RETHINKING THE PREVIOUSLY PREDICTABLE

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SPEED READ
- Consumers have two decision-making systems
- Decision-making is usually fast, automatic, intuitive
- Cognitive bias and short-term focus is the norm
- 5 selves: Bargain-Hunter, Gambler, Miser, Spender and Tycoon

When it comes to money, humans behave in an irrational manner, challenging aspects of classical economic theory. ALAN NEWMAN reveals the factors behind real world decision making.

In April 2013 the FCA published its first Occasional Paper, 'Applying Behavioural Economics at the Financial Conduct Authority'. In so doing it put behavioural economics on the boardroom agenda of financial services companies. That is to be applauded. On the other hand, it referred to errors and mistakes (by consumers) more than one hundred times. That is to be regretted, not only because it plays to a self-serving and unhelpful narrative ('consumers are the problem') but it also suggests that there are 'right answers' when it comes to financial decision-making. As with GCSE exams, there are no right answers.

Research on judgment and decision making challenges aspects of traditional economic theory which assumes that we are rational and selfish and our preferences are well defined and constant over time. This matters because traditional economic theory has underpinned policy formulation regarding markets and regulation for many years.

THINKING FAST AND SLOW

We now understand that people have two decision making systems: system 1 is subconscious, fast, automatic, intuitive and quasi-rational (rather than 'irrational'), and requires little effort. System 2 is conscious, slow, considered and rational: it requires a good deal of effort. Classical economics has assumed that we use system 2 most of the time. We don't. We use system 1. (However, in the group market, system 2 applies – for long term products a group orientated approach is more likely to be successful than direct to consumer.)

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Regularly faced with incomplete information and a need to make decisions quickly, the brain has evolved in such a way that cognitive biases (e.g. anchoring, framing, heuristics, loss aversion, mental accounting, multiple selves) are the norm. It therefore makes sense to work with these biases rather than try to correct them.

Insights from behavioural economics, particularly regarding hyperbolic discounting, the optimism bias and the status quo effect, suggest that the concept of auto-enrolment should be extended to long term protection products. The approach taken to pensions should be rolled out to life assurance, mortgage payment protection, or critical illness cover. Today save-as-you-earn schemes are linked to employee share plans but in the past they promoted savings habits: an example of the status quo effect. (Old style SAYE was an example of 'choice architecture' or 'nudging'.)

INFLUENCES ON THE SELF

In the financial services sector, including the FCA, behavioural economics is seen through the lens of cognitive psychology which deals with the acquisition, processing, and storing of information (e.g. intelligence, memory and language). Insufficient attention is paid to contributions to behavioural economics from social psychology (how families and/or groups make decisions) and evolutionary psychology. Considered advice accepted from an IFA, for example, may be rejected on a whim based on a comment from a trusted friend.

The modern human brain is about 150,000 years old and exhibits functional localisation: different parts of the brain specialise in different things such as empathy, facial recognition, fear, memory, music, naming, planning or speech. This makes information processing more efficient. But for our purposes the important point is this – brains don't do money: they're too recent.

It isn't strictly accurate to say that we're irrational: it would be more accurate to say that we're quasi rational because the brain subconsciously contextualises most of our decision making. Change the context and you'll probably change the decision – hence the appearance of inconsistency and irrationality: but appearances, in this instance, are deceiving.

THE IMPACT OF TODAY'S DECISION ON TOMORROW

The brain rarely defers gratification. It exhibits hyperbolic discounting, a time-inconsistent model, rather than exponential discounting which is time-consistent. In hyperbolic discounting, valuations fall very rapidly for small delay periods, but then fall slowly for longer delay periods. This contrasts with exponential discounting, in which valuation falls by a constant factor per unit delay, regardless of the total length of the delay. This has a strong effect on how we make decisions about money-and-the-future and why for most of us most of the time the natural focus is the short term. ►

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URGENCY TRUMPS IMPORTANCE

Improving or acquiring a skill is relatively easy if we’re motivated to do so. Whether we’re motivated to do so depends on a combination of our personality and our situation. Most of us start life with no skills regarding mortgage products. But when we want to buy a house and have a reasonable deposit, things change.

THE POWER OF HABIT

The brain is a habit machine. Habits are powerful. They reflect the lessons we’ve (subconsciously) learned over many years and, to a considerable extent, they define us. Habits strongly influence what we eat, who and what we’re attracted to, who and what we avoid, how we think, how we speak, how we argue, how we learn, and how we (mis)manage money. Habits are difficult to change.

Today, most psychologists view personality as ‘stable and enduring traits of an individual which distinguish him or her from other people’. There is broad agreement that there are five major traits (‘OCEAN’) which comprise the foundation of an individual’s personality:

- Openness indicates how willing we are to explore new ideas and ways of doing things.
- Conscientiousness indicates how well we plan and exhibit self-control.
- Extroversion indicates our desire for stimulation.
- Agreeableness indicates how easily we get along with others.
- Neuroticism indicates how we deal with negative emotions such as stress and anxiety.

PERSONALITY AND MONEY

Your personality has a profound effect on how you deal with money. If you score highly on conscientiousness, for example, you will tend to be dutiful and have a strong sense of personal responsibility. Somebody who has a higher-than-average level of anxiety might be expected to be more interested in insurance products than investments. A person with a high extroversion and a low conscientiousness score might be drawn to investing and gambling. You get the picture.

We’re social animals. We’re adaptable and behave differently in different situations. This doesn’t mean we’re two-faced or have multiple personalities, rather we have multiple selves each of whom turns up under different circumstances.

Research by the Open University and UCL for the BBC’s Big Money Test suggests that we have a combination of five selves when it comes to money matters: Bargain-Hunter, Gambler, Miser, Spender and Tycoon. With 100 points to allocate what would your respective scores be? What are the implications of your answer?

MISTAKE OR UNEXPECTED OUTCOME

We now enter the vexed area of ‘mistakes’. We can all agree that ‘two times three equals five’ is a mistake. But can we say that a divorce means that the marriage was a mistake? I might have been mis-sold an endowment policy when I took out a mortgage, but if I’ve been able to afford the monthly payments without difficulty and have now benefited from the policy, can we say that buying the endowment was a mistake? In many instances ‘mistakes’ are simply unexpected and/or unintended outcomes. They are not necessarily bad things. Who’s to say that spending money on one of debt reduction, critical-illness cover, pension pot, or life assurance, at the expense of the other three, is an error? Only hindsight can say, if then. Furthermore, just because a person does not spend her money in a manner that conforms to the assumptions, beliefs and biases of the government and financial services sector does not mean that she is error-prone and needs to be rescued from herself.

We use rules of thumb to deal with complexity and the biases that we all exhibit have evolved because they’ve worked. We (subconsciously) make and live with decisions that work for us and the way we perceive our world.

In the Executive Summary of the FCA’s paper we learn that ‘behavioural economics takes us beyond intuition and helps us be precise in detecting, understanding and remedying problems that arise from human mistakes’. That the FCA is paying attention to behavioural economics is to be welcomed, but FCA staff can also exhibit cognitive biases, and claiming that we can be precise when dealing with human behaviour is something of a stretch.

THE BOTTOM LINE

Lessons from psychology in general and behavioural economics in particular tell us that auto-enrolment and/or B2B sales work better than direct-to-consumer approaches when money meets the long term. They also tell us that we’re loss-averse and default readily to accepting the status quo and business-as-usual. To encourage us to act, therefore (i.e. financially protect ourselves and our futures), we need products to be more flexible, and we need to be sure that we have options, and simple and fair remedies, should our circumstances change. ◘

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The Realities of Spending: It is obvious that customers often behave irrationally, but the psychological factors that affect spending behaviour are many and complex. Greg Davies discusses some of the latest thinking in this area from Cambridge and Warwick, and shows how marketers might use these insights to improve product design and presentation.

The Emotional Reality of Financial Phobia: Financial services providers have long been frustrated by the seemingly irrational behaviour of their customers, but the cause of this ‘irrationality’ has not received serious attention. Is it laziness? Is it stupidity? No, research by Brendan Burchell suggests that we can only understand this phenomenon at the level of human emotions.