EMERGING CHALLENGES IN RETAIL FINANCE AND CONSUMER POLICY

Conference

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Agenda point 2: Behavioural economics and financial services – presentation of the topic for discussion

1. Brief introduction

Many users of financial services have difficulties understanding the features of financial products which they purchase. The effectiveness of financial education is somewhat limited in making consumers better prepared to figure out what is the best pension scheme or investment fund for them. Despite these constraints, consumers still purchase and engage with very complex financial products. It is therefore of vital importance for policymakers to understand how consumers take financial decisions. What criteria do they apply to decide? Is there room for policymakers to help consumers take better decisions while respecting their freedom of choice?

The behavioural determinants of consumers' purchases and financial decisions are broadly applied by providers of financial services, who often use behavioural insights to devise more efficient marketing techniques and maximise sales. More recently, regulators started using such behavioural insights for policymaking to improve financial consumer protection. However, there is still scope to explore further behavioural economics in retail financial services and, more importantly, to learn how best to apply such insights in regulatory work.

2. Are behavioural insights relevant for financial services?

Behavioural science investigates how consumers actually behave. Human behaviour is not (entirely or *predictably*) rational and does not result from a thorough consideration and comparison of information about the features of a given product. In financial services, in particular, consumers often struggle to take rational and calculated decisions, either because of asymmetry of information between them and providers, or due to poor financial literacy of consumers. They instead decide in a more intuitive way – for example using mental shortcuts or reproducing passively other people's choices – which may lead to 'sub-optimal' results.

Consumers' decisions may also be influenced by providers, whose sales strategies may encourage the purchase of certain, and not necessarily the most suitable, products for consumers. Relevant techniques and strategies have been used by businesses in marketing campaigns and in direct contacts with customers with an overall objective to enhance sales and increase profits. One of the techniques called 'framing' is a method of the product presentation which makes it more attractive for consumers. Framing allows providers to emphasise the benefits and features of the product which are important for consumers, and at the same time gives less prominence to less tempting aspects, e.g. penalties for late repayment of the credit instalments. Another common way to encourage consumers to make a particular choice is to provide a default option. It saves consumers' time and effort in hesitating between different alternatives and therefore, consumers are very likely to opt for it without giving it too much consideration. The 'default option' is closely related with the 'choice overload' bias, also frequently observed in financial services. Consumers who are puzzled by too many options to choose from in a product may even entirely refrain from the purchase. Thus, when providers have to present to consumers several alternatives to make the choice, they usually limit them to the minimum necessary. This greatly facilitates consumers' decisions but sometimes omits certain important elements. Finally, it has been proved that consumers are much more eager to buy something if they can pay for it later. Delayed payment means that they do not have to 'suffer' now whereas they can already enjoy the purchase. This is the technique on which the great majority of credit products are based and is broadly applied by financial services providers.

Further, there is evidence showing that when consumers with a good understanding of financial matters are confronted with a complex financial product, they are able to use their knowledge only to a very limited extent. Instead of a logic and prudent approach, they tend to be over-confident and over-optimistic about the future revenue, for instance when deciding on the level of risk they are ready to take. During the financial crisis, even financially literate consumers were found to take the most risky and often wrong investment decisions. This shows that financial education is not a bulletproof solution by itself, if it ignores the existence of deep-rooted behavioural biases. Any proposed solution to improve consumers' financial decisions would have to be conceived by taking into account the existence of somewhat widespread behavioural biases. This approach may be costly and time-consuming but it is critical to place more emphasis on the psychological side of the process of purchase of financial products if we aim for better-equipped and educated consumers. Only such consumers will be truly empowered, and will be able to contribute to the smooth functioning of financial markets.

Apart from over-confidence or over-reliance on one's knowledge, there are other reasons - already well-defined in the literature – why people take sub-optimal decisions when they come to buy financial products. This is usually related to the fact that they receive excessive or inadequate information and it is simply too much effort for them to process or understand it. Therefore, they skip the phase of information search, collection and evaluation. Instead of comparing different options to appreciate them better, consumers often take decisions based on their first impressions or feelings. In such situations, they very much rely on the recommendations received from the sales staff or financial intermediaries who, as the evidence shows, may influence consumers' choice. Further, it has been observed that even if consumers are made aware of the intermediary's conflict of interest, they ignore such information and still trust the advisor. They often pay more attention to the intermediary's friendly behaviour or to his alleged expertise, also because they are simply unable to make the choice themselves. Finally, some consumers naively believe that they are well protected by the law, trusting that this would prevent unfair offers to be placed on the market.

A number of behavioural biases are at play when it comes to consumers’ decisions relating to the purchase of financial services. This is because financial products tend to be particularly complex, while at the same time they involve substantial resources and often establish a long-term commitment for consumers. To make things more difficult, financial products are “experience goods”, that is goods the quality of which can only be ascertained after purchase. In the case of financial products, it may take years to fully appreciate them. Also, financial products are not subscribed to frequently, and most of them are one-off purchases by their very nature. This further limits the extent of learning-by-doing. These products can also be related to important life decisions (e.g. mortgage credit, pension savings), where consumers' choices can be easily driven by emotions, such as excitement, anxiety or fear rather than objective assessment of future effects. This 'emotional distortion' is closely related to another bias (the so-called 'present bias'), which lead consumers to focus more on the present implications of their decision, rather than on its future consequences. For instance, people with only temporary job contracts may take expensive mortgage credit to buy an apartment despite their unstable employment situation. In financial services consumers also tend to defer decisions carrying relatively small monetary implications though, as a whole, such behaviour may bring a substantial financial loss. It happens, for example, when we refrain from switching a bank account even though there are cheaper accounts than ours available in the market; or when we postpone cancelling our mobile phone insurance contract when the value of the device has already substantially decreased.

3. Other important aspects of the topic to be addressed during the conference

Some believe that adequate regulation can be more effective than education in shaping and changing consumers' behaviours. In financial services, there are already several examples of EU legislative measures where psychological aspects of the decision making process of consumers have been taken into account to a greater or lesser extent. The evidence shows that simple information (limited to the most important features of products) can greatly improve consumers' financial choices. For instance, the following recent EU legislations were inspired by such insights: the Consumer and Mortgage Credit Directives (CCD and MCD), the Payment Accounts Directive (PAD) and the Regulation on a new Key Information Document (KID) for packaged retail and insurance-based investment products (PRIIPs). Indeed, the PRIIPs

Regulation took into account an investigation of consumers' understanding of investment products, which demonstrated that: "*simplification and standardisation of product information enables consumers to make better quality investment decisions* and *providing pre-calculated and directly comparable relevant information about investments enables better choices between dissimilar options, e.g. across product classes"*.[1] In order to ensure that the PRIIPS KID is most useful to consumers, its presentation will be specified further in the level 2 measures taking behavioural aspects into account. Most importantly, the European Commission will conduct a consumer-testing study where different presentations will be directly tested on average consumers. The insights from this study will feed in the legal specifications of level 2 measures.

It is premature to evaluate if and to what extent the provision of simple and comparable product information allows consumers to take better financial decisions. This being said, it is worth exploring possible extensions to the current regulatory and non-regulatory framework. In this respect, different solutions are currently being discussed in some Member States. And these include even innovative ones, like labelling of investment products according to the level of risk involved, or pre-ticked options to minimise the risk involved in complex financial decisions.

The opponents to further financial regulation argue that, if it was true that consumers reward clarity and simplicity, there will be plenty of simple and clear products on offer, and the market would put forward the best solution by itself. The reality, though, is quite different. As John Kay puts it (*Financial Times*, 6th July 2011), *"If the winner of the competitive race is the company that is most innovative, not in productive efficiency or customer service, but in the ingenuity and opacity of its tariff structures, consumers will not be happy, or well served, in the long run".*

4. Potential challenges for policymakers

For policies to be effective in this domain, policy-makers would need to improve their knowledge about the very factors determining consumers' decisions. This seems a *sine- qua-non* condition for identifying the causes of market dysfunction and for conceiving the best policy solutions.

While, as mentioned earlier, some first attempts have already been made at EU level (e.g. PRIPs, CCD, MCD), several EU Member States are more advanced in exploring behavioural insights and in applying them in policymaking. Some national authorities (e.g. the UK Financial Conduct Authority) have even developed principles and guidelines which the regulator should follow to better incorporate behavioural insights into its initiatives.

New policies in financial services – both at national and EU level – should take into account behavioural insights since they shed light on the determinants of consumer behaviour. At the same time, consumers should be free to decide and even free to make mistakes, if these do

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[1] *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective*, November 2010.

not result from misleading or unfair practices of providers. Therefore, regulators could have to face a dilemma regarding the scope of their intervention. In this context, it is appropriate to reflect on the trade-off between consumers' freedom to decide, and the regulator’s need to prevent the sum of individual misbehaviours negatively affecting the economy, as in the case of the recent financial crisis.

5. List of possible questions for the discussion

1. What is the scale of the impact of behavioural biases on consumers' decisions? What proportions of consumers are driven by behavioural biases when buying financial products? What is the level of detriment brought about by “biased” decisions?

2. To what extent providers of financial services exploit behavioural biases of consumers via their marketing and sales strategies? Are these practices widespread and common among providers or rather rare?

3. Assuming that the exploitation of behavioural biases may enhance providers' profits, how can regulators encourage providers to opt for de-biasing instead? What are the benefits of 'de-biasing' for providers?

4. What are the most effective methods to influence consumers' behaviour? Is there a role for financial education in this respect?

5. How far can regulation go in impacting consumers' behaviour? Should it aim to limit consumer's choice in situations in which consumer is not able to take a rational decision and risks making a mistake?

6. What other forms of intervention can a regulator envisage to better protect consumers against mistakes resulting from both the complexity of financial decisions and from their own behavioural biases?

7. Are there any particular areas of financial services where measures limiting the impact of behavioural biases would be especially desirable for example complex investment products? Are there other areas?

8. Can product governance or simple financial products help consumers in making better financial decisions?

9. Reputation seems to be a key concept in many markets with one-off transactions (e.g., holiday renting, booking restaurants). In such markets, peer review systems developed over time, better informing consumers’ choices. Could such systems also apply to financial products or providers?