B.A.J. **10**, IV, 681-683 (2004)

GUEST EDITORIAL

THE NEW NORMAL! RATIONAL OR RATIONALISATION?

By H. H. Panjer

'The new normal'. What a horrible expression! We have heard it so many times. It seems that each time we experience a major shock, we are told that this is the 'new normal', and we had better get used to it. Consider just a few events of the last five years: the massive run-up in high-tech share prices up to February 2000; the attacks of 11 September 2001 in the United States of America; SARS in 2003 in Hong Kong and Canada; BSE in the United Kingdom, and now in Canada; the great tsunami of December 2004. Each time, it seems we were not sufficiently prepared. Often our reactions seemed bizarre, at least in retrospect. In the share price run-up, many investment advisors attempted to rationalise price/earnings ratios of 100, and even higher, using 'new valuation thinking', in an attempt to rationalise behaviour that was clearly not rational (at least based on knowledge developed over many years up to that point). Reactions of countries importing beef from countries where BSE was detected seemed far beyond how any rational person might behave personally when faced with the same perceived level of risk. After 11 September 2001, nail clippers became potential weapons on airplanes, while full bottles of wine (or, better yet, broken ones) were not.

As actuaries, we are supposed to be rational, to understand risk, and to be able to explain risk. Yet, even in industries where our opinions should be heard and valued, what appears to be quite irrational behaviour continues. Capital runs from the insurance sector immediately after each hurricane or other 'random' event; even though the industry has demonstrated its ability to handle the huge losses that will inevitably reoccur periodically, and its ability to raise premium rates in response to the public's irrational perception of increased risk.

'Every crisis creates opportunity'. Though we have heard this for ever, it may even have some merit. I believe that each major crisis involving significant loss creates the opportunity for actuaries to explain risk and risk management, and to develop new methodologies for the mitigation and management of risk in a rational way. This is the message of the new image campaign of the actuarial profession in North America, with the theme 'Turning Risk into Opportunity'. The need to sell the actuarial profession is reflected in the campaign's label and tagline: 'Actuaries: the best kept secret in business'.

As risk professionals, actuaries have the opportunity to learn from each event, to incorporate that knowledge into existing knowledge, and to advance the science of our profession. To grow and flourish as a profession, we need, also, to sell this knowledge to the rest of the world. Within the broader risk management community, one obvious area of potential contribution by actuaries is operational risk. To the financial institution facing operational risk, the challenge is to mitigate, to measure, and to manage that risk. To measure a company's overall exposure to risk requires loss modelling techniques that actuaries have been using for many years. I am currently preparing a book on operational risk for the broad risk management community. In the past couple of years, there has been a growing number of articles in the scholarly journals and the wider risk literature by actuarial experts on the application of loss modelling, extreme value theory, ruin theory and credibility theory in operational risk.

Scholarly journals provide one of the vehicles for providing that important information for broader consumption than to actuaries only. Scholarly journals have much greater credibility attached to them than claims made through general publications or through commercial means, such as television advertising, because articles in scholarly journals are subject to strict peer review. The press knows this. Almost every week, we hear about a research finding that is to be published in *The Lancet* or *The New England Journal of Medicine*. Drug companies know the value of the publication of positive findings in peer reviewed journals.

As a profession, we have often not placed high value on research – especially research which may not seem to be immediately ready to use in everyday work by the typical actuary; nor have we aggressively pushed our methodologies into other fields. Our profession's scholarly journals provide one vehicle for recording rational advances in knowledge, rational advances upon which subsequent rational advances can be based. Thus, it is with great enthusiasm, that I, as the Editor of the *North American Actuarial Journal*, welcome the new *Annals of Actuarial Science* to the community of scholarly journals. Undoubtedly, the new *Annals of Actuarial Science* will join the ranks of the top scientific journals. This, in turn, will encourage serious authors, both actuaries and non-actuaries, to have their work published in it. As a scientific journal, it will carry the cachet of other scientific journals without the baggage associated with professional publications, which often tend to discourage non-actuaries from reading our journals. This move is consistent with the move made in the creation, in 1997, of the *North American Actuarial Journal*. The *NAAJ* only publishes articles that are rigorously peer reviewed. It is also attracting the attention of actuarial and other researchers. Approximately half of the authors are not members of the Society of Actuaries, the sponsoring organisation. Furthermore, there appears to be a significant increase in citations to the Journal as compared to its predecessor. The effect is both to bring actuarial research to the attention of those in related fields, and to bring in research from related fields, so that actuaries can benefit from developments of others in areas such as finance, risk management, accounting and insurance economics.

Scientific knowledge gained from random events seldom creates a genuine 'new normal'. It can provide new insight, but the fundamentals seldom change. (There are a few clear exceptions, such as the breakthrough in option pricing theory by Black and Scholes.) Wild market run-ups are the result of irrational exuberance. There is no new valuation theory coming out of the 'new valuation thinking' of 1999 to 2000. Shocks in our system can cause us, in the scientific community, to re-examine our models and hypotheses and to adjust our models, all the result of rational thinking.

The profession, and the broad public, will be stronger with another journal supporting rational thought. 'Shocks' in our systems demand scientific solutions rather than knee-jerk unproven or un-scrutinised ideas. Scientific journals provide the way for that to happen.

And the profession will be stronger!

Professor Harry H. Panjer is at the University of Waterloo, Waterloo, Canada. He is a Past President of the Canadian Institute of Actuaries and of the Society of Actuaries, is an Honorary Fellow of the Institute of Actuaries, and is the Editor of the *North American Actuarial Journal.*