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Behavioural finance issues and the bank client

In the wake of the global financial crisis, public debate about the financial sector has been less restrained than it has for many years. Within this context, my research on how Australians feel about financial investment is based on theoretical insights from Frank Knight and Joseph Schumpeter. This research suggests that consumers may be seen less as customers than clients, and highlights the importance of financial professionalism.¹



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IN BROAD TERMS, Knight and Schumpeter, whose works are so relevant, suggested that:

- uncertainty always underlies financial action, and ‘risk’ is not a substitute, as assumed by the financial sector, for the extraordinary future-orientation of economic life; and
- since there is no agreed understanding about money, then alternative views – for example, that money is a social relation – are just as important in framing research questions as orthodox views.

These issues are significant because the financial sector is so complex that any description is already framed by assumptions, which affect diagnoses about how the industry does or *should* serve consumers. These two insights provide the theoretical framework for my research on how Australians *feel* about financial investment – their *attitudes* not behaviour. This research leads me to suggest that, depending on assumptions about the industry and about society, consumers may be seen less as customers than clients.

Uncertainty not risk

My research on the attitudes of populations and of senior financiers to financial decisions (e.g. Pixley 2004, 2007, 2009) is grounded in my home turf, sociology. Yet some of the best of economics is analytically useful: first, the assumption that investors face uncertainty, not simple risk, as commonly used. This is not a matter of semantics. There are usually many benefits in investing. Nonetheless, decisions are made under uncertainty about risks, dangers and vulnerabilities, and potential gains (often very widely spread), that are unquantifiable, and the outcomes are unknowable.

Theoretically, sociology long ago rejected the hopes for accurate predictions, but the typical practice within the financial sector to seek predictions – based on ‘risk’ – is of enormous interest. One can also ask why uncertainty is neglected in some of the behavioural finance research, as a sociological question. ‘Financial literacy’ schemes, for example, have laudable aims, but the actual term *can* imply that *successful* or ‘effective’ financial strategies are possible through knowledge. It is true that populations lack basic understanding of how compound interest works, or what probability distributions actually describe. But as Frank Knight indicated back in the 1920s, probability only applies to risk not uncertainty.

Risk involves *known chances* that can be objectively quantified: a dice throw has many possible outcomes but each dice has only six sides. In contrast, uncertainty involves *unknown chances*. If anyone understands probability distributions of known chances, they know outcomes are uncertain (pure luck) but they actually *know* the chances or odds of winning (a lottery at three million to one). However, one cannot make projections of probable outcomes from any past trend about unknown possibilities that might occur after

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innovation and new decisions. The sociological question is why we long to know the future, though it is not available to us.

Hope to control the future is a condition of modernity (as opposed to fatalism) but instead of brave ventures into the unknown, this hope for control seems to have become pathological. The irony is that the old pastime of gambling is more likely to face losses than investment in assets that entail a right to sell and usually to some income stream. Yet, gambling is *less uncertain* than investment. Option selling does *resemble* gambling except that it is not taxed like gambling (which Fischer Black wanted: see Mehrling 2005, pp. 138–9). Yet ultimately, option price choices are based on expectations. Expectations are not *known chances* but ‘imagination and hope’ (as Shackle 1972, called them). This point suggests that a sound understanding of probability, and therefore literacy in the mathematical odds of known outcomes, is a side-track, unless used as a warning to consumers.

While the behavioural economics/finance literature is extremely useful for ‘gambling literacy’, investment is not pure gambling in the formal, mathematical sense, because it faces uncertainty (and entails property ownership of unknown chances). The different conclusions from laboratory tests on ‘behaviour’ can be classified into the ‘errors school’, the ‘emotions help’ school and the ‘emotions are irrational’ school. Tversky and Kahneman (2000) find that experts make mistakes in probability calculations as much as non-experts: they become overconfident and then over-timid or they juggle both extremes. But as Sheila Dow points out (2008, p. 4), Kahneman and Tversky only mention uncertainty in passing, not in reporting laboratory results of individual decisions. In these results, they find ‘errors’, mental framing (heuristics), irrationality and other deviations from *predictions* of rationality models.

Generally, behavioural finance provides countless examples of these errors due to: hubris from ‘self-attribution bias’; fear and thrill among traders *wired* for pulse rates,

‘skin conductance’, heart rates; cheating; risk aversion; regret and greed, (e.g. Andersson & Tour 2005; Barber & Odean 2001; Lo & Repin 2002; for summaries, see Loewenstein 2002; Rabin 1998). Their *empirical* efforts in scientifically replicable experiments to criticise the rational actor model (based on deductions about individuals) are laudable, but are equally framed at the level of individuals, and they seek stable, predictable correlations between their ‘stimulus-response’ experiments. Neither model can explain ‘the large changes in behaviour associated with financial instability’ (Dow 2008, pp. 3-4). One cannot introduce greed, thrill or irrationality – nor rational actors – to explain a ‘large event’ if all these individual emotions, rational attempts and behaviours are always present in contradictory ways.

More important to a sociologist, both sides forget that *firms neither think nor feel*; that structured situations of high competition over *profits* (Weber 1978, not ‘self-love’), and success or failure, lead financial firms in particular directions, whether to the financial fragility of high leverage or to credit freezes (Minsky 1985). Individual consumers must face these huge financial institutions, which rarely change character. For example, Goldman Sachs (now a bank) is very different from HSBC. The scale of the financial industry – with global sales of billions of promises – is also overwhelming. Lessons for individuals on how to plan and control their financial futures, however well intended, tend to neglect the scale of the industry and its markets, and international regulatory and societal cultural variations.

It is also important to note that the financial industry cannot control the future – given that this latest serious crisis in global financial markets came, allegedly, out of the blue. Wisdom is our best guide to facing the future; no-one can predict the future, yet *some* in the industry made claims about future-proof products. Uncertainty cannot be quantified: it is a constant condition, *whether perceived or not*. There is never less uncertainty or greater uncertainty. Perceptions here are one important issue. (The other is whether uncertainty ‘matters’ – to banks, for example – in vulnerability to loss, failure.)

Social scientists tend to make a distinction between behaviour and perceptions/attitudes. Surveys of either are not easily correlated (nor provide credible arguments regarding causality). We have an overwhelming amount of data on financial behaviour, but few high-quality surveys on feelings and individual or collectively held perceptions. With perceptions of the future, for example, the Australian Survey of Social Attitudes (AuSSA, run from the ANU) shows this lack of connection.

Armed with behavioural data, for example, that nearly every Australian adult uses a bank (98%), the survey examines whether Australians have ‘confidence’ in financial institutions. In AuSSA 2003, 73% of respondents said they had little confidence in banks (Gibson *et al.* 2004). Banks were *the least trusted* of Australia’s *major institutions* (below even the ‘media’) and these sentiments were closely echoed in AuSSA 2005. Comparisons are only suggestive, because many surveys are not very representative. Even so, the *Financial Times* (Edgecliff-

Johnson 2009) reports a 'Trust Barometer' of over 4000 'opinion leaders' around the world. It found *nearly* 70% who said they trusted banks in the United States in 2008, but only 36% of 'leading' Americans indicated in early 2009 that they 'trust the banking industry'.

My own AuSSA data found over four years that Australians – nearly a majority – felt anxiety about their financial futures: many were unsure and very few disagreed. Respondents were highly ambivalent about taking on risks and debts 'to improve their wealth', well before the global financial crisis (GFC). The educated were more confident about financial investments based on 'knowledge' than those less educated, who mostly selected 'luck' and 'sufficient wealth' as reasons for financial success (Pixley 2007). While these results need to be compared with results from the same questions after the GFC, even then, we cannot pretend to know the reasons for them. Perceptions of uncertainty *appear* to be high in Australian attitudes, in distrust in banks and 'anxiety', before the GFC, and far more than among American opinion leaders. Comparable surveys of other populations may give better hypotheses.

An intriguing research question is whether the cynical attitudes of Australians play a role in *placing limits* on the financial industry here. This is *the* interesting sociological question because cultural, regulatory, economic and political traditions cannot be ignored (see De Bondt 2005). This complex approach does not aim to offer predictions but interpretation, and experienced financiers make plain (Pixley 2004) that over-reliance on probability distributions is a factor in the financial industry's efforts to find a 'sure thing'. The idea, too, that people were likely to 'embrace' risk-taking (Baker & Simon 2002), which it was hoped might make Australia a great 'share owning democracy' (Donaghue *et al.* 2003), may have been based on over-simple economic assumptions (Pixley 2007). Risk-taking never gained the acceptance in Germany and France that it did in the United States, for example.

An important approach to money

The second theoretical issue is how to understand money. Conventional nostrums that money is merely another tradable commodity, and not a promise, play what sociologists call a *performative* role in generating collective confidence or gloom. So too, claims by firms about the possibilities of prediction represent an attempt to reduce perceived uncertainty to known chances.

Money, seen as promise – a social relation between creditors and debtors that requires the 'community' to step in with guarantees to the banking sector – opens up one alternative view (with a distinguished heritage in Schumpeter 1954; Weber 1978; Simmel 1978). This view has far more resonance since the GFC, as does the former and still-correct idea that banks are special. They lend long on tiny fractional reserves in demand deposits, and these loans are deposited: banks create money. When it is paid back, money disappears. During the GFC, the role of the state and of regulations over money became obvious. But was the public anger at banks due to lack of financial

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literacy? At the inter-firm level, many banks can suffer as a result of a run on one bank – yet the depositors at Northern Rock in England were acting perfectly rationally. The case only emphasises how rationality at the individual level can be disastrous for inter-connected banks and their fragile system of credit/credibility.

The GFC also highlighted the fragility of capital markets, whose development has been justified by the notion that banks were not special and not 'really' intermediaries. Years ago, Schumpeter took this view to task.

First, banks lend/create money because, in Schumpeter's words, 'loans create deposits' (1954, p. 1114). Loans are deposited far more than savings, and lent out and *used as money* over and over again, over different time-spans, for a fee, among many banks. Loans create more money through layers of deferred promises to pay, which stretch into the future.

Second, banks are therefore special, and have a *vital purpose*. To Schumpeter, banks are the 'engine of capitalism' (1954, p. 318, p. 278) to such an extent that 'credit operations' of many kinds play an 'essential' role in financing new development (Schumpeter 1954, p. 318; 1934, pp. 70–4). This is not trivial: 'the creation of new purchasing power out of nothing' by banks is the source of *most* development (1934, p. 73). The banker 'authorises people, in the name of society as it were' to innovate, and is 'the ephor' (supervisor/ magistrate) of 'the exchange economy' (1934, p. 74).

Third, there are clear dangers in manufacturing money. Primarily, banks may abuse depositors' trust by ignoring 'limits' to 'pumping credit means of payments' into this engine (Schumpeter 1934, p. 114). Sometimes, 'too many' ventures fail inadvertently, credit creation turns out not to be for future socially productive purposes, or banks are not sufficiently cautious in lending for a range of new proposals, and too many lend for thousands of the same schemes. The GFC occurred as mounting suspicions that banks were engaging in these sorts of activities produced a rush to withdraw funds from certain instruments, financial institutions and whole segments of financial markets.

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Fourth, what should be done if such a depressive situation is reached where firms collapse, no new ventures are proposed and debts are scaled down? Schumpeter argued that banks' purposes (during a depression) should be to create a 'credit policy' between individual banks with central banks. He worried that the banking sector's actual 'credit restriction' – so often seen in such times – only aimed to 'destroy without function' (Schumpeter 1934, p. 254).

These interconnections between banks and their collective role in development (or not) are the key to banking practices. To repeat, banks are 'the headquarters of the capitalist system' from 'trading in credit for the purpose of financing development' (Schumpeter 1934, pp. 126–7). Such a view is a far cry from the view that banks need not be intermediaries – *or take a serious view of this role* – because the wholesale money markets would be an efficient alternative. The corollary of the notion that markets are efficient is that millions of people could be involved as long as each individual was financially literate.

From the alternative view, banks need professional officials that engage in long-term community investment, and who are also required to serve the firm, their depositors, their creditors and be responsible about the public guarantees provided by the community. On the consumer side, we know many clients know nothing about money or banking practices; some may *even be bored* by money. Alan Greenspan suggested that his 'mistake' (see Goodman 2008) was to imagine that bankers could be trusted to take care of clients' savings and investments as one might trust the pharmacist to provide the correct advice about one's prescriptions. Why should the public, all with specific expertise, know about complex practices of banks, any more than we know about medicinal drugs or electric lights? We live in a highly differentiated, impersonal society of global dependencies.

Another question is the extent to which financial leaders and financial engineers understand money (Lo 2008). Habits built from notions that money is a commodity and not a claim, credit or fragile promise are difficult to change. Since 2009, there has been a greater concentration of financial institutions, and winners, such as Goldman Sachs, that are again active in cross-country arbitrage and proprietary trading (Plender 2009). Once again, the great social benefits of credit creation – and its dangers of manufacturing 'too much' money – are lost from view.

Moving on

Nevertheless, future research that poses other theoretical agendas is pressing. How far have Australians become even more cynical about banks since the GFC? Can we explore distinctions between risk and uncertainty, and ask if 'loans create deposits', without putting words into people's mouths? To some extent, all research suggests that 'things could be different' because it poses options that people may not have considered before. My approach suggests much can be gained by comparative, quality surveys of key countries, and by cross-national interviews about financial leadership.

For example, preliminary survey evidence in my collaborative work with London Metropolitan University shows that proportionately more Australians who were surveyed agreed with my question: 'I worry *a lot* about my financial future' (45% in 2003; 48% in my AuSSA survey of 2005, and 37% of British people). The British data was generated only from an opinion poll (Mori) and the poll was conducted *after* the dramatic late-2007 run on the mortgage bank Northern Rock. Why were the British who were polled less worried? Were Australians correct? A run on a British bank had not occurred *since* 1866. In the Australian case, my quality surveys showed the extent to which age and education were most significant in correlations with fatalism or risk-taking ('mental frames' as the finance behaviourists put it). But are there better hypotheses?

Survey data can only provide *correlations* with other *significant* variables. Results can only suggest potential *causes*. My research is based on a rejection of any possibility of accurate predictions and on accepting the options posed by Schumpeter and his student Hyman Minsky – banks can be the 'engine of capitalism' and gateway to development or they can be 'merchants of debt'.

What is the banks' relationship with the public? Should banks serve customers or is the public better seen as clients? Answers to these questions, one way or the other, seem to suggest the need for training for financial professionalism.² ☺

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Notes

- 1 This paper is based on a presentation to Finsia's Consumer Finance Symposium, Melbourne, August 2009.
- 2 The ongoing encouragement of financial services professionalism is an overarching goal of Finsia.

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