Behavioural risk management for trustees

NEIL MCCONVILLE FIA

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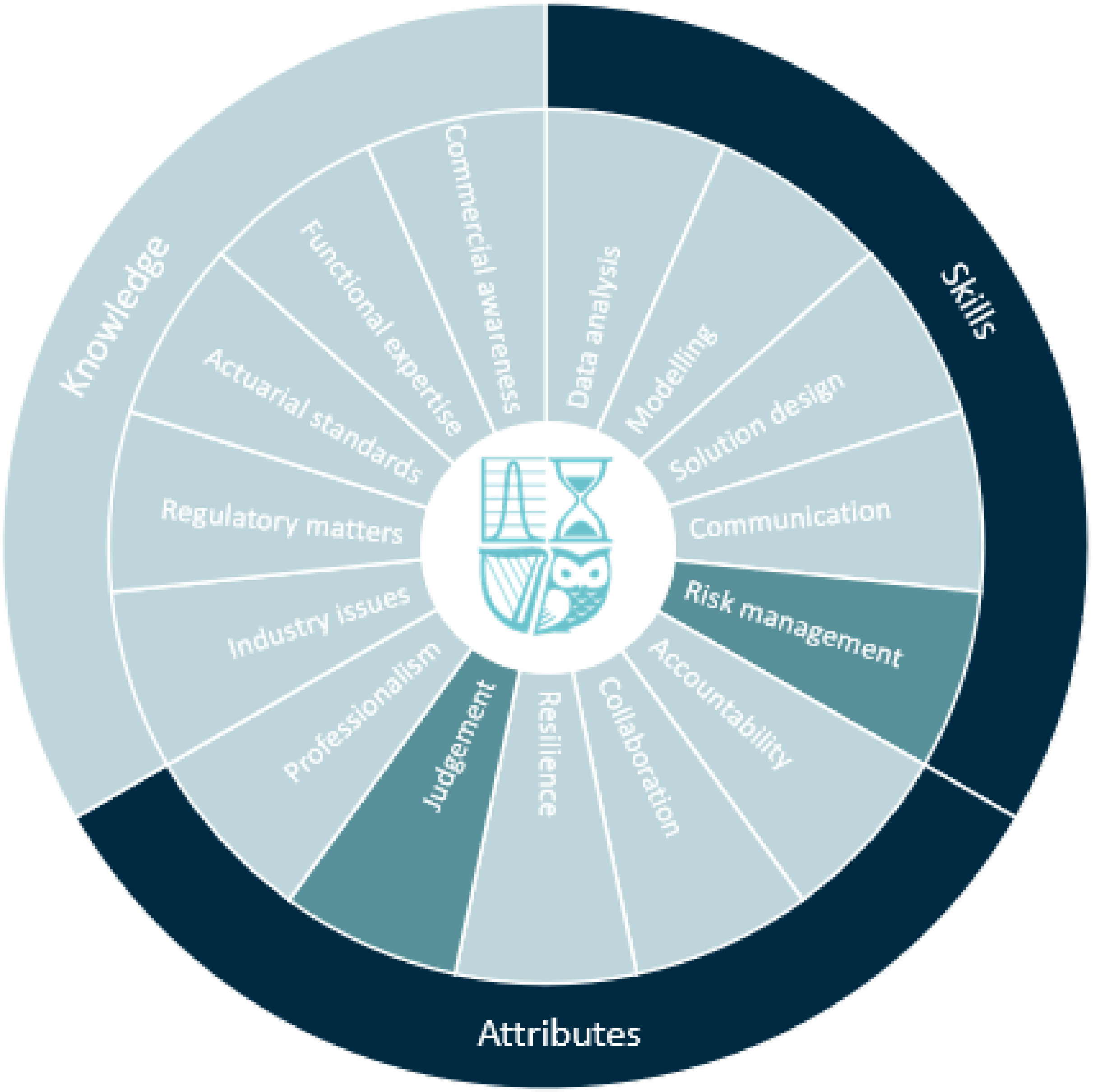
SAI Competency Framework Wheel



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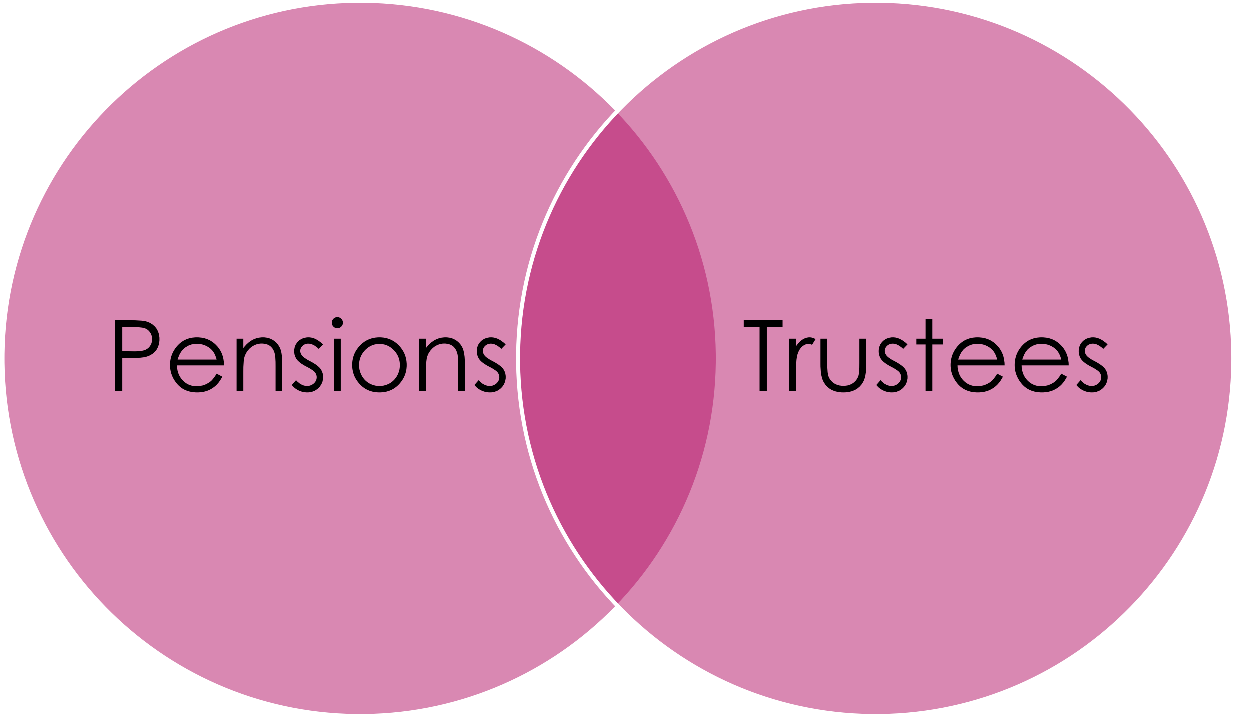
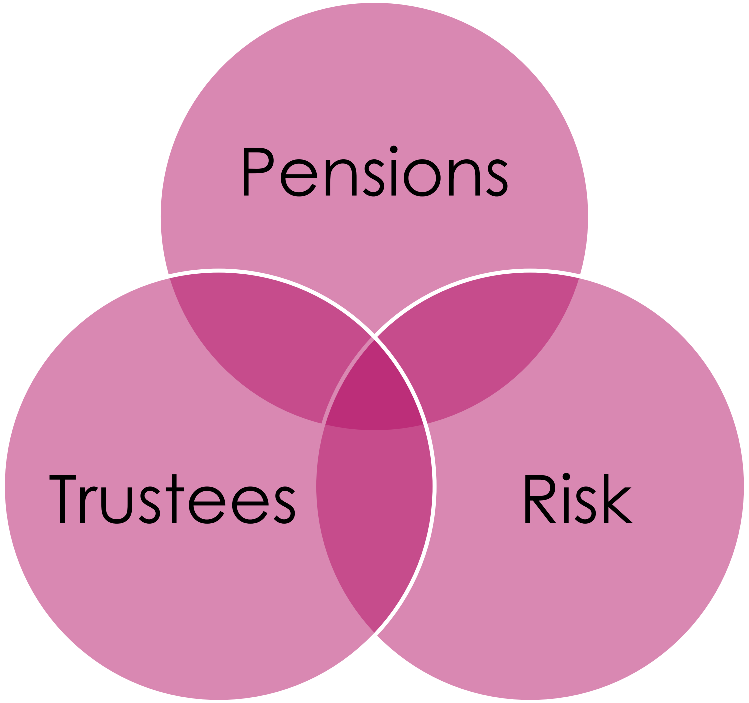
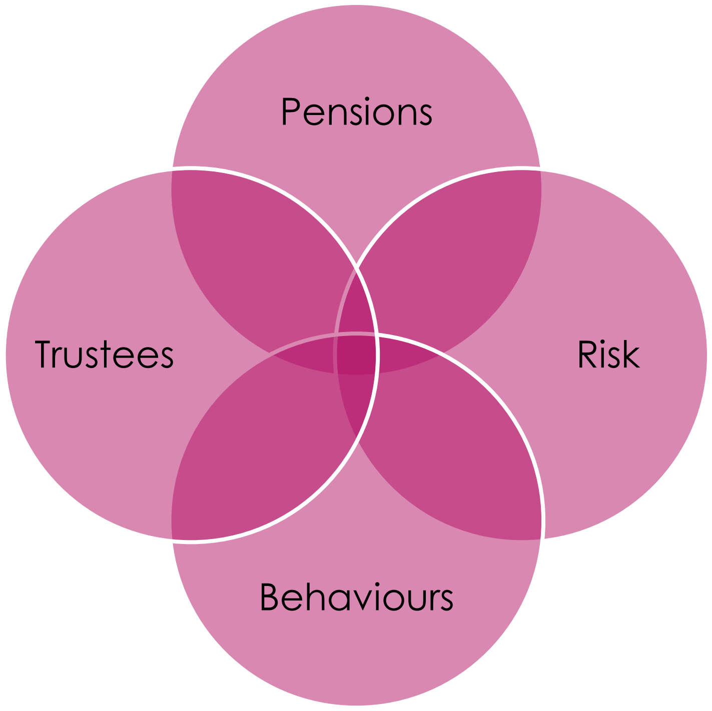


Overview



Overview



Enterprise risk management and pensions

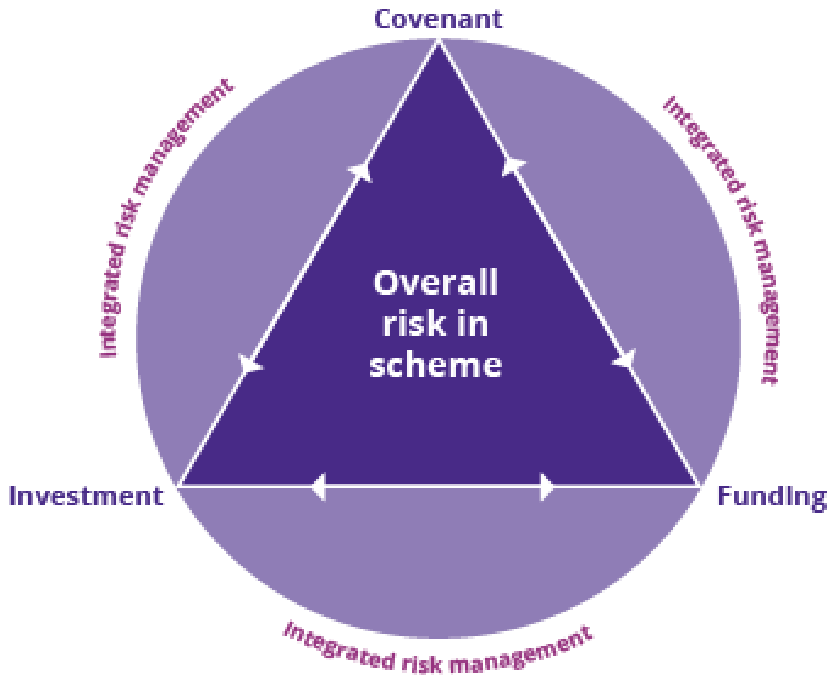
Enterprise Risk Management

- No one definition of Enterprise Risk Management
- Why (Enterprise) Risk Management
- Benefits of Enterprise Risk Management.

Typical categories of risk

- Market Risk
  - Risks arising from changes in market values or other features related to financial markets
- Credit Risk
  - Risk that counterparty unable or unwilling to make payments required
  - In the case of bonds default on repayment of debt
  - Counterparty credit risk, risk third party does not perform functions
- Operational Risk
  - Risks of losses resulting from inadequate or failed internal processes, people, systems or external events

Integrated Risk Management



Source tPR

Effective Risk Management

			Inherent Risks					Residual Risks							
Risk Category	**Risk**	**Risk Indicator**	**Impact**	**Likeli-hood**	**Risk Score**	**Risk Owner**	**Internal Control Process**	**Impact**	**Likeli-hood**	**Risk Score**	**Further Actions to Mitigate Risk**	**Links to internal control documents**	**Last Reviewed**	**Review Frequency**	**Next Review Due**
Investments	Inappropriate or inadequate investment strategy	R1	5	3	**15**		Investment Strategy Review completed XXXX. Quarterly updates from XXXXXX.	5	2	**10**	Review investment strategy following each actuarial valuation.		QX 20XX	Quarterly	QX 20XX
Sponsor Covenant	Weakening of the sponsor covenant	R2	4	3	**12**		XX part of the Trustee board. Trustees to monitor XXXXX metrics and discuss annually.	3	3	**9**	Annual update from XXXXX.		QX 20XX	Annually	QX 20XX
Funding	XXXXX not adequately funded	R3	5	3	**15**		Recovery plan approved by Trustees	4	2	**8**	Three yearly valuations by Actuary / trustees		QX 20XX	Annually	QX 20XX
	Interest rate risk	R4	4	2	**8**		Review and challenge assumption at valuation date	3	2	**6**	Monitor movement in rates during intervalution period		QX 20XX	Annually	QX 20XX
	Inflation risk	R5	4	2	**8**		Review and challenge assumption at valuation date	3	2	**6**	Monitor movement in rates during intervalution period		QX 20XX	Annually	QX 20XX
	Longevity risk	R6	4	2	**8**		Review and challenge assumption at valuation date	3	2	**6**	Monitor CMI/SAPS releases		QX 20XX	Annually	QX 20XX
Operational	Benefits calculated / set up incorrectly	R7	3	4	**12**		XXXXX internal quality controls. Ensure administrators sufficiently experienced	3	3	**9**	Request copy of XXXXXX internal quality controls/admin documentation.		QX 20XX	Annually	QX 20XX
	IT systems	R8	2	2	**4**		XXXXX and advisors IT and internal controls policies.	2	1	**2**	Ensure, systems, models and spreadsheets properly documented, backed up and		QX 20XX	Annually	QX 20XX
	Cyber Risk	R9	4	3	**12**		XXXXX and advisors cyber risk policy.	4	2	**8**	Obtain copy of all cyber risk policies and notice of updates. Use secure methods of		QX 20XX	Annually	QX 20XX

Effective Risk Management

Bias

Bias

- Poor decision making and biases act as barriers to effective risk management
- Research in psychology and economics found humans are systematically biased
- Improving our ability to identify and understand errors of judgement can limit damage caused by such errors
- Decision makers are more aware of cognitive biases and how they undermine decision making, without us knowing.

Fast thinking

- Bias can be a function of intuition (consists of experience, training, memory and/or "gut feeling") or heuristics (mental shortcuts that we take)
  - Can be thought of as fast thinking

Puzzle

- A bat and ball costs €1.10.
- The bat costs one euro more than the ball.
- How much does the ball cost?

Source: Daniel Kahneman

Slow thinking

- Bias can also be a function of deliberate thought, when fast thinking doesn't offer a solution
  - Can be though of as slow thinking
- Go to www.menti.com – code xx xx xx xx

Source: Daniel Kahneman

Types of Bias

- Psychologists and behavioural economists have identified many biases, that can be loosely broken down into the following categories:
  - Action-orientated biases
  - Pattern-recognition biases
  - Interest biases
  - Stability biases
  - Social biases.

Interest biases

- Framing effect
  - People decide on options depending on whether options presented in positive or negative effect.

Interest biases

- Denominator neglect
- Consider a new vaccine that protects you from a fatal disease
- You read a flyer in your local doctors, in the small print it says that there is a likelihood of permanent disability of 0.005%
- That evening you see a news report talking about the vaccine and it states that 5 in 100,000 adults are at risk of permanent disability.
- Does this change your opinion of the vaccine?

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Stability biases

- Anchoring effect
  - Bias towards initial or previously observed value.
- Regret aversion
  - Aversion to losing what we have compared to what we don’t have.
- Status Quo bias
  - Resistance to change or more difficult the decision, more likely not to act.

Social biases

- Halo effect
  - Confident person - more willing to be open to their comments and news
- Groupthink
  - Opinions deviate to the norm or general consensus
- Sunflower effect
  - Tendency for groups to align views with leaders.

Barriers to effective decision making

- Heuristics tend to result in finding adequate, though imperfect, answers to difficult questions
- Substituting one question for another can be a good strategy for solving difficult problems.

Barriers to effective decision making

- Conservatism
- Ego
- Attention
- Emotion

Source: Daniel Crosby DA

Nudges and pensions

Nudges

- A nudge is essentially a means of encouraging or guiding behaviour
- Without mandating or instructing
- Ideally without need for heavy financial incentives or sanctions
- Think of it as a gentle push in a particular direction.

Nudges and pensions – Auto enrolment

- Policymakers toiled with issue of encouraging pension saving for years
- Offered generous tax breaks and subsidies running into many billions
- Many people did not avail of them and effectively left money on the table
- Made a small change to the default.

Nudges and pensions – Save more tomorrow – Auto escalation

- Commit to series of contribution increases timed with salary increases
- Members don’t see their income go down
- Also don’t see increased pension contributions as losses
- Once join savings increases are automatic
- Using force of inertia and status quo to increase savings.

Source: Richard Thaler

Nudges and pensions – Save more tomorrow - Auto escalation

- Plays on a series of psychological principles that underline human behaviour
  - People say they think they should save more, plan to do so, but never do
  - Self control restrictions, easier to adopt something if happen in the future
  - Loss aversion, people hate to see their income fall
  - Status Quo bias, general inertia plays a big part.

Risk behaviours

Risk Behaviours - Gains

- Consider the following improvements in chances of **receiving** €100,000.
  A. From 0% to 5%
  B. From 5% to 10%
  C. From 60% to 65%
  D. From 95% to 100%
- Is the news equally good in each case?
- Possibility effect
  - Causes highly unlikely outcomes to be weighed disproportionately more than they deserve.
- Certainty effect
  - Causes highly likely outcomes to be given less weight that their probability justifies.

Risk Behaviours - losses

- Consider the following reduction in chances of **losing** €100,000.
  A. From 100% to 95%
  B. From 5% to 0%
- Decision weights that people apply to outcomes are not identical to probabilities of the outcomes.

Conclusions

- Enterprise risk management and pensions
- Behavioural bias
- Nudges and pensions
- Risk behaviours.

Questions?

Please click on the 'Raise Hand' icon
to ask a question
and
wait to be unmuted
or
Use the Q&A function