



The use of risk in understanding financial decisions and institutional uncertainty

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ABSTRACT

The idea that rationality and emotional factors are involved in financial decisions is well accepted in many economic approaches and in organisation theory. This paper compares specific relevant arguments in behavioural finance and sociology. The aim is to show the implications of these different analyses for the financial sector. The question is whether behavioural finance emphasises the concept of risk more than uncertainty. The paper suggests that cognitive and emotional factors are usefully examined in light of approaches from both behavioural finance and sociology. The first looks at individuals primarily, the second at structural (policy and market) factors. I argue that the latter influence organisational choices of different time orientations towards the future. In exploring the potential of this approach, the paper poses three organisational decision models, that take uncertainty and its relevant social institutions into account, while acknowledging that time preferences and discounting by individuals are well-explored in behavioural economic frameworks.

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1. Introduction

A major problem for most economic decisions (as in life), is that we do not know how the outcomes (results) or the consequences of outcomes will turn out. In the financial field, as is well-known, policies to control inflation have reduced its uncertainty. Along with this renewed emphasis, and on independent, transparent central banks, technical risk analysis grew in importance. If all of this provided somewhat greater predictability to financial actors, uncertainty has not of course disappeared. Rather, it has been displaced into a string of unexpected asset inflations (Greenspan¹) and, at the time of writing, a global financial crisis. It would again appear that the rationality of probability calculations cannot strictly apply. However, whereas many economic approaches to decisions explain failures and excesses as either irrational 'residuals' or, far more plausibly in behavioural economics, as due to limits to rationality, cognitive dissonance, human errors and bias or insufficient emotion-awareness, the argument here begins with the assumption that uncertainty cannot be overcome. Where scholars depart

from, and practitioners' rely on, predictive models, there is a tendency to avoid what institutional actors are *able* to do in real-life situations, in trying to cope with uncertainty as best they can. In sociology, moreover, analysis of major economic sectors, like finance, starts in the context of organisational decisions, where aims are for profit and the maintenance of a corporate reputation. Sociology does not start with individual psychological preferences for immediate or delayed individual utility, as discussed in the literature on inter-temporal choice,² on the grounds that firms cannot be ascribed individual attributes such as urges for gratification, traits or feelings. An institutional office imposes specific duties on the person, who certainly comes to the job with traits, skills, values and habits. The suggestion here is the most that officials can do in reaching organisational decisions, however capable, experienced and professionally expert in calculating probability, is to imagine possible futures for the organisation. These are influenced but not determined by specific policies and acceptance of uncertainty or otherwise.

Projected futures are not vague figments but can be precisely classified: they have clear methods which are institutionalised

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¹ Alan Greenspan, then Chairman of the US Federal Reserve made this point before the dot com boom really was underway; Transcription of Federal Open Market Committee (FOMC), 24 September 1996: 30–31. These transcriptions provide a wealth of data on the Fed's past orientation (see Pixley, 2004).

² For example an excellent review is in Fredrick et al. (2002). Further into this paper, the ideas of time discounting and time preferences are compared to organisational decisions. Sociologists regard Adam Smith's reference to self-love as a bit cheeky in reference to a bakery *firm* or a butcher *shop*, even if self-interest can be imputed to a specific butcher. Thus for sociology, individual motives and organisational purposes, whilst not easy to separate are not the same, or do not follow the same operational logic.

in organisations and determine new policies and create financial products. For example, futures can be imagined by constructing a few long-term and openly declared uncertain futures in order to reach a decision or, conversely by drawing on a long-term past of booms, the Great Depression and hyper-inflation (see Figs. 1, 2 and 3 on pp. 10, 11, 12). Nearly every central banker constructs numerous parallels with historical pasts to arrive *ex ante* at what past event might plausibly apply to the current decision. This prevalent mode is not, then, about individual time preferences. The most typical time orientation of the commercial financial sector focuses on the present, yet, none of these time-views is an attribute of individuals or their personal psychology in the first instance. Individuals are required, in their official positions, to estimate futures in these specific time-frameworks (Pixley, 2009). For example, well-capitalised firms could choose any time perspective, compared to individuals who may be constrained by socio-economic position and personality-type. But firms may have an imposed competitive framework, or large debt which renders ‘short-termism’ essential for profitability, share value or (sometimes) survival. With such a present-orientation, risk assessment models – with some assumptions that are quite ordinary often described as ‘extreme events’ in the tails of probability distributions (Rajan, 2005) – are cognitive and emotional ‘scripts’ of organisations for rationalising away uncertainty and the necessity of emotions in the collective active sense of *esprit de corps*.³

This is less likely with the other time-views (which are not infallible either). It is fair to say, though, that financial problems have arisen with exclusive use of short-term models, such as the role of portfolio insurance in the 1987 crash (Jacobs, 1999) and the predictive products which unravelled during 2007. Of course, whether individual creators of each innovative product *really* believed – *ex ante* – that their products were infallible, or just another approach in a pragmatic, competitive search for new ways to make profits and keep market share, is less easily answered. In my view, that is the crucial question. Meantime, the notion that emotions and intuition provide a rational, stabilising framework as much – or more than – a destabilising role for decisions, whether collective or individual (Pixley, 2004) is increasingly accepted in a wide literature.

The paper first reviews, very selectively, the approaches to decisions in behavioural economics/finance and psychology where affect can be an alternative to cognitive reasoning or can help cognitive reasoning.⁴ It examines whether these challenges to the rational economic agent of orthodoxy start with an assumption of inevitable uncertainty or depart with other assumptions – more about risk. They certainly include the important one of heuristics, particularly affect. The paper also briefly reviews some organisational approaches. Second, it introduces three time-views, and briefly explores the explanatory potential of these dynamic models within firms and at the field level. The hypothesis is that collective *anticipations about the future* are framed by time orientations which vary among firms/bureaucracies within the current Anglo-American financial policies that regulate markets. The ways that time-views are chosen in other finance centres, and whether time discounting by individuals is comparable to organisations, are also relevant to this question.

³ To model ‘extreme events’ that occur once every 100,000 years, *except in actuality*, can become a straitjacket, as shown in a computer model of Goldman Sachs in mid-2007 that lost 30% of value over a week. Gillian Tett and Anuj Gangahar ‘Why computer models proved unequal to market turmoil’. *Financial Times*, 14 August 2007. Accessed Factiva same day.

⁴ This is an expanding literature (see Andersson, 2006), although this paper does not pretend to be exhaustive. On this point, and others, I am grateful to additional comments and references from an anonymous referee.

By introducing time into the question of how firms decide and act, I suggest that cognition, emotion and ethical responsibilities are equally involved in board-room and firm decisions. All three ways of facing the future could be usefully used in the process.

2. Risk

Before identifying basic assumptions in behavioural finance, this section clarifies how risk is used for the purposes of this paper. Sociologists usually link widespread adoption of active risk-taking with the rise of modernity. Types of risk assessment started in insuring against merchants’ losses from sea-trading hazards, in bank loans for entrepreneurial ideas and in life insurance. The process of calculating the number of lives that would end in any one year was just one of the many efforts to improve techniques for estimating future profitable outcomes (Baker and Simon, 2002). Max Weber cites the same efforts within firms – to arrive at calculated predictions with the use of double-entry book-keeping and what he claimed were *predictable* outcomes of class conflicts – as one unique aspect of the rise of western capitalism. Weber took a broad view of the conditions for rational capital accounting, which he alleges are more predictable (‘formal rationality’ meaning ‘exact calculation’: 1978: 111) than a planned economy. Conditions include the ‘appropriation of the means of production by individual units’, that is, by ‘property’ (Weber, 1978: 93) and, while profits (the aim of the enterprise) depend on consumers’ ‘effective demand’ (not wants or demand: 108) which did concern him, the ‘highest possible degree of calculability’ is gained from conflicts in the market. The outcome of these battles and compromises is, Weber argues, ‘decisively influenced by the ability of persons who are more plentifully supplied with money to outbid the others, and of those more favourably situated for production to underbid their rivals on the selling side’ (Weber, 1978: 93). Thus, outcomes are predictable provided that we are armed with knowledge of wealth and power distributions.

Weber’s optimism for calculation is surely over-stated (see Wiley, 1983), because, as Luhmann says (1988), fatalism or *fortuna* and traditional habits were replaced (to some extent) by active risk-taking and innovation (see also Knight, 1921). Innovation by definition has uncertain, unknowable outcomes and such creative optimism is a hallmark of modernity. The uncertainties, new ideas (some successful, others not), and crises that developed out of such a changeable and unpredictable economy saw a move away from mechanistic, cause-effect laws so typical of the nineteenth century’s hopes for a predictable ‘science of society’, and into ‘the universe of probability’. It gave twentieth century policy-makers some coherence to cope with a modern ‘risky’ world. William James and Charles Pierce developed notions of ‘standard deviation’ and ‘risk assessment’ to help make chance ‘inescapable and controllable’ (Fraser, 2005: 224), or at least to some extent, as Porter recounts in his *Trust in Numbers* (1995). Although these developments met moral (religious) opposition to seeing life and particularly economic life as a game of chance, I am only concerned with probabilistic risk. It can never imply certainty but it can appear to minimise uncertainty.

The practical problem is that when mathematical products based on risk distributions are computerised, they lock actors on a one-way track with no room for discretion. IT models are often claimed to minimise human error, but scholars like Friedrich von Hayek expressed disappointment with the emphasis on mathematical models. Yet the hope for reducing/converting uncertainty to risk remains among some economists. In behavioural finance, for example, this is one definition: ‘Finance looks at the various forms of human disappointments and economic sufferings as risks to which probabilities can be attached (Shiller, 2003: 1). However, Knight ([1921] 1965) codified the difference between risk (known

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