

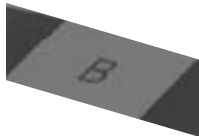
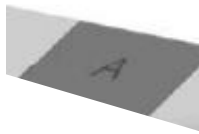
# Behavioural economics and competition in financial markets: FCA's regulatory experience

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Centre for Competition Policy 12<sup>th</sup> Annual Conference

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Is the population of Venezuela more or less than 65 million people?

How many people do you think live in Venezuela?

Is the population of Venezuela more or less than 10 million people?

How many people do you think live in Venezuela?

They said: 16.4m

The real answer is: 28 million

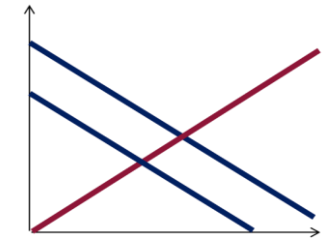
# Building capacity for behavioural science for policy: FCA's regulatory experience

Existing literature

Occasional Paper No.1

## Applying behavioural economics at the Financial Conduct Authority

April 2013



Original empirics

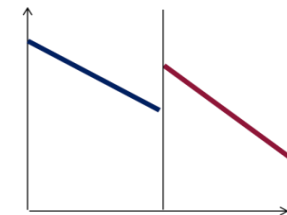
Field trials



Lab experiments

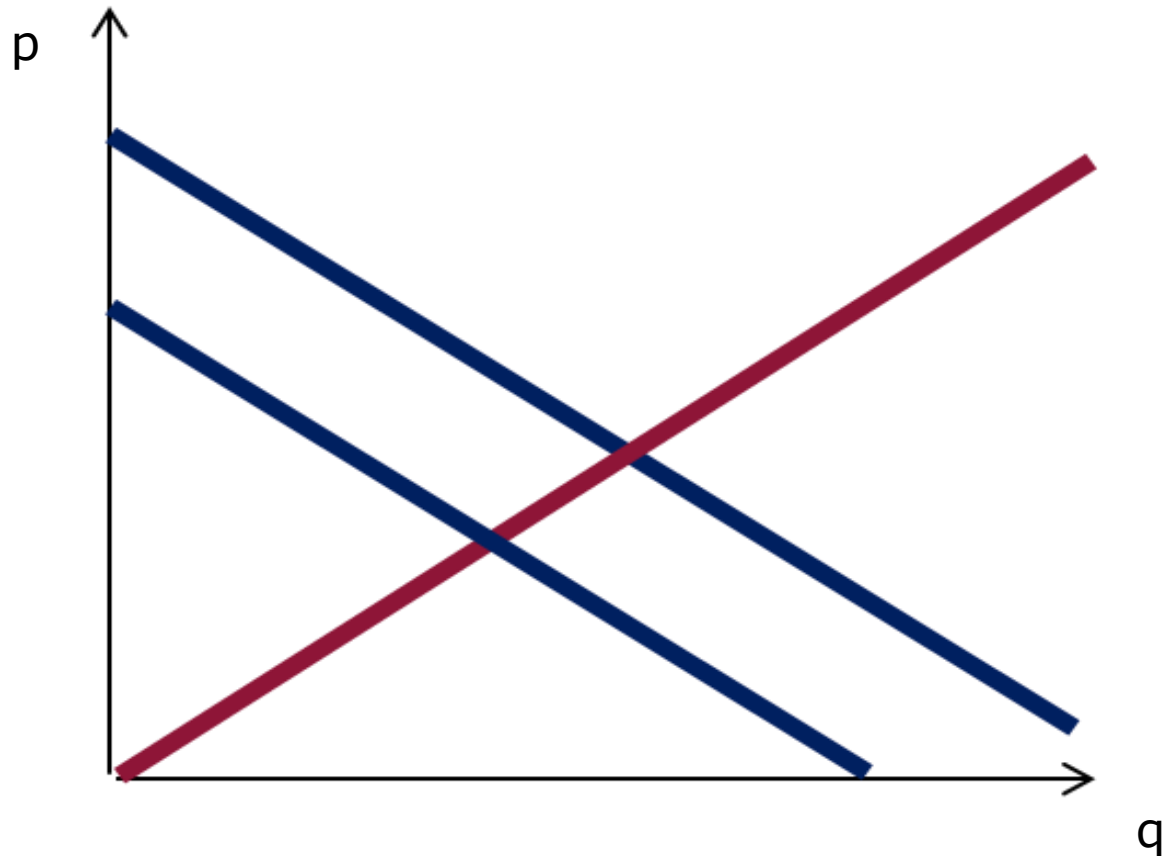


Natural experiments

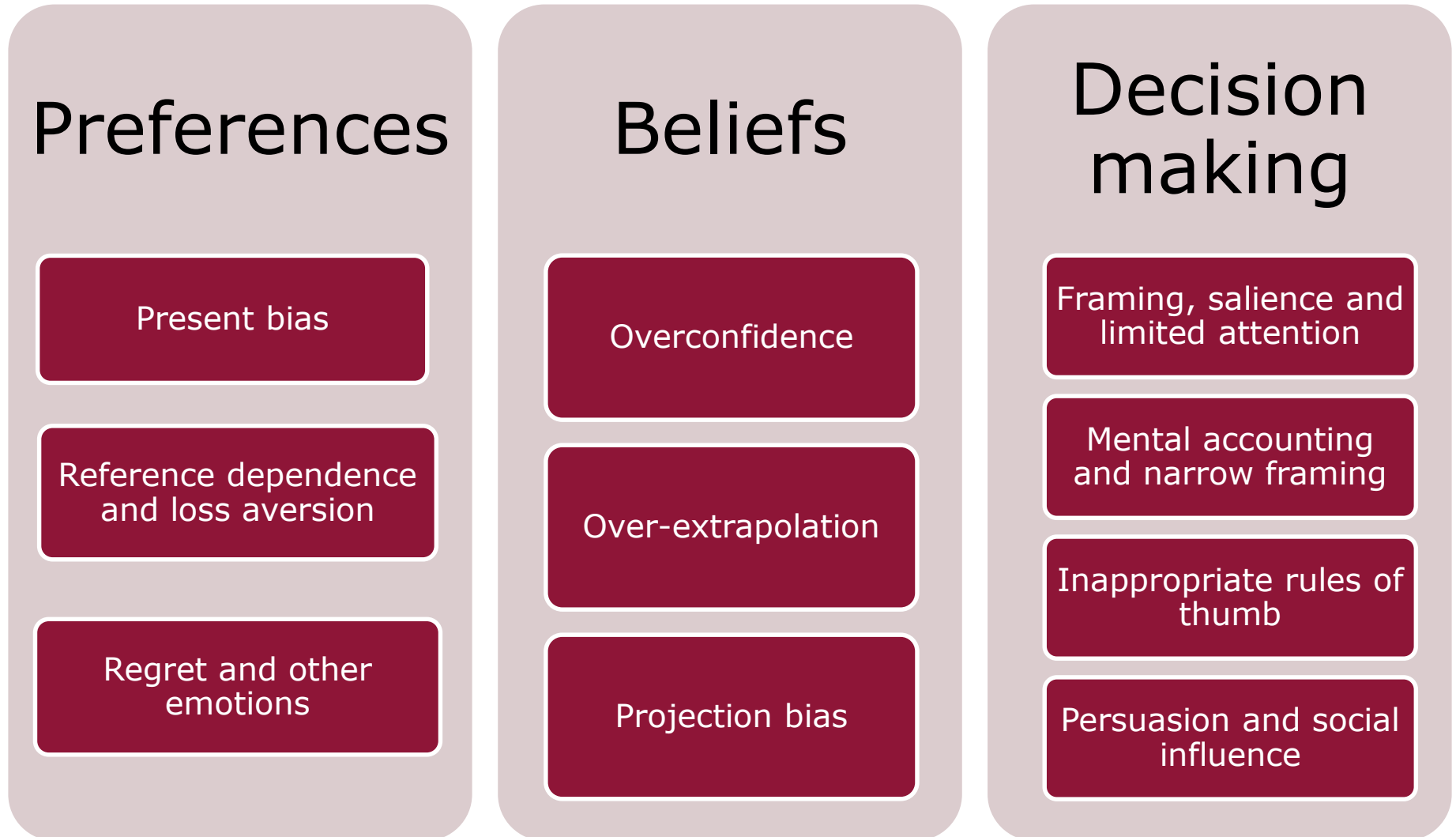


## **II. Applying behavioural economics: our framework**

# Behavioural economics helps us understand demand and supply



# Framework for biases





# Firms react to biases to maximise profit

The image shows a screenshot of a flight booking confirmation page with several callouts pointing to specific elements:

- Social norms and regret avoidance:** Points to the "IMPORTANT MESSAGE!" banner.
- Focus attention on negative outcome:** Points to the text "MANY PEOPLE DEEPLY REGRET NOT TAKING OUT TRAVEL INSURANCE!".
- Frames probability of claiming as large:** Points to the text "€2,223 WAS THE AVERAGE MEDICAL COSTS FOR RYANAIR INSURED PASSENGERS".
- Green button much more prominent:** Points to the "YES, PLEASE ADD COVER TO MY BOOKING" button.

The screenshot content includes:

- SMS Confirmation:** Select one of the following options. ( Click for information )
  - I wish to receive a text message confirming my reservation number and flight details.
  - I do not wish to receive text messages.Your mobile phone number will be used to send you text messages.
- Official Cabin:** Hard : ...ard S ...9.00 G
- Medical and Repatriation:** COVER INCLUDES (FROM JUST €7.10)
  - ✓ Medical and Repatriation ✓ Cance
  - (plus many other benefits designed to provide you with pe

# Firm responses to biases

Includes:

- Attractive headline prices with “shrouded” high extra charges
- ‘Teaser rates’ or ‘free trials’
- Add-on purchases included by default
- Complex price schemes
- Irrelevant bonuses or bundling

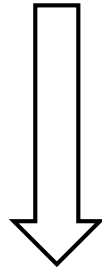
# Equilibrium: biases can impede effective competition

- *Sophisticated* consumers may not discipline firms
- Better products for less sophisticated consumers may not be profitable (e.g. mortgages and PPI)
- Biases can interact with other market failures (e.g. moral and behavioural hazard in health insurance)

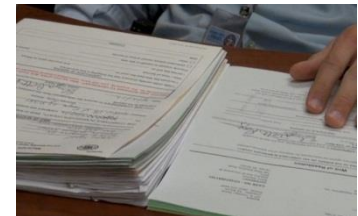
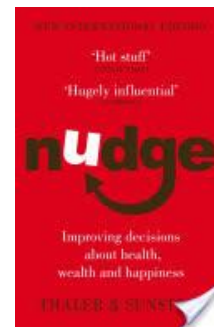
# Framework for Policy

1. Use theory and existing empirical evidence (to assess problems)
2. Develop empirical evidence (to diagnose)
3. Evaluate interventions (incl. CBA)

"Soft"



"Hard"



## III. Practical examples

- 1. Field trials**
- 2. Lab experiments**
- 3. Natural experiments**

# Field trials: compensation letters



Policy reference: [REDACTED]

- You bought [REDACTED] with [REDACTED] which you cancelled
- This letter contains important information, please read it carefully and respond if necessary

Dear [REDACTED]

In September 2010, you took advantage of our offer of [REDACTED] when you purchased our [REDACTED]. You cancelled the policy in February 2011 and the premium you were paying at the time was £3.99.

We are committed to the ongoing improvement of the products we offer and our service and we welcome all feedback from our customers. Therefore, we would like to know if you cancelled your policy because you were in any way dissatisfied with the product or the way it was sold to you. It may be that you are entitled to a refund.

## What you need to do

If you would like to discuss this with us please feel free to speak to one of our friendly team on [REDACTED] between 9am - 5.30pm, Monday to Friday or 9am - 1pm on Saturdays quoting your policy reference [REDACTED].

Yours sincerely,

Customer Services Team

Policy reference: [REDACTED]

- You could be entitled to a refund on the [REDACTED] you bought
- If you have any concerns about the product or how we sold it to you, please call [REDACTED]

Dear

In May 2011, you bought our [REDACTED], including our opening offer of [REDACTED]. You cancelled the policy in December 2011 and the premium you were paying at the time was £4.99.

We would like to know if you cancelled your policy because you were in any way dissatisfied with the product or the way it we sold it to you. If so, you could be entitled to a refund.

## What you need to do

If you have any concerns, please call us on [REDACTED] between 9am - 5.30pm, Monday to Friday or 9am - 1pm on Saturdays quoting your policy reference [REDACTED].

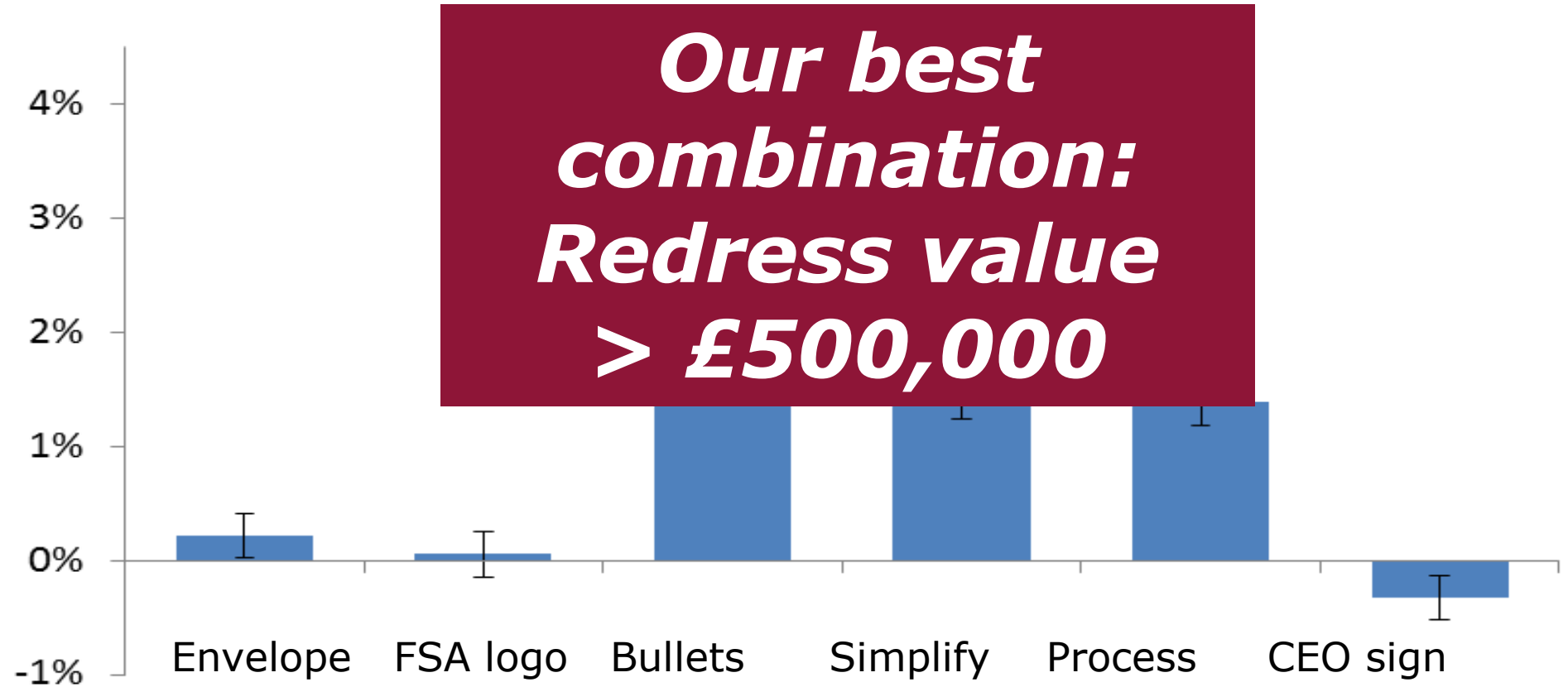
We will review your case on the telephone and you will know if you are due a refund within five minutes.

Yours sincerely,

[REDACTED]  
CEO 6

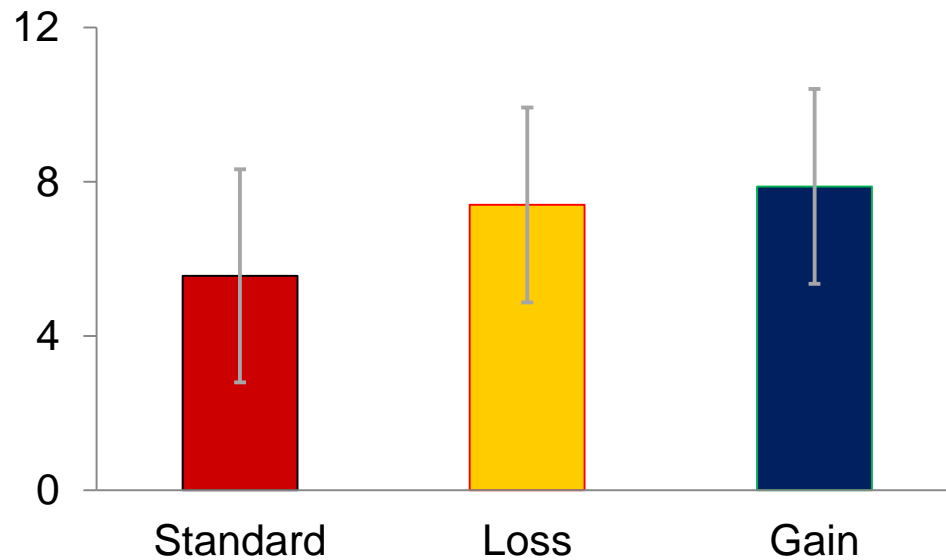
# Field trials: compensation letters

Base response rate = 1.5%



# Field trials: savings

Percentage point *increase* in external switching  
(from 40-70%)



- Primarily reminder effect
- Timing matters



# Lab trials: GI add-ons

- Add-on sales make it difficult for consumers to shop around, consider standalone alternatives, switch, understand products?
- Weaken competition and drive poor consumer outcomes?

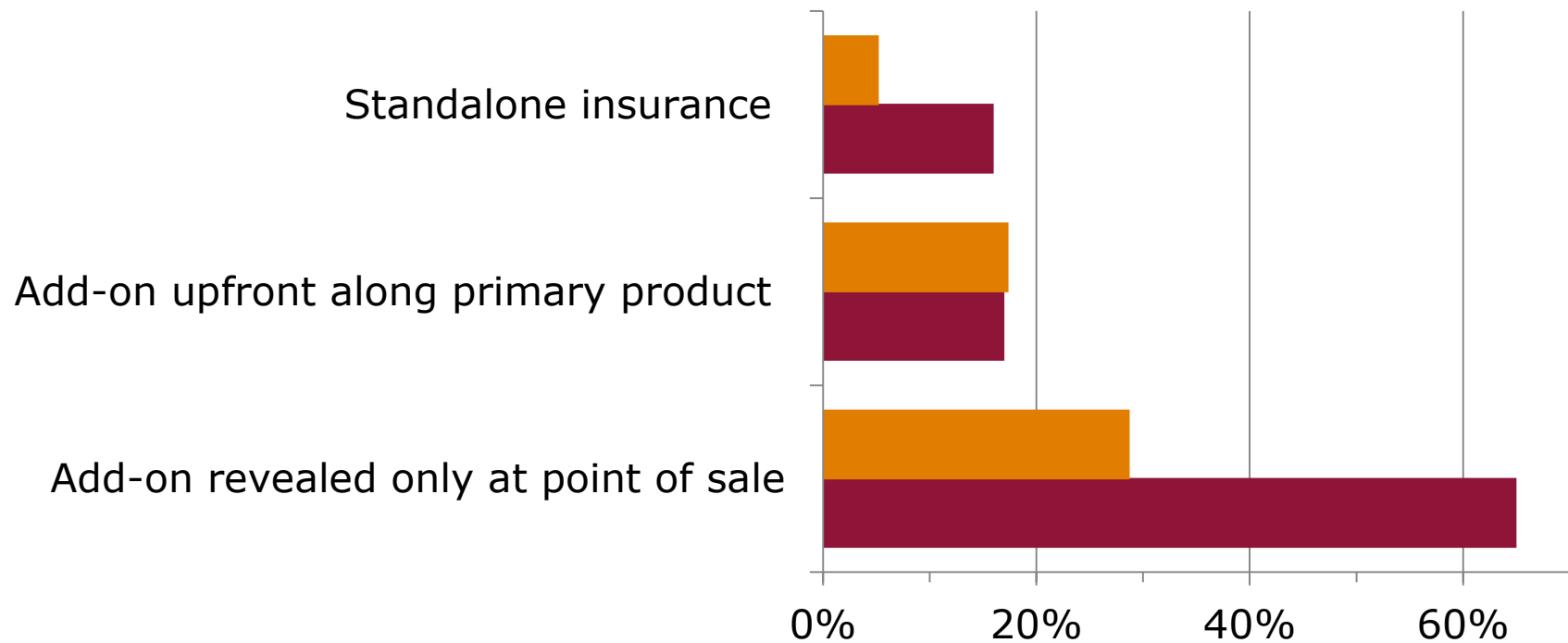
# Behavioural experiment

- Online environment mimicked key market features
- Varied price format and point at which add-ons introduced
- Identify effects on extent/effectiveness of shopping around and add-on take-up

# Add-on sales have powerful results

## Proportion who...

- ...did not identify best combination
- ...purchased first insurance offer



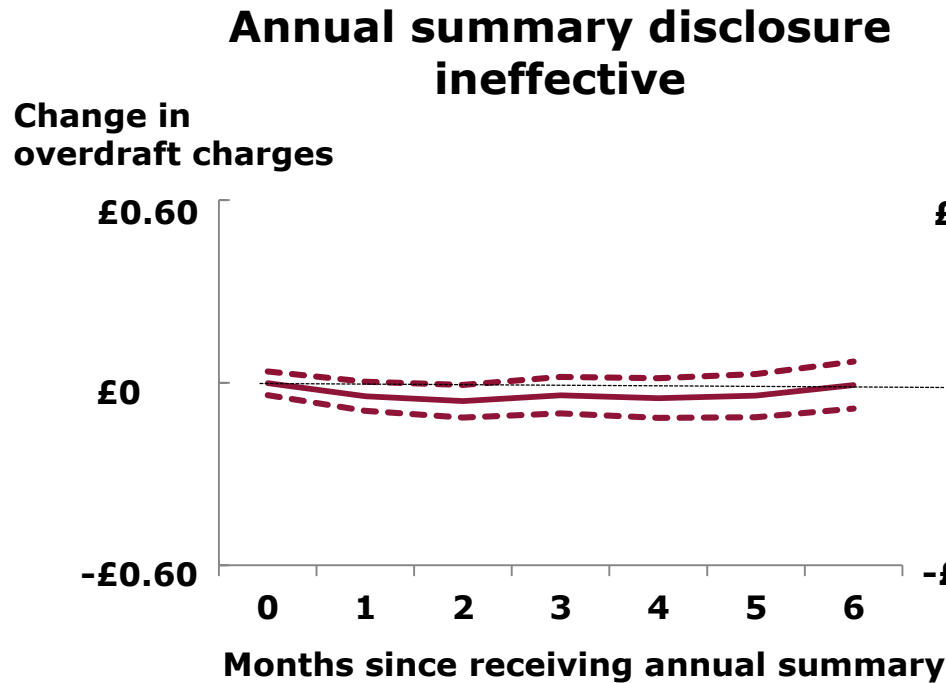
**...including on average prices paid**

Standalone: £72

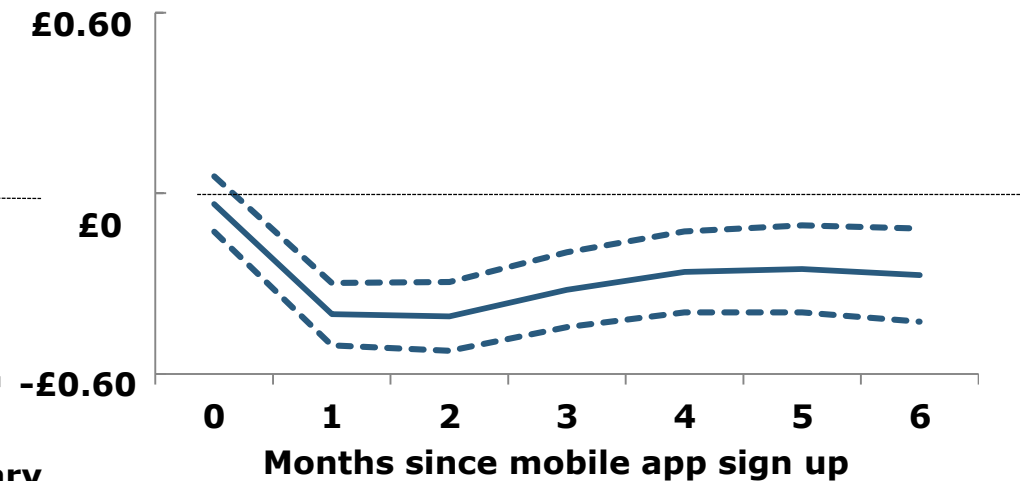
Both prices upfront: £89

Add-on price revealed only after main  
product selected: £102

# Natural experiment: personal current accounts



### Mobile banking apps effective - especially with SMS alerts



# Natural experiment: payday lending price cap

Parliament created duty to impose cap. Structure and level decided by FCA

## Questions:

1

What happens to firms and firms' lending decisions as a result of a price cap?

2

What options are there for consumers who no longer have access to payday loans?

3

Are these consumers better or worse off as a result of not getting payday loans?

# UK payday lending market

## **2012-13**

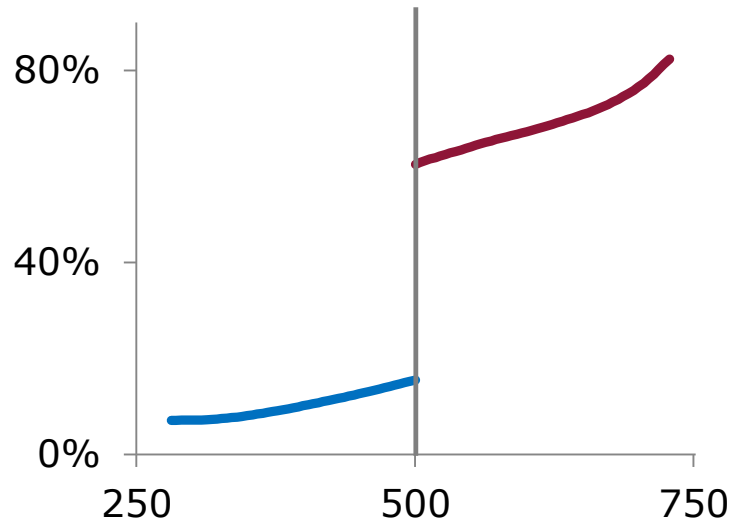
- £270 & 17 day
- Cost  $\sim 1.2\%$  per day (before cap)
- 4.6m applied for loan,  $\sim 10\%$  of adult population

# Regression discontinuity design

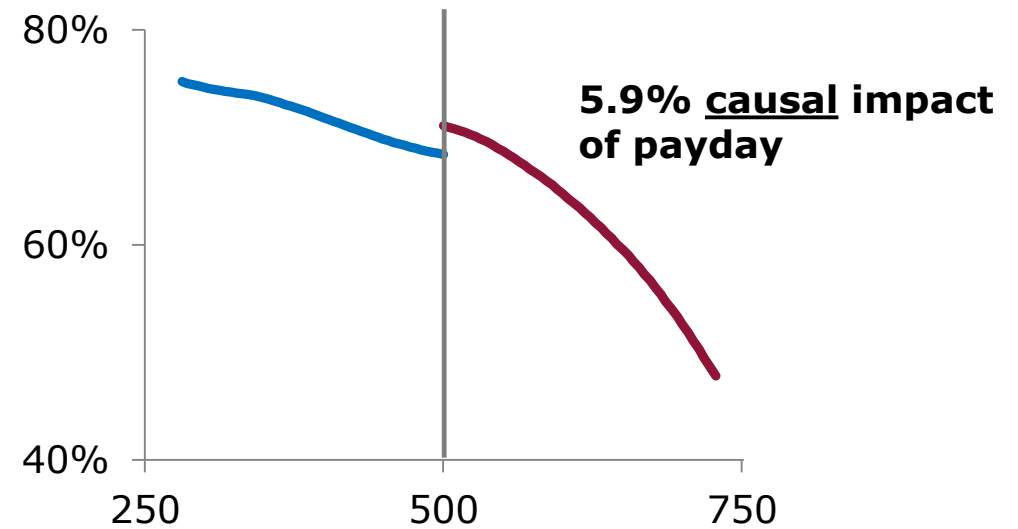
1<sup>st</sup> Stage:

2<sup>nd</sup> Stage:

Prob. getting  
payday loan



Prob. missing  
non-payday payment



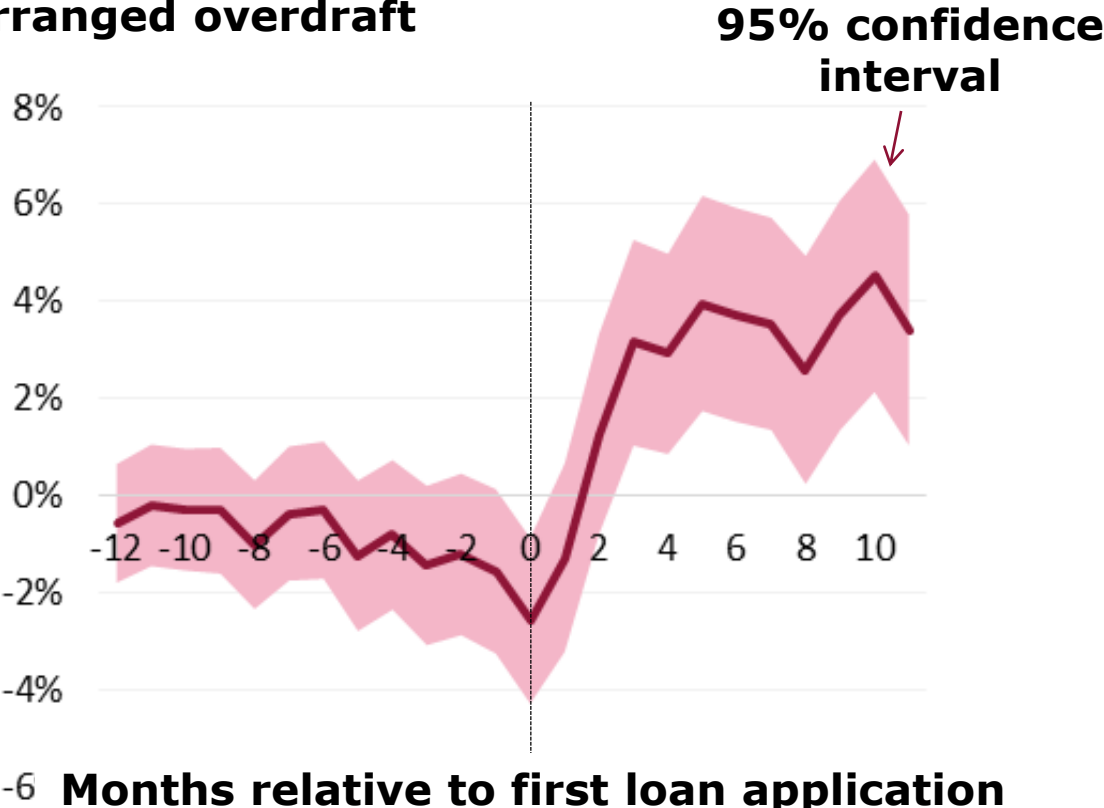
Internal Credit Score





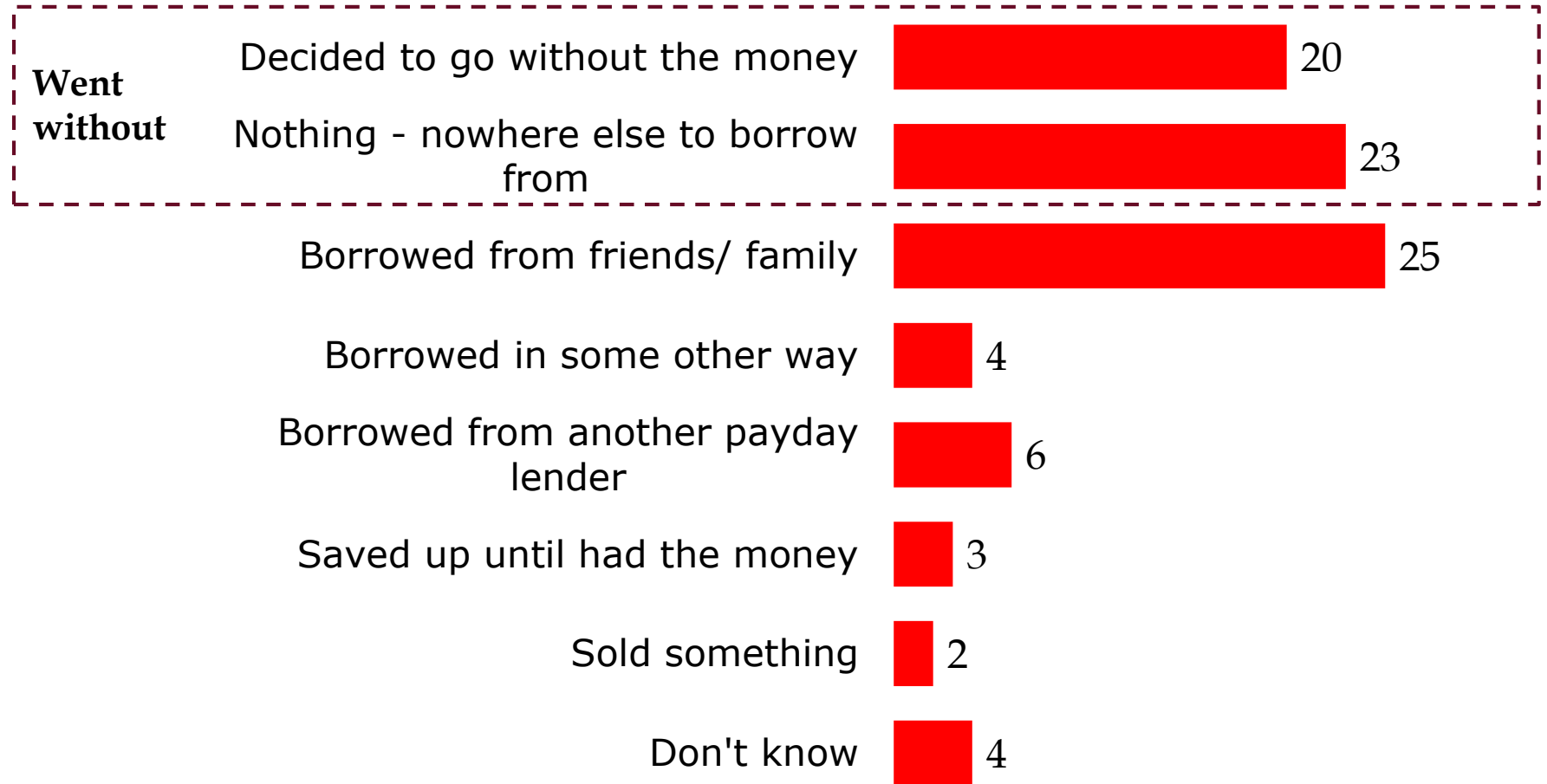
# Causal impact of payday loan use

**Change in likelihood of unarranged overdraft**



- Impacts other borrowing, missing payments, credit score...

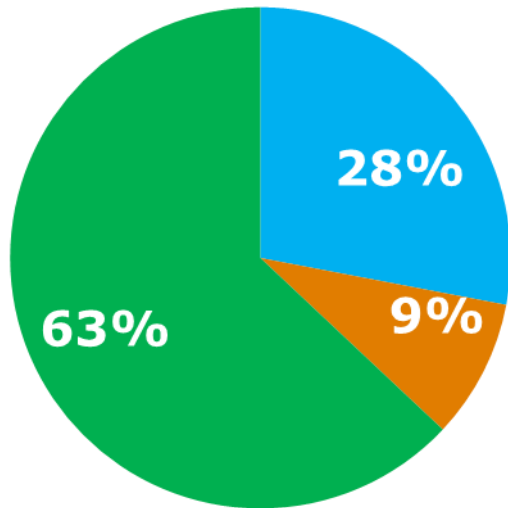
# If no payday loan... most do not borrow



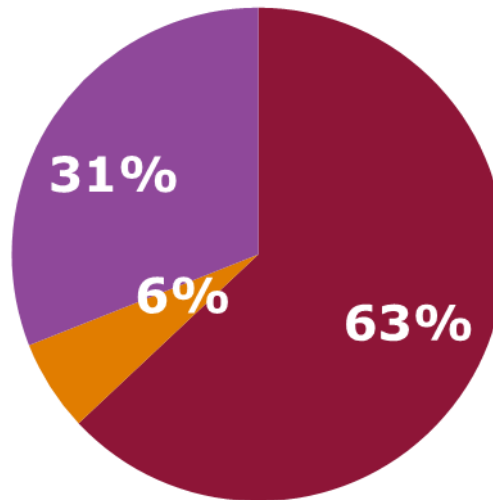
No increase in loan shark use, nor impact on subjective well-being or financial distress

# High regret (arguably)

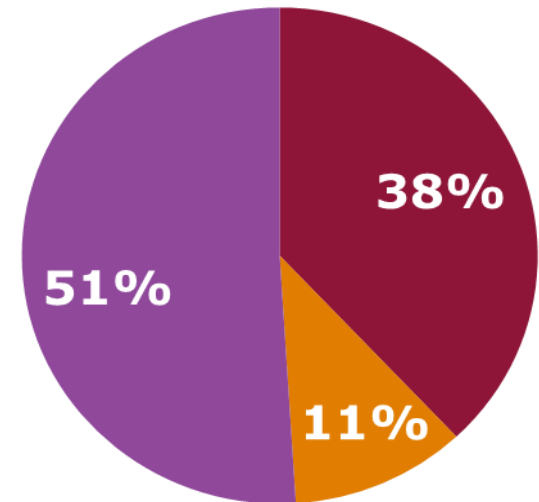
Without loans



With loans



Habitual borrowers  
(10+ loans in 2013)



- Better if application accepted
- Indifferent
- For the best application declined

- Happy with decision to borrow
- Indifferent
- Regret borrowing

# Our work since 2013

## Occasional Paper # / Title

#1 **Applying behavioural economics** at the FCA

#2 Encouraging consumers to claim **redress**

#3 How does selling **insurance as an add-on** affect consumer decisions

#7 Stimulating interest: **reminding savers** to act when rates decrease

#9 Two plus two makes five? Survey evidence that investors overvalue **structured deposits**

#10 The impact of annual summaries, text alerts and mobile apps on **consumer banking behaviour**

#12 Encouraging consumers to act at renewal: Evidence from field trials in **home and motor insurance**

**Pay day lending** price cap (CP14/10)

Does the framing of **retirement income** options matter?

## **IV. Where next?**

# Where are we at now?



## Quality assurance: standardising processes

- Honing ethics process
- Monitoring research execution
- Conducting detailed data analysis
- Incorporating incentives of firms



## Consolidating and building research network

- Accessing policy-relevant theory & methods
- Encompassing multiple disciplines
- Dealing with limited resource
- Creating shared incentives



## Sharing lessons

- Domestically: UKCN, CMA, BIT
- Internationally: CFPB, G20-OECD

# Way forward (1)



## Using behavioural insights:

- **Upstream policy design (diagnosis)**
- **Downstream policy design (remedies)**

# Way forward (2)

## Technical challenges:

- **Selecting optimal methods**
- **Using trials in cost-benefit analysis: considering external validity including equilibrium effects**
- **Modelling preferences and errors**
- **Incorporating cost of time or effort**
- **Tackling thorny issues, e.g. switching**



# Conclusions

- **Important to build consumer psychology into problem diagnosis and remedy design:** demand *and* supply
- **Good evidence important for major decisions** as do not know what will work, like firms. Data on real consumer behaviour, and field trials, particularly useful. Limited resource means judicious choices though
- **Failure of much mandated disclosure.** Possibly need to use nudges in addition, and maybe sometimes harder interventions
- **Encouraging switching is challenging,** but there is progress and many public bodies are facing the same issue