
BOOK REVIEW



Mark Kritzman, Senior Editor

BEHAVIORAL RISK MANAGEMENT: MANAGING THE PSYCHOLOGY THAT DRIVES DECISIONS AND INFLUENCES OPERATIONAL RISK

Hersh Shefrin
(Reviewed by
Cel Kulasekaran)

The Journal of Investment Management had the pleasure of hosting leading scholars and practitioners of behavioral finance at its spring 2016 conference. The timeliness of the conference coincided with the recent publication of Hersh Shefrin's *Behavioral Risk Management: Managing the Psychology That Drives Decisions and Influences Operational Risk*. Shefrin participated and provided a cohesive structure to the conference by moderating its entire agenda. *Behavioral Risk Management*

is Shefrin's fifth book following *Ending the Management Illusion*, and reflects similar themes presented and discussed at the recent conference. Behavioral finance is a growing field that seeks to explain and apply the psychology of biases and heuristics in the financial markets. Hersh Shefrin has been a valuable scholar in this field since the introduction of psychology in risk management, almost four decades ago.

Shefrin sets out to provide a strong narrative to show that behavioral finance is indeed a significant factor in recent risk management failures, instead of just as a complementary tool to quantitative methods. Shefrin hopes to convince his readers that the set of tools and ideas in behavioral psychology should be taken into account for improving risk

management practices across institutions. His book succeeds in illustrating important ideas and introducing key innovations in behavioral psychology into risk management. *Behavioral Risk Management* focuses on broadening the reader's understanding of psychological tools and recognizing behavioral pitfalls in management. Shefrin's work with Meir Statman¹ appears to echo themes throughout the book.

The book is divided into three parts. The first part of the book introduces the core psychological issues associated with behavioral finance. These include concepts on emotions, framing, personality, and judgment issues. The second part of the book focuses on case studies and insights into major risk events since 2008, applying the core concepts from the first part.

Finally, the appendices, which the more enthusiastic readers should not dismiss, provide further details and a more rigorous treatment of the core concepts introduced and discussed in the earlier sections of the book.

In Part I, Shefrin's key insight appears to be one implication of Kahneman and Tversky's (1979) prospect theory², articulated well in Shefrin and Statman's (2000) behavioral portfolio theory³, is that people whose incomes fall short of their aspirations are inclined to take great risk as they strive to reach their aspirations. He then finds it useful to use the security, potential, and aspiration (SP/A) theory to focus on three emotions – fear, hope, and ambition.

Part II begins with chapter 6, discussing organizational culture and its decision-making process for taking risk. Chapter 7 examines the Minsky's Financial Instability Hypotheses (FIH) as a key macro-economic dynamics framework. The micro foundations of Part I are applied to cases in Part II using Minsky's FIH framework. Chapter 8 explains the aspirational pitfalls at UBS and Merrill Lynch that lead to systemic problems fundamental to the subprime crisis. Chapter 9 extends the narrative to groupthink and aspirational issues present at S&P

and Moody's, both of which are rating agencies central to issues rooted in the beginnings of the subprime crisis. Chapter 10 explores common motifs from the previous two chapters with case studies of Fannie Mae, Freddie Mac, and AIG.

Next, Shefrin uses events that unfolded at RBS, Fortis, and ABN AMRO Bank to show that the same behavioral dynamics and pitfalls not only apply in American institutions, but also in Europe. Chapter 10 looks into econometric techniques for measuring systemic risk and how probabilities of outlier events can vary over time.

The next case study shifts focus toward regulation, the psychology of fraud (particularly in the Madoff Ponzi scheme), and the SEC. Chapter 16 and 17 explains the downfall of MF Global and failures at JP Morgan. Chapter 19 departs from examples within the financial sector to risk management in the energy sector with discussions around the mismanagement at Consolidated Edison (Con Ed), Minerals Management Service (MMS), and British Petroleum (BP). The final study looks at examples in transportation where the failures at Southwest Airlines, GM's ignition switch problems, and their regulatory agencies are discussed.

Appendix A gives a deeper treatment of the Lola Lopes's SP/A theory model, and appendix B a deeper treatment of prospect theory. Appendix C is interesting as it attempts to integrate prospect theory and SP/A theory into a coherent whole. Appendix D details insights into experiments used to identify heuristics and psychological biases, while appendix E describes Shapira's organizational risk model formally. Appendix F – H discusses FIH modeling issues, empirical models for measuring sentiment, and a formal model for identifying failing banks. Appendix I shows interestingly that FIH dynamics apply even to China and Europe.

Hersh Shefrin's narratives and discussions are honest and blunt, and sensitive to tensions and pressures in the real economy. *Behavioral Risk Management* is a comprehensive, current, and deeply informed text with robust methods to understand and use in an economy bent on perfecting risk governance at all levels. Shefrin's book should be on your reading list this season.

Notes

- 1 Shefrin, Hersh, and Statman Meir. "Behavioral Finance in the Financial Crisis: Market Efficiency,

Minsky, and Keynes.” Rethinking the Financial Crisis. Ed. Alan S. Blinder, Andrew W. Lo, and Robert M. Solow. Russell Sage Foundation, 2012. 99–135.

² Kahneman, Daniel, and Tversky Amos. “Prospect Theory: An Analysis of Decision under Risk.” *Econometrica* 47.2 (1979): 263–291.

³ Shefrin, Hersh, and Statman Meir. “Behavioral Portfolio Theory.” *The Journal of Financial and Quantitative Analysis* 35.2 (2000): 127–151.