Managing agency risk
  - Leadership – overcoming slavishness
  - Distinguishing between the spirit and the intellect.



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## Insufficient Thought / Low Level Narratives

- Adequate regulation of risk necessitates:
  - Avoiding regression to low level narratives – any descent towards the lowest common denominator
  - Facilitating the thought to create sufficiently high level narratives
- Example: the nature of banking organisations
  - Low level narrative = banks are the lifeblood of the economy ('banks are good')
  - Low level narrative = banks are the parasites of society ('banks are bad')
  - Higher level narrative = banks are the bad bacteria in the stomach of a capitalist economy ('good & bad')
- Example: risk appetite statements
  - No adequate assessment of the 'healthiness' or otherwise of the risk appetites
  - Comparison against risk capacity – a low level narrative
  - Making thought subservient to the 'humble servant' – who might develop hubris.



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## Setting Adequate Regulatory Principles

- Adam Smith
  - Low level narrative – Adam Smith was in favour of free markets
  - High level narrative – Adam Smith was in favour of free markets regulated by '*superiorly prudent*' individuals.
- Definition of *Prudence* ('*Mere Prudence*') – Adam Smith
  - 1) Propriety, 2) Superior reason and understanding, by which an individual is capable of discerning the remote consequences of all their actions, and of foreseeing the advantage or detriment which is likely to result from them, 3) Self-command, by which an individual is enabled to abstain from present pleasure or to endure present pain, in order to obtain a greater pleasure or to avoid a greater pain in some future time
  - Should markets be regulated by 'Idiotes'?
  - Inadequacy of the 'prudent person rule'.



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## Setting Adequate Regulatory Principles

- Definition of *Superior Prudence* - Adam Smith
  - Adam Smith defines “*superior prudence*” as wise and judicious conduct, when directed to greater and nobler purposes beyond that of the care of the health, the wealth, the position and reputation of the individual. He says it comes about when prudence is combined with adherence to greater and more splendid principles, with valour, with strong benevolence, with regard to the rules of justice, and all these supported by a proper degree of self-command. It is the best head joined to the best heart.
- Necessity to adhere to the following principles:
  - Courage
  - Strong benevolence
  - Justice
- Necessity to have a ‘*superiorly prudent person rule*’!



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## Setting Adequate Professional Standards

- ‘*Being a Professional*’ – extract from CA1 Core Reading
  - Professionalism is the way in which an actuary carries out the work and presents the advice resulting from the use of the skills acquired through this course and beyond. As a professional, an actuary will be required to make decisions and take personal **responsibility** for those decisions. An actuary must act with integrity and with **detachment** from his or her own personal circumstances. An actuary must also develop a direct, personal and **trusting** relationship with a client in order to advise on the most suitable solution for that particular client. **An actuary must also recognise that the views of others (including other actuaries) may differ from his/her own and that the other views may be valid.**
  - A professional must achieve and demonstrate **competence** in his/her specialised skill, and its practical application, in order to build the **trust** of clients and the **public** in the advice that is presented. Additionally, an actuary should also maintain and improve competence in the skills that are necessary to provide actuarial advice.
- Is this adequate in light of the *human condition*?



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## Setting Adequate Professional Standards

- *'Professionalism Plus'*
  - Functionally trust
    - Functional trust has three prerequisites, 1) competence, 2) honesty and 3) care.
  - Logical and rational thinking needs to be adequately pessimistic and adequately ego-critical.
    - Not sufficient to recognise that others may have different views and that the other views may be valid.
    - There is a necessity to seek out the views of others who have a different opinion to you.
  - Adherence to the principle of *superior prudence* rather adherence to *mere prudence*.
  - Adequate overcoming of the ego
    - Not sufficient to act with integrity and with detachment from his or her own personal circumstances
    - Necessity to have ascended to higher levels of the *human condition*
  - Motivational assessments to differentiate intrinsic versus extrinsic motivation.



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## Ego Risk

- Ego risk – the risk that comes from the alternative realities created by the ego
  - These provide the excuses that individuals use to justify regressive actions
  - Dangerous when combined with a capability to use intellectual deviousness to create a 'virtuous' pretence (including compliance with regulations) to cover-up regressive behaviours.
- Examples:
  - Fraud at Independent Insurance – intellectual deviousness and pretence to 'virtue'
  - *Anal-sadistic character* / individuals with the *death instinct* (Freud, Fromm).
- Currently no formal assessment of 'ego risk'
- Similarly for other psychological risks.



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## Agency Risk

- Agency risk – the risk that comes from the misalignment of interests among stakeholders.
  - Principal-agent problem – principal hires agent to act on his/her behalf, but agent's interest is also to act on it's own behalf
  - A 'solution' is to hire a regulator (an agent to keep an eye on the other agent)
  - But then have agency risk in regulator, as regulator's interest can also be to act in it's own interest
  - Potential for a highly dysfunctional bureaucratic system which may not be fit for purpose.
- Mitigation:
  - Intrinsically motivated individuals (aiming for justice over mere expedience)
  - Primary or dominant motivation = to do their work well.
- Necessity for *superior prudence* rather than *mere prudence*.
  - Mere prudence is likely to be part of the problem rather than the solution.



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## Adequate Leadership & Avoiding Slavishness

- Necessity for leadership
  - The majority have the third type of mind.
- Necessity for participation to avoid rule by tyrants
  - Solon and benevolent tyrants.
- Nietzsche – 'Master Morality' versus 'Slave Morality'
  - Rule by logical and rational thinking = rule by the humble servant
  - The humble servant has a tendency to be lazy and is incapable of understanding the world
  - The fallacy of the benevolent "they"
  - Slavishness invites the rule of a tyrant to maintain a degree of expedience.
- Follies of Intrinsic motivation



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## Intellect v Spirit

- “*Man’s creation came not of the intellect but of the spirit. Therefore I tell you it is not intellect but the spirit of man that rules the world.*” – Antoine de Saint-Exupery
- Necessity for courage!
  - “*A nation that makes a great distinction between its scholars and its warriors will have its laws made by cowards and its wars fought by fools.*” – Thucydides.
- Necessity for action!
  - “*Having knowledge but lacking the power to express it clearly is no better than never having any ideas at all.*” - Pericles



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## Recommendations

- A function of the regulator should be to foster and nurture the creation of higher level narratives – rather than just enforce adherence to low level narratives.
- Replace the ‘*prudent person rule*’ with a ‘*superiorly prudent person rule*’.
- Replace or evolve the current ethos of professionalism into an ethos of ‘*Professionalism Plus*’.
- Begin investigation and management of psychological risks.
- Begin investigation and management of political risks.
- Aim to create a progressive environment that aids ascent of the *human condition*.



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## Implications for Actuaries

- Actuaries are potentially very well placed to benefit from such changes.
- But first...
- Another perspective on the importance of good communication by actuaries
  - Civilisations are created from what is required of people, rather than what is provided for them. If individuals require less of themselves after more has been provided for them, they have been 'barbarised' as they will have moved down the human condition.
  - Focusing only on actuaries providing better communication rather than taking a bigger picture perspective of the issue of communication may be leading to actuaries barbarising their clients, managers and employers.
- The core strength of actuaries is not communication – have we forgotten what our core strengths are?
  - Lets looks at what the trolls have been saying about us for a clue to our strengths



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## Implications for Actuaries

- Actuaries frequently compared to those with Asperger Syndrome
- Positive Traits of Asperger Syndrome
  - Honesty and directness
  - Reliability and loyalty
  - Dedication and determination
  - A strong moral code and sense of justice
  - A strong desire to seek knowledge, truth and perfection
  - A distinct sense of humour
  - Exceptional long-term memory.
- Might such individuals be regarded as likely to meet the '*superiorly prudent person rule*'?
- Was this the original idea behind the '*appointed actuary*' regime?



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## Questions



## Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

Comments, questions: *[paragonresearchltd@gmail.com](mailto:paragonresearchltd@gmail.com)*



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