What Designs Investment Bankers?

Economic and Psychological Risk Attitudes of Investment Bankers and Socialization

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ABSTRACT

This paper investigates the risk attitudes of investment bankers with experiment and survey. The experiment measures risk preferences through multiple risky lottery choices, and the survey questionnaire explores the willingness to take instrumental and stimulating risks. We consider both traditional economic and psychological dimension. The investment bankers in our sample are more willing to take instrumental risks than other groups. Within the investment banker group, traders and analysts, who implement financial knowledge in practice, show markedly higher levels of risk preference converging near risk-neutrality. Our results suggest that the nature and nurturing environment of investment bankers matters as well as compensation schemes and organization structure.

Keywords: investment banker, trader, risk attitude, risk preference, risk aversion, instrumental risk taking, stimulating risk taking

1. **INTRODUCTION**

Most research on risk preferences deals with general sample, and not financial professionals. We find that investment bankers, in particular traders and research analysts, may have different risk preference – they are less risk averse than control groups. These results are highly related to performance evaluation and the length of work experience, suggesting that the socialization process at organizational or personal level can change risk preference. This proposes policy and managerial implications about how to nurture investment bankers or how to design organizational culture.

There seems to be widespread public opinion that investment bankers are liable for the recent global financial crises and scandals. Prominent figures such as Lord Turner, chairman of the United Kingdom Financial Services Authority, do not hesitate to denounce the investment banking industry for its “cynical greed” (BBC news, 3 July 2012). Influential media such as the Spiegel reports the bonuses of some investment bankers, mentioning “global rage at banker’s bonus excesses” (20 Feb 2009). According to this view, investment bankers as individuals, or investment banks as entities (or perhaps both) do not act in the best interests of their clients as they officially claim to do – instead, they take on excessive levels of risk which are unjustified by any of their business activities. Investment bankers are overly paid in a time horizon that is much too short than is reasonable, and this type of compensation scheme generates greed and dishonest behavior, urging bankers to take on excessive levels of risk. This inevitably brings on financial turmoil. However, incentive systems may not be all there is to the differing risk attitudes of investment bankers – we can, for example, think of socialization processes. However, extant literature is mostly silent whether these characteristics are ‘selected’ or ‘nurtured’.

Complementing this popular view that investment banking features such as compensation schemes ‘nurture’ investment bankers to take excessive risk, we analyze the characteristics of

investment bankers' risk attitudes. It is important to understand the behavior of investment bankers from both the nature and nurture views. Depending on the view, we can arrive at very different implications for policy making (e.g. regulations) and management (e.g. hiring, training and compensating bankers). We frame this idea using the decision-making theory, the core concepts of which are attitudes or preferences toward risk. We hypothesize that investment bankers have different risk attitudes as compared to the general public. If our hypothesis is right, the nature of investment bankers may indeed contribute to the global financial crisis.

Discovering investment bankers' risk preferences has another important implication in finance theory. General consumption decisions can be analyzed as the behavior of the homogeneous representative agent. However, investment decisions differ significantly in that a small number of professionals monopolize large-scale financial decisions. In financial markets, investment professionals are the ones directly involved in the price discovery process, while individual investors play a less important role. Therefore, financial theories need to focus more on the characteristics of investment professionals, who are responsible for most of the action in the market. For example, when studying how risk aversion properties of investors influence the price determination process, the risk preferences of investment bankers should be analyzed and taken into account, since they are the ones who in real life make the large-scale investment decisions.

Previous studies analyze risk attitudes and find significant heterogeneity in elicited individual risk attitudes. A survey of risk attitudes finds that the average subject is moderately risk averse, but there is also considerable heterogeneity in individual risk attitudes (Harrison and Rutström 2008). Part of the results may lie in the sample itself – in extant literature, most surveys and experiments work with a representative sample of a country's population. The samples usually have a great extent of heterogeneity in age, education, cognitive ability et cetera, which

may contribute to findings that risk attitudes are variant or heterogeneous within populations.

Despite its importance, the literature on risk preferences hardly analyzes the risk attitudes of investment bankers and the organizations they belong to. To the best of our knowledge, extant research on the topic mostly focuses on the non-professional public or students, and analysis of investment professionals who are the main players in financial markets is scarce. This is because the activities of investment bankers are under tight organizational control, and are mostly veiled from public sight. Hence, relevant data are not readily available. This paper seeks to fill this void in the literature. We measure and analyze the risk attitudes and behaviors of investment professionals (which also represent the risk attitudes of the organizations they belong to) using experiment and survey. In particular, we seek to define whether investment bankers, in particular traders and analysts, have distinct risk preferences. We investigate whether the compensation structure and the culture of the investment banking industry influence identities and behaviors of bankers, and explore what the economic and psychological characteristics of investment-banker risk taking are. From this novel perspective, we deduce policy-making (e.g. regulations) and managerial implications (e.g. hiring, training, and compensation structure).

The rest of the paper is organized as follows. Section 2 reviews the previous literature and our contributions to it. In Section 3, we develop testable hypotheses. Section 4 describes the experimental design such as procedures and subjects. Section 5 shows empirical results. In section 6, we discuss the implication of the results and its relation to the quality of financial decision-making by investment bankers, and explore how psychological risk attitude is associated with economic risk attitude. Section 7 concludes.

2. LITERATURE REVIEW

This paper extends the various strands of relevant literature – investment banker characteristics and behavior, identity/preference formation, determinants of risk attitudes, and economic versus psychological risk attitudes. The following subsections deal with each of these topics in detail. Table I summarizes presents the contributions of our study.

******* Insert **Table I** about here *******

2.1. Eliciting Risk Attitudes

A canonical model of decision-making under uncertainty in economics, named expected utility theory (EUT), was developed mathematically by von Neumann and Morgenstern (vNM) in 1944. vNM prove several axioms including ordering, continuity and independence, which guarantee the existence of a utility index such that the ordering of lotteries based on individuals' expected utilities fully coincides with their actual preferences. The proof makes the case for modeling a person's behavior as if she acts to maximize expected utility, given that her preferences satisfy these axioms. Expected utility has a very simple and appealing way of combining probabilities and monetary outcomes. Risk attitude is solely captured by the curvature of the utility function over monetary outcomes.

Standard economic and financial theories generally assume individuals' risk attitudes to be risk averse. However, many view the individual risk attitude as a free parameter, such as in subjective expected utility theory (Savage 1954) and prospect theory (Kahneman and Tversky 1979). These theories state that the individual's attitude toward risk may be variant or heterogeneous over populations and time.

The importance of understanding risk attitudes has led economists and psychologists to develop numerous methodologies to elicit and measure individual attitudes towards risk. Various