



31 May – 03 June 2016
at ISEG – Lisbon School of Economics
and Management

Herding Behaviour as a Source of Risk

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Agenda

1. Overview
2. Examples of positive and negative herding behaviour
3. Case studies
4. Managing adverse behaviour
5. Q&A



Definition of herd-like behaviour

- Herd-like behaviour arises when the group to which an individual(s) belongs to or is associated with has a disproportionate impact on their reasoning or their decisions.
- From another perspective, herd-like behaviour arises when there is an inadequate amount of individual thought to counteract the influence of the group in arriving at their decisions.

Analogy

- The analogy of the Fish, the Shoal and the Trawler¹
 - Somewhat helpful behaviour – protects fish from sharks
 - But also highly destructive – can result in near total loss of shoal
 - The behaviour of the group influences the choice of the prudent decision for the individual.



¹Credit to Tony Jeffery, FIA of Bank of England



Aim of herd-like behaviour working party

- To investigate the underlying drivers of herd-like behaviour and how it manifests in financial service organisations
- To raise awareness of herd-like behaviour as a source of risk
- To recommend changes to mitigate adverse herd-like behaviour



Drivers of herd-like behaviour

- Selfish herding – Hamilton's '**selfish herd**' model² views HLB as a selfish act where each individual seeks to reduce their exposure to a perceived threat or predator at the periphery of the herd
- Threats – may take many forms in the insurance industry:
 - **Organisational culture** – fear of dominant senior leaders; fear of being perceived as uncooperative; or fear of voicing contentious opinion
 - **Competition** – fear of losing market share
 - **Regulator** – fear of a capital add-on, adverse ruling, or scrutiny
 - **Auditors** – fear of assumptions/methodology/results not being accepted by the auditor

²Hamilton, W.D. (1971). "Geometry for the Selfish Herd". Journal of Theoretical Biology



Model to assess herd like behaviour— Narrative risk³

“All things were together. Then thought came and arranged them.” Anaxagoras

- Using the distinction between a narrative and an analysis
- What is a narrative?
- Example – stock market crash
 - Shallow narratives – superficial understanding
 - Deeper narratives – sufficient depth and breath to not only attain some understanding but to also facilitate progressive resolution of problems
- Why is it important?
 - People cast their own identity in some sort of narrative form
 - **The ‘narrative’ dominates and limits the ‘analysis’**

³Theory is based on the work of Greek Philosophers Anaxagoras, Plato and on Greek mythology.



Narrative risk

- Dangers from shallow narratives
 - Rhetoric can prevail over reason and logic
- Shallow narratives inhibit rather than facilitate progressive outcomes and inhibit resolution of conflicts
- Shallow narratives usually result in poor outcomes
- Shallow narratives create herd-like behaviour risks



- ✓ Herd-like behaviour can aid reaching optimum outcomes in the context of influence from a progressive group
 - ✓ e.g. being Fellow of IFoA, standing on the shoulders of giants, etc.
- ✓ A group or organisation acting as one to achieve a common goal – greater than the sum of parts
- ✓ An organisation or individual may have less information than the industry
- ✓ Reduces volatility of outcomes – can suppress reckless behaviour



Example

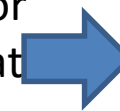
Driver

Outcome

1 Suppressing ideas and questions at meetings/committees

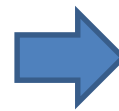


Fear of looking 'stupid' or appearing difficult – 'that annoying person'



Decisions made without full set of considerations and insufficient challenge
> **sub-optimal outcome**

2 Too much reliance on industry when setting assumptions



Greater challenge & scrutiny from auditors/PRA if out of line with peers



Internal views & data suppressed
> **Lower contribution to pool of knowledge**

3 Mis-pricing & poor product design



Competition and fear of missing out



Own information & analysis suppressed
> **Quick wins can turn into long term losses**



Financial market bubbles



(more on this later)

Unsustainable products



(more on this later)

Crashes or collapses

Scandals



Potential higher risk areas of HLB now

Longevity
assumptions

Product
design

Working party
reliance

Solvency II
internal
models

Benchmark
reliance

Investment
strategy

ESG

VaR measures

Insurance
cycle

Case study (1) – financial market bubbles

- Examples
 - Tulip bubble
 - South-sea bubble
 - 1929 Stock market crash
 - Dot com bubble
 - Financial crisis of 2008





Case study (1) – financial market bubbles

- Could be argued to result from shallow narratives – extreme cases
 - Shoe-shine boy explaining how to make money in 1929
 - Internet stocks in 1999
 - Tulips in Holland
- Assessing the risk of a stock market bubble could be considered to be assessing the risk that the stock market narrative has become too shallow – either generally or in relation to a particular issue.
 - Bubble risk = could be considered the tail risk in any narrative risk



Case study (1) – financial market bubbles

- Bubbles typically happen when something causes a shock to the group narrative, some big change, e.g. the internet, tulips and quantitative easing
 - The group mind does not think – so struggles to create a sensible narrative (Trotter and Bernais)
- Careful using shallow narratives to explain previous bubbles.



Case study (1) – financial market bubbles

- Quantitative Easing
– current ‘big change’
- Existing narrative
- Alternative narrative



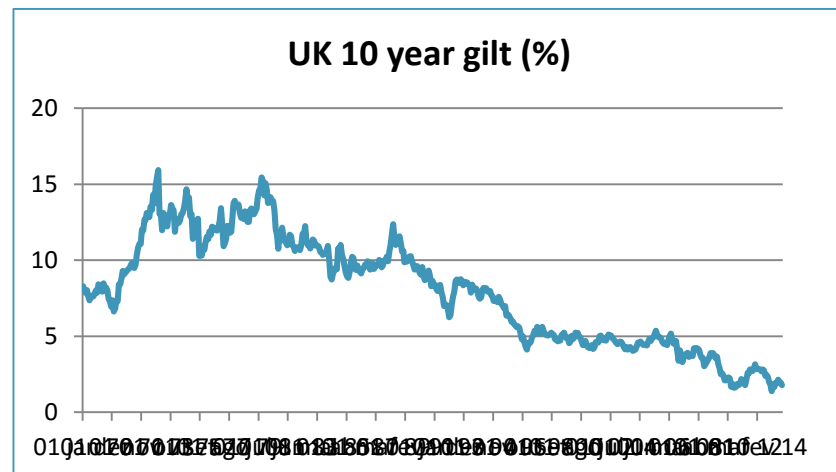
Case study (2) – banking crisis

- Banks are good – life blood and heartbeat of the economy – save them!
- Banks are bad – just parasites, taking money from some, keeping some and give the rest to others, not producing anything – let them die!
- Both shallow narratives – with bad outcomes
- Deeper narratives – ?

Case study (3) – Guaranteed Annuity Options

- Guaranteed Annuity Options (GAOs) are a policy feature, that give policyholders an option to purchase an annuity at a guaranteed rate on retirement
 - GAOs were first launched by a mutual life insurer and were eventually offered by up to 40 companies offered GAOs over the 1970s to 1980s
 - Most options were written in a high inflationary and interest rate environment, where guarantees were not biting.

Most GAOs
were written
over the
'70s-'80s





Case study (3) – GAOs

- The cost:
 - Estimated collective losses of £10bn⁴ across the industry
 - Reduced credibility of the insurance industry and the actuarial profession in the eyes of the public
- Underlying signs of HLB:
 - Companies perceived GAO offerings as key to maintaining competitive position
 - After a prolonged period of high interest rates, people started to believe this was the new normal – it was difficult for individuals to recognise the risk of rates reducing and voice caution
 - Complex risks involved over a long horizon, but modelling and risk mitigation instruments were limited

⁴ 'Did anyone learn anything from the Equitable Life? Lessons and learnings from financial crises' Roberts, 2012



Managing Adverse Behaviour

- Two approaches
 - Macro – investigate the narrative to discern if it is deep or shallow, take remedial action if a shallow narrative is discerned
 - Micro – investigate the extent to which individuals are thinking for themselves – the **‘Know yourself test’**.
- Challenges
 - Macro – difficult
 - Micro – new approach, necessity to step outside the herd to use it



Cultural change

'No problem can be solved from the same level of consciousness that created it.' Albert Einstein

- HLB emerges from lack or suppression of creative and imaginative thought and challenge
- Problems
 - Dominant CEO / dominant boss => disobedience = can get fired
 - Whistleblowing => may be difficult initially for the individual, despite clear recent guidance on professional responsibilities
 - Organisational culture rarely encourages much curiosity
- Creative thought necessitates self-awareness

Ideas

- Open forum events in organisational social calendars that provide a safe environment to submit ideas, challenge strategy and question leaders - and laugh⁵



- Regulatory requirements to demonstrate rigorous challenge from a diverse group and cultural support of such actions.
- Policies to encourage progressive curiosity.

⁵Idea is based on the concept that if you cannot laugh at somebody, they have authority over you, and so you curtail your self-awareness. Linked to the comedy festivals in Ancient Athens – politicians were made to sit in the front row while they were being made fun of by the actors



Questions

Comments

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