Book review

Behavioural Risk Management: Managing the Psychology that Drives Decisions and Influences Operational Risk
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Palgrave Macmillan
2016
518 pp.
Review DOI 10.1108/JRF-05-2016-176

This book advances the behavioral finance project by moving beyond the historic focus on pricing anomalies (under-reaction, overreaction, value premia, etc.) to reach within the black box of the firm to examine the risks of getting stuff done, or operational risk, within a variety of institutions[1]. The author is a true frontiersman of the subject who features in Richard Thalers' recent account of the founding of the research area (Thaler, 2015, pp. 223-224).

The present book can be seen as part of Sherfirn's ongoing attempt to develop our understanding of behavioral corporate finance, still a relatively neglected part of the larger behavioral project (Sherfin, 2005, 2008). While the academic pedigree of this text is clear, the recent financial crisis of 2008 gives it its policy bite. Indeed many of its case-study applications address the evolution of that Crisis (Chapters 7 to 11 on various actors in that crisis). A central argument of the book is that we need to understand the psychology of risk management and not just the quantitative tools (VAR, Gaussian copula, etc.) for conducting it. This serves to remind of Simon's "behavioral scissors" of context and cognition (Simon, 1990). Various quantitative tools help risk managers mentally process the emergence of risk, but their results and interpretation cannot be ripped out of the context in which risk arises and is managed. In the book's Preface, the author stresses that risk managers, especially, chief risk officers, fully recognize the importance of these issues but do not know how to act in the face of them or to revise their current risk management protocols in light of psychological insights. So the final chapter of the book provides a checklist for avoiding some of the most common behavioral errors.

Overall, the book is treasure trove of applications of behavioral finance theory to a wide array of interesting case studies. In this prospect theory is given pride of place as a "game changer" in the study of behavioral finance (see page 37). But Sherfin also notes the limits on that beautiful advance exposed by the recognition that financial decisions are often made under conditions of uncertainty as opposed to risk (see Chapter 13's discussion of "fast and frugal" reasoning). Any serious scholar in the behavioral field will want to read this book, if only to act as a foil to their own thoughts, a topic which I discuss briefly below. It lays out the terrain of a new frontier of the behavioral project, returning Professor Sherfin to the role he took at the inception of behavioral finance as a coherent field.

The Journal of Risk Finance
Vol. 17 No. 3, 2016
pp. 370-372
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1526-5943

While the focus of the book is firmly upon corporate finance, it has clear implications for asset pricing, still rightly regarded as many as the core of finance theory. This is because the central role of the accumulation of systemic risk. Specifically, the book emphasizes the role of "sentiment" in asset pricing and the emergence of speculative bubbles in particular (Chapter 15). A welcome contribution is to renew attention to the work of Hyman Minsky and his financial instability hypothesis especially (see Chapter 7). In Britain, I think, until 2008, there was no greater sign that a colleague was a hopeless crank than to hear them mutter about Minsky. This book reminds us of the importance of financial innovation, Ponzi finance and State collusion in propagating the financial crisis. In this, Sherfin brings us buried treasure. Elsewhere, he reminds us that "greedy bankers" were not alone in their rush to the precipice in 2008, the rating agencies (Chapter 9) and the financial regulators (Chapter 10, 13 and 14) also distinguished themselves by their malignant, if not complicit, neglect. This serves to remind us that behavioral and public choice perspectives on the origins of the crisis are not mutually exclusive. Nor is risk management solely the concern of the financial sector, as discussions of the problems at British Petroleum (Chapter 18) and General Motors (Chapter 19) show.

A great strength of the book is the sheer variety of biases applications covered. Indeed, Sherfin makes a note of the 100 or more biases discussed in the literature, but the book tries to focus on only half a dozen of these biases (Chapter 4), surely a relief to his readers. One bias missing which may be worthy of discussion is presence bias, or what Laibson (1997) has called elsewhere "boldness". In both written and cinematic accounts of the recent crisis, one is struck by the common belief that although the sale of securitized debt was a scam, those trading in it would be rich before the institution they worked for reaped what they sowed. Perhaps this underlay the comment by Chuck Prince of Citigroup that while the music kept playing, he was still dancing (see page 213). While institutions may die, their employees need not. Perhaps this very "get rich quick" attitude made the whole rush towards the precipice all the more intoxicating, if ultimately more painful.

One bias the book does discuss extensively is groupthink, the tendency not to want to rock the boat even in the face of clearly flawed consensus. But groupthink is portrayed as an unconscious bias driven by a desire not to "make waves" or aggravate an already unhappy ship. Randall Morck has argued in a series of papers (Morck, 2008, 2010) that misplaced loyalty to dominant CEO might induce more conscious surrender to collectively grim fate. This suggests that the agency bias, which in many ways began any serious discussion of corporate finance, must be balanced by a potential "loyalty bias" which allows board members to sacrifice their company on the altar of their CEO's pride.

This suggests that there is room to build upon the structure established by Sherfin's text. Thus, the book is a call to arms as well as a celebration of what has already been achieved. We can only hope emerging research will allow discussion of the 2008 Crisis to fall onto the syllabus of economic history courses as opposed as being integrated into part of the "new normal" in financial markets.

Note

1. The European Bank Authority defines operational risk as "risk of losses stemming from inadequate or failed internal processes, people and systems or from external events". Operational risk includes legal risks but excludes reputational risk and is embedded in all banking products and activities www.eba.europa.eu/regulation-and-policy/operational-risk

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