

Behavioral Economics: Applications for Financial Services



FORDFOUNDATION

Remember this number:

7238592 OR 61

Which snack would you like?



61 =



7238592 =



#1: The Power of Defaults

Making choices is often difficult.

As a result, the default option – what happens when you do nothing – is often the most common outcome.

Application: While maintaining choice, set defaults so the easiest option is broadly the “best” – or so alternatives require purposeful action.

Example: Switching from opt-in to an opt-out in a large corporation's 401(k) plan increased participation by new hires from 37% to 86%, and among the lowest-income employees from 13% to 80%.



***How It's Being
Applied to Financial
Regulation:***

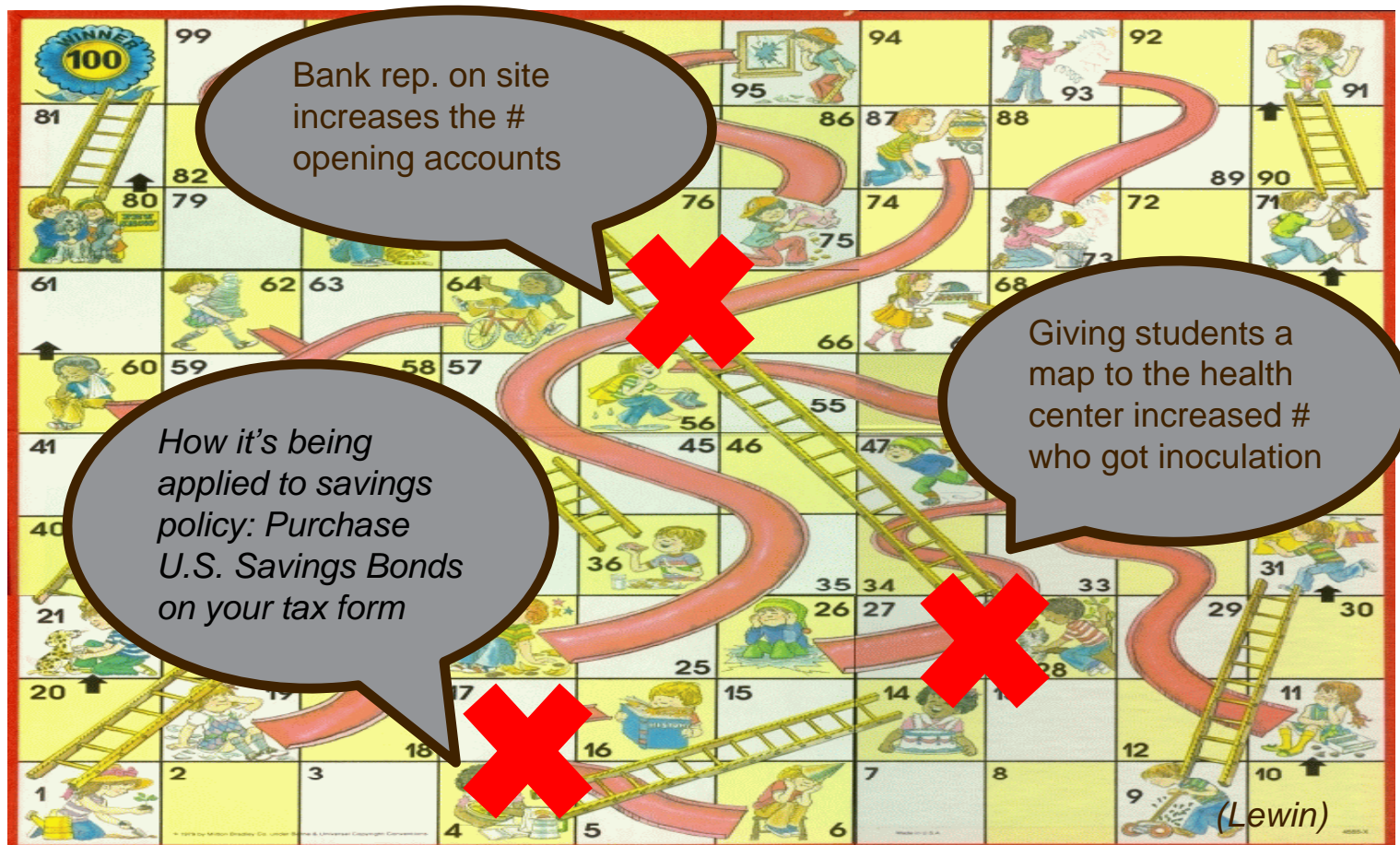
*New opt-in
requirement for debit
card overdraft
requires conscious
consumer choice.*

#2: Hassle & Channel Factors

Even seemingly minor hassles can make us much less likely to do something.

Channels point us in a direction – and we are then more likely to keep going.

Application: Thinking from the consumer's perspective, look for ways to reduce hassles and create channels to success.



#3: Mental Accounting

People compartmentalize money into distinct categories and have different propensities to save or spend from different mental accounts.

Application: Use product or policy design to create mental accounts that support consumers' financial goals.

Q: Which option will likely result in the greatest amount saved from \$1,200 increase in income:

- a. \$50 additional in each paycheck (2x/month)
- b. \$1,200 one-time bonus check
- c. \$1,200 given as a VISA branded gift card
- d. \$1,200 deposited into a new savings account

How It's Being Applied to Credit Cards:
New disclosures more clearly define an “account” for interest charges over the life of the debt.

#4: Proliferation of Choice

We tend to think more choices are always better. But when faced with too many alternatives (especially that can't be easily compared), people are less likely to choose any option.

Application: Focus on a limited set of options, or structure choices to facilitate decision-making.

Tasting tables in an upscale grocery store:

Number of jams displayed	Number who stopped	Number who bought jam
24	60%	3%
6	40%	30%

(Iyenger & Lepper, 2000; B. Schwarz, 2000)

How It's Being Applied to Mortgages:

Among proposals considered was requirement for all lenders to offer a “plain vanilla” mortgage that could be easily compared.



#5: Identity & Affirmation

We may make different choices in the same situation depending on identity.

We feel more comfortable making a choice when we feel confident in ourselves or know that others have made the same choice.

Application: Build consumer confidence in their ability to make good decisions.

Affirmation at Trenton Area Soup Kitchen:

Neutral: *Describe what you might eat on a typical day*

Affirmation: *Think of a personal experience where you felt successful or proud*

	Neutral	Affirmation
Stopped to consider	44%	58%
Took information	36%	79%

(Crystal Hall, Princeton University dissertation)

Note: A “default” offering often takes on air of being the “recommended” option, thereby instilling greater confidence (and increasing take-up) among consumers. E.g. default 401(k) investment option.

Key Points to Remember

- There are no neutral choices – everything we do influences people one way or the other.
- *Knowing what to do and wanting to do it don't always translate into action.*
- By applying the lessons from behavioral economics, we can make it easier for people to act in ways that support their short- and long-term financial goals.
- *Be careful though. With so many behavioral influences all around us, it's hard to predict or know what changes will make a difference.*