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Aversion to Risk Aversion

Risk aversion is a conversation-stopper. I mean this in two senses. First, for people with mono-causal world views, one explanation is enough. It is not fanciful, I think, to identify a standard research strategy. When confronting some stylized institutional fact (e.g., hedging in futures markets, commission pricing, sharecropping, indexation of prices) invoke risk aversion. If that appears consistent with the facts, stop the search. This strategy is not a necessary consequence of the assumption of risk aversion, but the pattern seems, from an informal reading of the evidence, to be a strong one. Deprived of the risk-aversion short cut, the analyst would be forced to pursue other, and, I believe richer, lines of thought. Which leads to my second point: modeling entails opportunity costs. If risk aversion is to be included, then we have to simplify the world on other ways in order to build tractable models or otherwise make some sense of a complicated reality. If we assume that people are more or less risk neutral, then we can focus on the sorts of questions that I think are important in understanding economic institutions. If we insist on including risk preferences in the model, then these other considerations must be put aside.

A common retort to the no-risk-aversion position is: But don't you believe that people really are risk averse? The *ad hominem* variant on this theme is: Well, do you buy insurance? There are a number of responses to these arguments. The first, and probably least important, is that the evidence from the cognitive psychologists suggests that risk aversion does not adequately describe behavior. But that observation is largely beside the point. Even if everybody were risk averse it might still be appropriate to assume risk neutrality. To make any headway in theorizing we must simplify reality and assume things known to be false.

I am bewildered by economists who make the "people really are risk averse" argument and at the same time make wildly unrealistic assumptions about the ability of individuals to make complex calculations and engage in long chains of sophisticated reasoning. The evidence on risk aversion is at least mixed. The evidence regarding people's reasoning skills we see every day and it is pretty clear that most people can't handle tenth grade word problems, let alone some of the sophisticated mental feats routinely assigned to them by economic theorists. My point is not that the unrealistic assumptions negate the conclusions. It is simply that the assumption regarding risk preferences should, like the assumptions regarding computational skills, be judged for their usefulness, not for their realism.

The question about the purchase of insurance, alluded to above, had an implied premise: people buy insurance because (and only because) they are risk averse. This is a good example of how the risk-aversion assumption stifles inquiry. There are numerous reasons why parties might buy insurance even if they are not risk averse. An interesting array of problems and solutions awaits the analyst willing to go beyond the limits imposed by a risk-aversion based research strategy.

Why might a large corporation with publicly traded shares buy various lines of casualty insurance? One might try to attack the problem by assuming that managers are risk averse and that the behavior of the firm in this dimension reflects the manager's preferences. I doubt that this line of argument will work. It implies that corporations which self-insure for the same problems act as if they are not risk averse. I suspect that it would require some elaborate intellectual contortions to develop a plausible argument as to why some corporations act as if they are risk averse and others risk neutral.

It seems to me far more helpful to suppress the question of attitudes toward risk and focus on why a risk neutral corporation might buy insurance. Perhaps the most interesting reason is that the insurance company is a specialist provider of risk management services. The insurance company provides services (for example, inspection) to reduce the firm's expected accident costs (including the costs of litigation and rehabilitation of victims). Since it is difficult to determine how well an inspector has performed the promised service, it is plausible that the inspection contract would make compensation contingent upon performance. That is, an efficient inspection contract might include deductibles, copayments, and ceilings -- standard features of insurance contracts. (I suspect, by the way, that it would be difficult to reconcile liability ceilings with a risk-aversion explanation). The share of the premium dollar going to inspection services varies considerably over different lines of insurance. For some it is undeniably important, with over twenty percent of the premium for some lines of insurance (steam boiler and elevator insurance, for example) going to inspection services.

The existence of self-insurance can be treated more naturally when the problem is viewed in this light. Instead of focusing on the relative risk aversion of organizations, the focus is on whether a firm should perform its risk management activities internally, or whether it should purchase some, or all, of them from an external provider. This is a standard make-versus-buy question that would confront the corporation regardless of whether it was risk averse, risk neutral, risk loving, or had some even more complicated preferences regarding risk.

What is the effect of insurance on a corporation's accident costs? A risk-aversion framework suggests that costs will remain the same (the risks are exogenous) or increase (moral hazard results in less accident avoidance by the corporations). My framework suggests that insurance could easily result in a decrease in accident costs if the external provider of risk management services is a more efficient provider than the self-insuring corporation. Thus, if public policy resulted in an increase in the costs of commercial insurance relative to self-insurance, my framework would suggest that it is plausible that accident costs would rise -- a result that could not be derived from the risk-aversion approach.