

The application of behavioural economics to retail banking (and regulatory decisions, competition law and public policy more generally...)

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The standard approach fails to understand the competitive process



Market studies involve an analysis of a particular market, or practices across a range of goods and services, ***with the aim of identifying and addressing any aspects of market failure*** from competition issues to consumer detriment and the effect of government regulations – **OFT website**

If the partial genius of market economies lies in their capacity to achieve co-ordination without a co-ordinator, the greater genius lies in their ability to innovate and adapt in an environment of uncertainty and change. The sustained achievement of market economies comes from their pace of innovation—in products, technology and organisation—derived from the ability of market systems to undertake small-scale experiment, to watch the results, to mimic what works and discard what doesn't – **“The Failure of Market Failure”** John Kay, Prospect Magazine 2007



The long overdue death of rational economic man (and market failure?)

“For many non-Austrian economists this hypothesis is invoked with apologies and is something of a necessary evil” *On the Method of Austrian Economics*
Israel Kirzner

1. **Neoclassical:** *framing “perfect competition”, focus on equilibrium, static efficiency not dynamic*
2. **Assumptions:** *constrained optimisation, well defined (and behaved) set of preferences*

Conclusions

1. **Market failure endemic:** *impossible benchmark*
2. **“Markets get stuck in bad equilibrium”:** *solution if not supply side (concentration) is typically to focus on information remedies*
3. **More information = more rational decisions = better market outcomes**
4. **Ignores:** *the market process and good science!*

So what has all that got to do with behavioural economics?



Attention

How much do you think about this normally?

Loss aversion

How is fear of missing out in the future influencing your behaviour now?

Associations

What do you implicitly associate (positively or negatively)?

Ease/habit

Which option is easiest; what's the line of least resistance?

Reward

Does the product or process provide a "buzz"?

Social proof

What do you see, think and feel others do?

Priming

What first thoughts or messages are shaping your subsequent actions?

Heuristics

What rules of thumb do you usually fall back to in situations like these?

Framing

What is the context you are being given (or allowed to believe)?

Behavioural economics is a means of understanding the market process and the “greater genius”

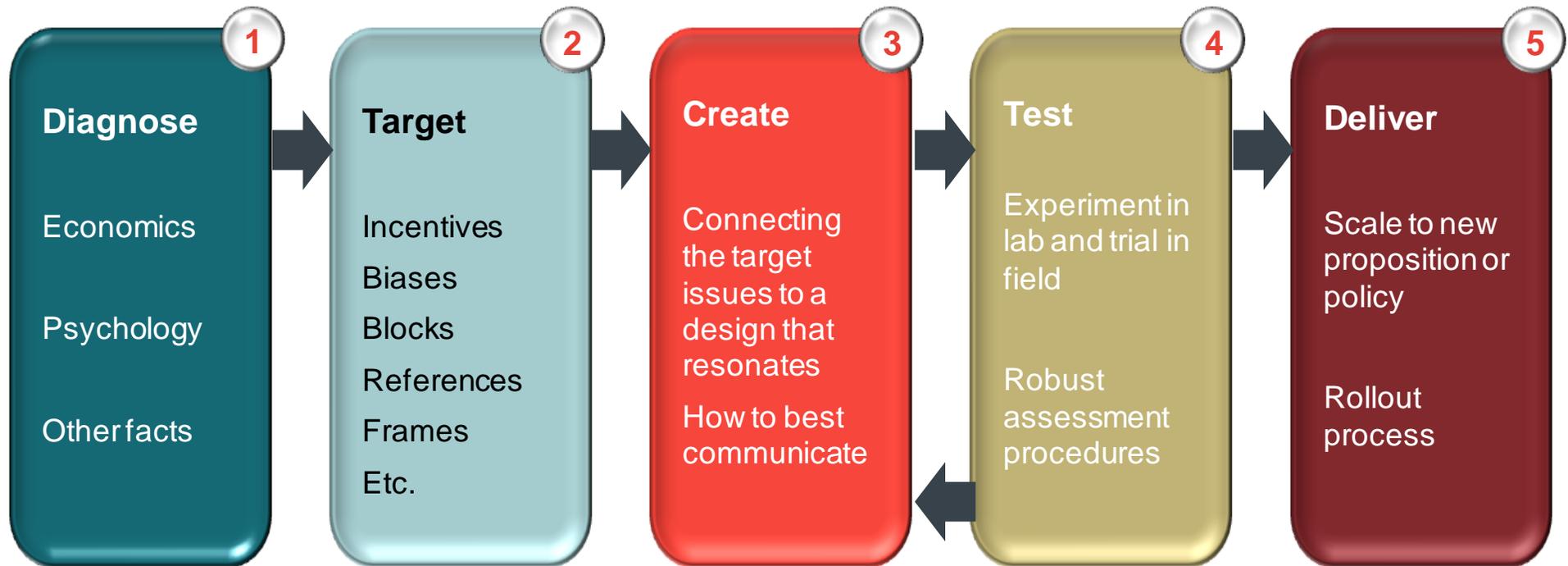


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The implications for policy makers, regulators and competition authorities are simple but profound and represent nothing more than good science

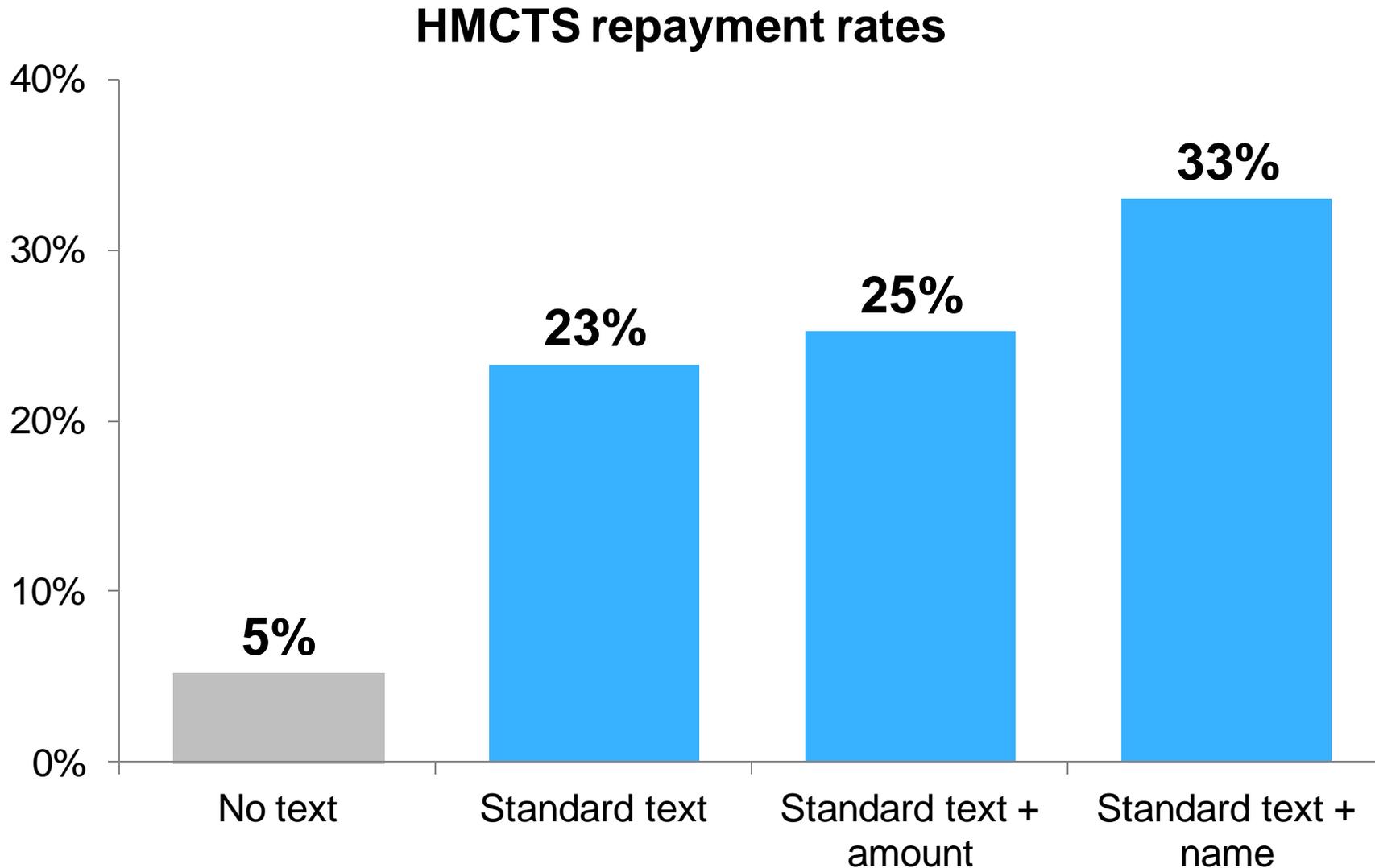
“All new policies get assessed but...rather badly. We should do it right... There's a lack of humility in policy making... In the 1970s there were lots of doctors aggressively opposed to Randomised Controlled Trials. RCTS let you check whether the policy is having the outcomes you want...and if things don't work we should probably stop them” **Ben Goldacre aka author of “Bad Science”**

The right approach: how to design a good intervention



Simple approach: test, trial (randomised) and learn but with profound implications for public policy, regulatory decisions and competition law

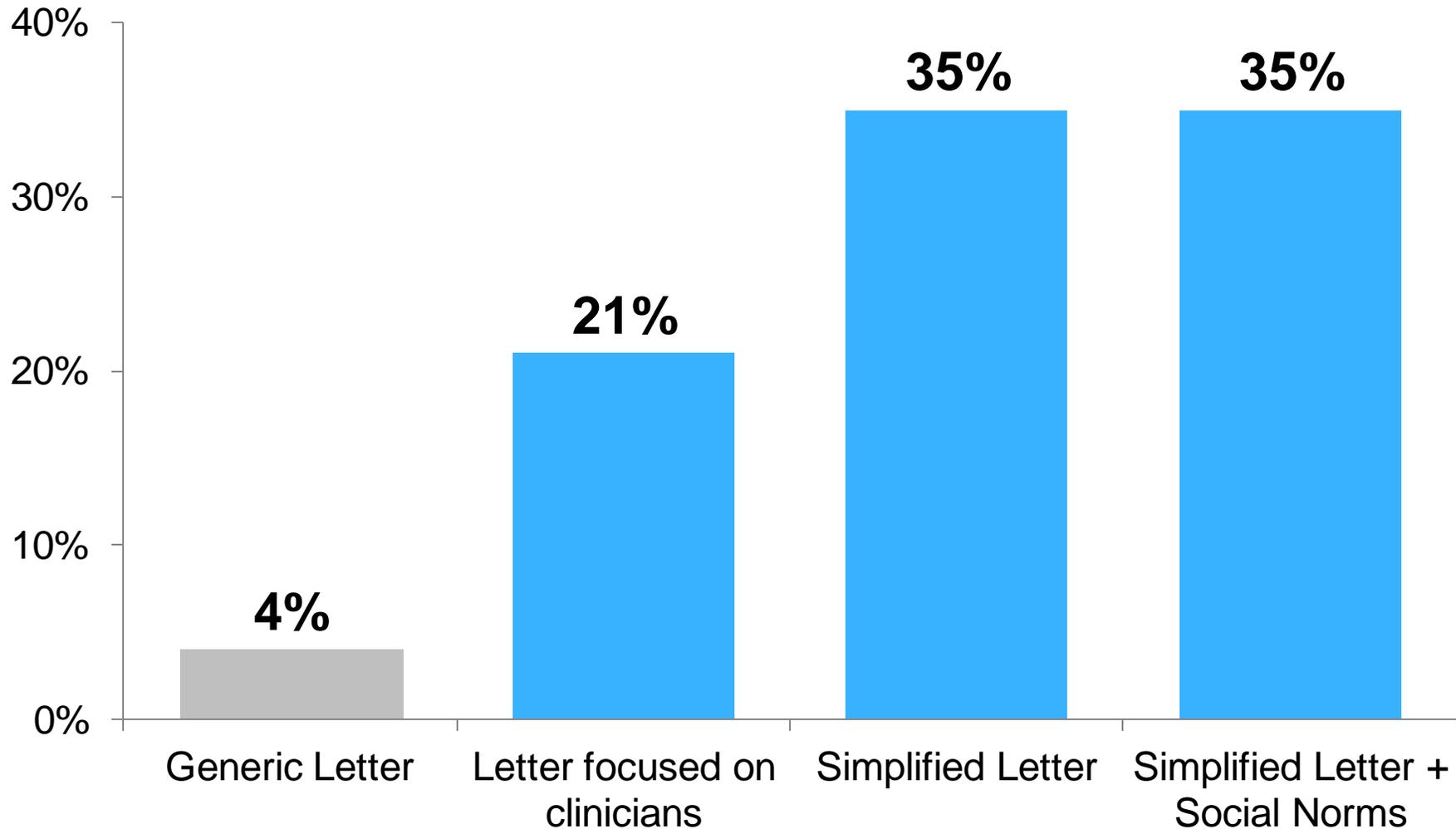
Case Study 1: The Behavioural Insights Unit: Getting people to pay their Court Fines



Case Study 1: The Behavioural Insights Unit: Getting Doctors to pay their tax



Response Rates of Doctors to HMRC Letters

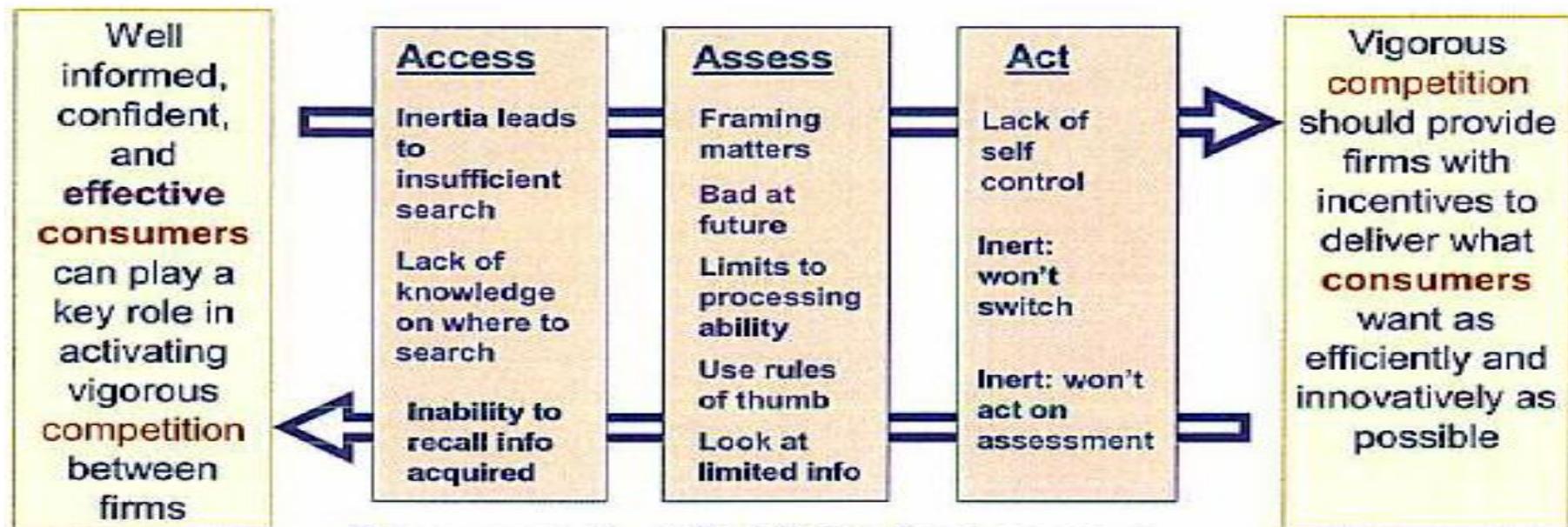


Case Study 2: The OFT and Personal Current Accounts



OFFICE OF FAIR TRADING

...and can reduce consumers' ability to make effective decisions at every stage



Consumers that find it harder to access, assess and act on information will create barriers to the virtuous circle

Case Study 2: The OFT and Personal Current Accounts



Concern is not just academic

- **Personal Current Account Market:**

**Consumer
behaviour**

“...A significant number of consumers do not know how much they will effectively pay in bank fees or how individual elements in the charging structure will be implemented, either before or after they are incurred...”

**impacts
banks
behaviour**

“...this means banks have less incentive to provide better offers on insufficient funds and interests. Without better offers from banks, however, consumers have little incentive to switch.”

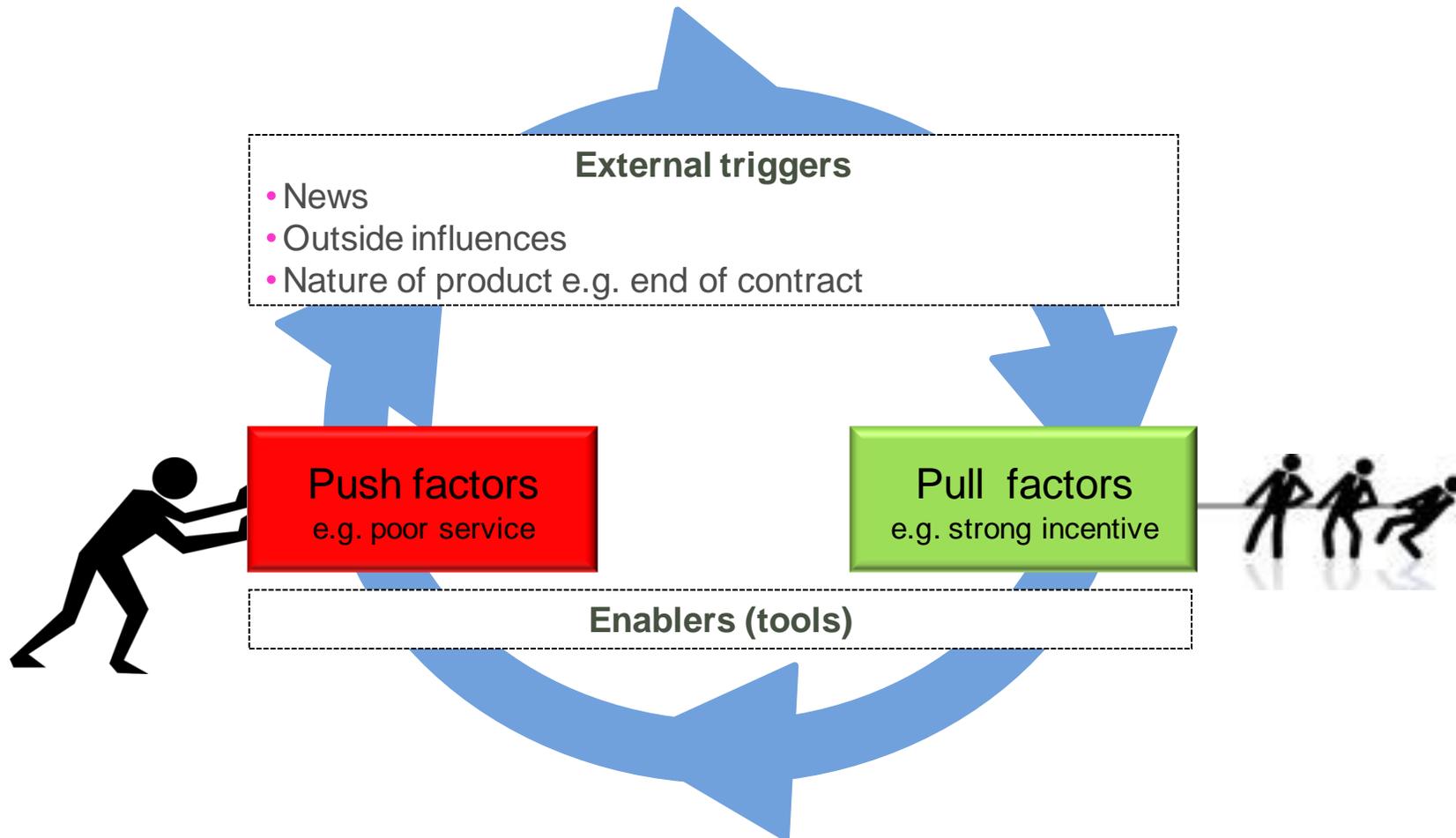
**Impacts
market
outcome**

“...The OFT believes that the market may be stuck in an equilibrium that does not work well for many consumers.”

Case Study 2: The OFT and Personal Current Accounts



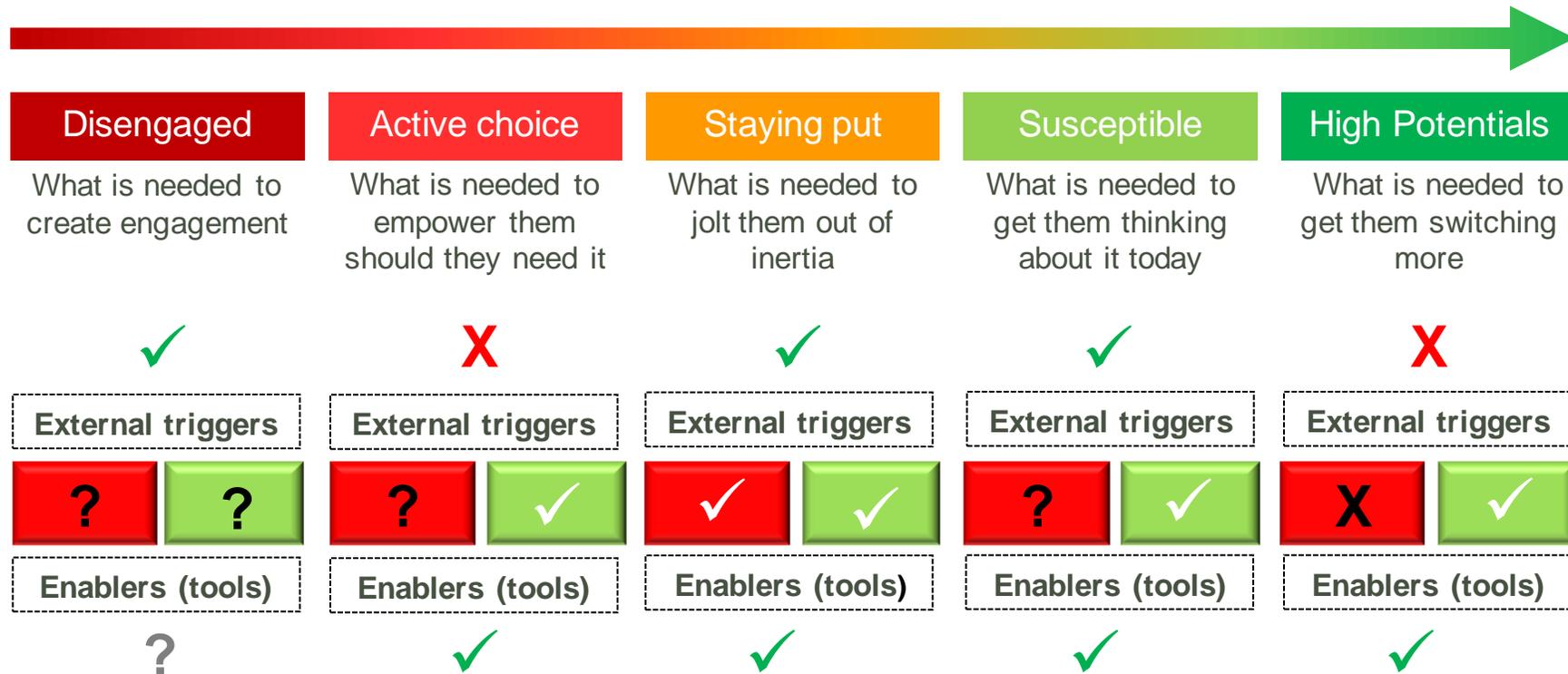
There is a need for push, pull, external triggers and enablers to encourage movement. The external triggers need to challenge the mindset that a PCA is for life and the bedrock of finances.



Case Study 2: The OFT and Personal Current Accounts



Different consumer types might need to be engaged and disrupted by different factors to encourage them to think about switching their PCA.



Legend

? Unknown/may not be applicable ✗ not applicable ✓ applicable

Case Study 3: The FSA and Retail Distribution Review



Diagnosis of the problem

- **Callum McCarthy 2006 – “Is the present business model bust?”**
- ***My contention is that we have a system which serves neither the producer of the services nor the consumer of the services. It is doubtful whether it serves the intermediary either***
- **Key failures:**
- Adviser remuneration conflicting with consumer interest
- Mis-selling
- Poor product persistency

RDR Objectives

- an industry that engages with consumers in a way that delivers more clarity for them on products and services;
- a market which allows more consumers to have their needs and wants addressed;
- remuneration arrangements that allow competitive forces to work in favour of consumers;
- standards of professionalism that inspire consumer confidence and build trust;
- an industry where firms are sufficiently viable to deliver on their longer-term
- commitments and where they treat their customers fairly; and
- a regulatory framework that can support delivery of all of these aspirations and which does not inhibit future innovation where this benefits consumers.

Policy Measures

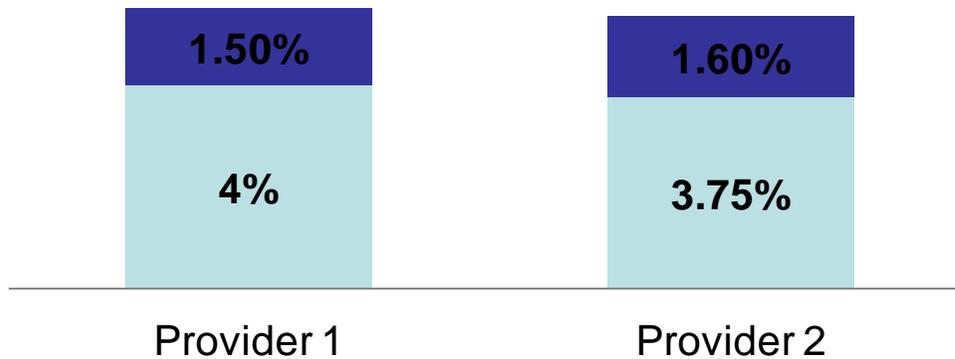
- **Improving the clarity with which firms describe their services to consumers;**
- **Addressing the potential for adviser remuneration to distort consumer outcomes through adviser charging model;**
- **Increasing the professional standards of advisers.**

Case Study 3: The FSA and Retail Distribution Review



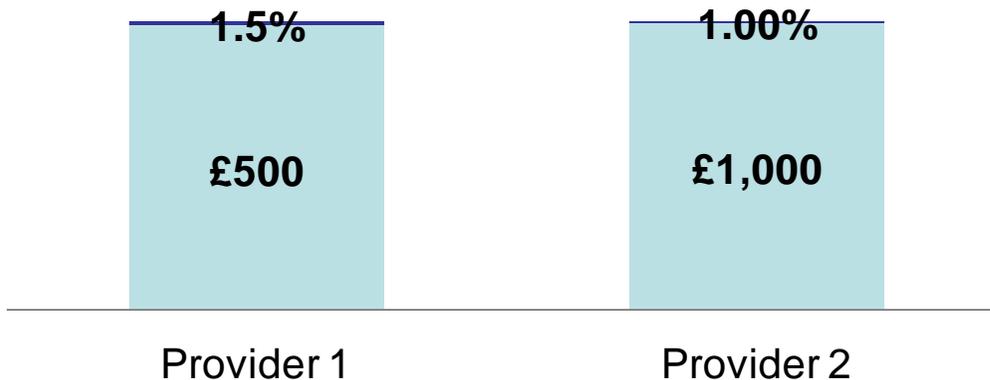
Pre-RDR Customer decision

■ NPV Commission ■ Annual Management Charge



Post RDR - Consumer decision

■ Advice fee ■ Annual Management Charge



Stylised example of single investment product consumer choice

What is the best deal in each case?

Behavioural economics insights around impact of:

Upfront fees vs. “free”

Framing AMC vs upfront fee

Case Study 4: A good intervention using behavioural economics: Comparison websites?



- Very little on non-price features; no richness on what matters to consumers
- A maximum of 6 policy features: leading the user to think these are the only variables
- Does not allow the user to order quotes by non price factors such as customer net promoter score, service,
- Ambiguity of features; details buried in the T&Cs and could lead to unexpected costs or exclusions, cost of calling, ease of calling etc
- Most sites have similar appearances and offer almost identical comparisons
- Products which cannot be opened online are generally not displayed

Focus on price alone can lead to:

- Dysfunctional behaviours (e.g. motor insurance)
- Disrupts normal competitive process – race to bottom on price cannot build brand around service premium (i.e. Virgin vs Ryanair)
- Could lead to ‘bad’ switches which are not necessarily best for the consumer

In aggregators defence there is limited independent, comparable non-price information made available in these industries

The challenges



- 1. The devil is in the detail**
- 2. It requires imagination and innovation from regulators and industry**
- 3. It can be expensive and you need to tolerate multiple failures**
- 4. It takes time: *changing embedded social norms takes years***
- 5. How to persuade the politicians: *the parable of smart meters***
- 6. How to persuade the media: *passing the Daily Mail test***

Conclusions



- 1. Rational economic man is dead – that’s a good thing**
- 2. Understand markets and competition as a process, probably never in equilibrium, constantly trialling, learning (through failure and success) and adapting**
- 3. Regulators/competition authorities (and civil servants) can make positive interventions but based on replicating the successful market process (and good science!): test, trial and learn**
- 4. Current approach pays lip-service but not deeply embedded or understood**
- 5. How to win over the politicians and the media: solutions to big problems will take longer under the approach and will lead to multiple failures: no quick fixes or silver bullets**