THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Research impact: making a difference

Motivating better consumer decisions through behavioural economics

LSE research contributed to a significant shift in the way the UK's financial regulator protects consumers and encourages better financial decisions

What was the problem?

According to mainstream economic theory, consumers make rational decisions as long as they have the necessary information.

The new field of behavioural economics has shown that, in practice, people's decisions can be greatly influenced by seemingly irrelevant aspects of their personalities and by the environment in which their decisions are made.

Economists have realised that this can have major implications for understanding how people make personal financial decisions such as taking out payment protection and mortgage insurance.

What did we do?

People buying financial services are particularly prone to cognitive biases – the human tendency to make systematic judgemental errors. These biases can be manipulated by astute sellers of financial services to induce the purchase of inappropriate products. Based on their earlier research, the Financial Services Authority (FSA), at the time the UK's main financial regulator, commissioned LSE professors of management David de Meza and Diane Reyniers and their then colleague Bernd Irlenbusch to devise and run an experiment to investigate the sources of payment protection insurance and mortgage protection insurance mis-selling.

The LSE report produced three core findings:

- Too much information can be harmful: providing information about an insurance policy's value for money and the seller's commission had little effect on the decision to buy insurance, even though buyers said they wanted that information. An excess of information has a tendency to hinder consumers in making good choices.
- Sellers have a major influence: consumers respond to high sales pressure, especially if they tend to have a high general level of trust in others. Egregious examples include the mis-selling of payment protection insurance (PPI) and mortgage protection insurance.
- Financial literacy has only minor impacts: financial behaviour is better explained by biases than by inadequate understanding.

The results of the experiment suggest that better financial education will do little to improve financial decision making, leading the FSA to commission a second paper to look into this question more explicitly. This concluded that problems are more to do with human nature than poor financial literacy.

The researchers suggested that financial regulation should focus more on measures that directly influence consumers' decisions and less on financial education and rules on information disclosure.

What happened?

Influenced by these findings, the Financial Services Authority made a decisive shift away from improving the information that financial firms must disclose and raising consumers' levels of financial literacy and towards using an understanding of consumer behaviour to influence the way that financial firms behave in the marketplace.

In an interview with The Financial Times, the Financial Services Authority's chief executive Martin Wheatley made it clear that, based on research into behavioural economics, the regulator no longer assumed that consumers were always rational.

Wheatley specifically highlighted payment protection insurance as an example of a scandal that might have been avoided if the insights of behavioural economics had been applied. He told the newspaper he would push firms to improve the way they designed and sold products to ensure that they were purchased by the customers for whom they were designed.

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In 2013 the Financial Conduct Authority (which had replaced the Financial Services Authority) banned independent financial advisers from receiving a commission on the sales of financial products. Such commission payments increased the risk that advisers would provide personalised recommendations that maximized their commissions as opposed to recommendations that best suited their clients' needs.

The Financial Services Authority indicated that its decision to move away from relying on information disclosure as its main tool for protecting consumers was influenced by the LSE research. The relevance and value of the research to the FSA's operations had become clear as the result of presentations and lengthy and frequent discussions between researchers and FSA staff over the course of the experiment and report writing.

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At Ofcom, the UK's communications regulator, the FSA experiment was included as part of an internal presentation on the role of experiments in formulating regulatory policy.

In addition, the researchers made presentations to the House of Lords and to various chambers of commerce, consumer protection conferences and party political conferences. These efforts contributed to a groundswell of interest in finding applications for behavioural economics within the realm of public policy. For example, the UK Government recently set up the Behavioural Insights Team, often called the 'Nudge Unit', to apply insights from academic research in behavioural economics and psychology to the development of public policy and services.

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