ASIC
Australian Securities & Investments Commission

ASIC and behavioural economics: Regulating for real people

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CHECK AGAINST DELIVERY

Thank you for inviting me to speak here today at the Queensland University Behavioural Economics Group (QuBE) symposium on the impacts of behavioural economics on financial markets and regulations.

As everyone here knows, the approach to understanding markets and regulation captured by the term 'behavioural economics' is increasingly an accepted part of the regulatory narrative. At ASIC, we believe that enhanced behavioural understanding can help us to significantly improve market and consumer outcomes.

Why behavioural economics

Why did ASIC look to behavioural economics to help us in our regulatory and policy work? In short, it started with a frustration with key elements of what we might call more 'traditional' approaches to retail financial market regulation, which involved a heavy reliance on the use of disclosure as a regulatory tool.

It has long been recognised that financial products and services have particular features that make consumer choices difficult, and these have tended to make the sector a particularly rich environment for behavioural biases to impact people's decisions.

Financial products and services:

- are inherently complex and often require consumers to make important decisions involving risk and uncertainty. Yet as the UK financial services regulator notes, people are generally bad (even terrible!) intuitive statisticians and so are prone to making systematic errors in these decisions
- represent extreme examples of 'credence goods', in that the quality may not been known for years or even decades after they are purchased
- can involve critical long-term promises to the purchaser (e.g. insurance or investments)
- include examples of products that are infrequently purchased and so provide limited opportunity for feedback and learning
- often involve significant sums of money.

At the same time, many financial services and products are essential for participation in the modern economy. Of course, this does not just involve those on higher incomes, and includes people experiencing financial or other disadvantage. So the vast majority of consumers in Australia have a bank account, superannuation is compulsory for those in the workforce, and most people have insurance for their cars, their homes or their lives.

It is for some of these reasons that certain financial institutions are subject to intensive prudential regulation. However, for most retail financial markets the regulatory regime in Australia had, until recently, has been based around disclosure, including for risky, complex products. I've summed this up before as 'anything goes, as long as you disclose'. Relying on disclosure in this way has also essentially meant that much of the responsibility for avoiding harm is placed with consumers themselves in the first instance.

The assumption in relying on disclosure, of course, stems from a particular approach in neoclassical economics. Individual consumers are assumed to be fully rational agents who make decisions relying on all the information available to maximise their outcomes. They use information optimally.

However, the experience in retail financial markets often did not play out in this manner. This was not just a question of a few people making poor choices, but persistent and systemic poor market outcomes in areas as diverse as financial planning, consumer credit insurance or investments in debentures.

What was the typical policy and regulatory response to these sub-optimal market outcomes? Well, given the assumption that consumers, and suppliers, are fundamentally rational, the inevitable response over many years was to tinker with disclosure. If consumers are experiencing problems, and market outcomes are poor, it must be because we haven't given them enough information or the right type of information. And yet even with our tinkering, in most cases problems persisted.

They say the definition of insanity is doing the same thing over and over again and expecting a different result. That's where we were in retail financial regulation. We were tinkering so much we risked going insane! We were wasting money and resources –

including the resources of industry participants, who were producing large amounts of disclosure documents – while failing to fix market problems.

Disclosure seemed to be the answer before the question had even been asked or the problem defined.

Now, it's important to note that disclosure remains a key component of any well-functioning market, particularly in financial services. However, it became clearer that too much weight was being put on formal disclosure requirements to fix any and every market problem.

The global financial crisis (GFC) was a particular catalyst to changing this approach. It became clear that we needed to think differently about the problems and the solutions in retail financial markets. And one of the tools that assisted this change in thinking was behavioural economics, as it helped to explain in a more useful way why some of our regulatory interventions were failing.

Don't misunderstand me, I don't want to suggest that behavioural economics has all the answers – it doesn't. However, behavioural economics helped us to understand the problem more effectively. And behavioural economics helped to underline that we needed a more diverse regulatory toolkit. In fact, you could say that it is now included as one of the tools in the toolkit.

I'd now like to run through some examples of how a more behaviourally informed approach to regulation has played out in practice in the financial services sector. I will start at the level of policy reform, then move to the particular actions taken by ASIC.

Broad policy reform

I will begin by noting that, just as marketers and advertisers have been tapping into the observed behaviour of consumers for years, often without a specific reliance on behavioural sciences, so too have some policy reforms reflected an understanding of problems that is far more consistent with the behavioural economics rationale than traditional economic assumptions.

Let me provide three examples, from big to small. Interestingly, each of these examples show that in developing a behaviourally informed understanding of the problem, the solution that behavioural economics itself suggests for achieving better outcomes for consumers may sometimes be a mandate or prohibition.

The first example of reform is compulsory superannuation. If consumers systematically made rational decisions in their long-term self-interest, then there would be no need to make super compulsory. But we have well-recognised biases against such long-term decision making (including present bias, overconfidence, imperfect self-control) and so compulsory super was implemented as a 'shove' rather than a 'nudge'.

The second is the prohibition against conflicted remuneration in the financial advice sector. For many, many years, the operating policy assumption was that simply disclosing

conflicts of interest would deal with any problems such conflicts may create, as consumers could then factor these conflicts into their decision making. In fact, the research shows that consumers may perversely trust the conflicted adviser more after such disclosure, or at least not know how to 'adjust' for it.

The third I'd like to mention is the recent reform in the credit space that prohibits unsolicited offers of increases in your credit card limit. Why would you do that? As we know, people consistently overestimate their ability to repay debts in the future, especially where the repayment has an element of discretion. This is why credit card issuers make unsolicited offers. They can catch people at financially vulnerable or aspirational moments, and harness their present bias and overconfidence.

Each of these policy interventions has in practice been behaviourally informed, even if they did not intentionally rely on the behavioural economics discipline. They have also set the scene for an increasing and deliberate integration of behavioural economics across the financial services sector.

Applying behavioural economics in ASIC

Turning now to ASIC. We set up a Behavioural Economics team in 2014. It sits in our Strategic Intelligence team and has staff with experience across economics, social and market research, communications, and consumer policy. The Behavioural Economics team is built on an existing legacy of qualitative and quantitative research by ASIC across topics as varied as cold-calling scams, shadow shopping of financial advice, building insurance and funeral funds.

We have taken a staged approach to applying behavioural economics across ASIC.

First, we are using behavioural economics to understand problems. Action bias can mean that our instinct – as regulators and policy makers – can be to race to a solution before assessing. Many experts and practitioners in behavioural sciences advise fighting this urge (in ourselves and others) and getting better at understanding the problem. An understanding of how people actually behave and make – and sometimes avoid – decisions or actions is essential to tailoring regulatory regimes.

We are also using behavioural economics to identify product architecture or sales methods that might harness or amplify biases and lead to poor consumer outcomes. We know that how information is framed can make a significant difference to how a consumer interprets and responds to it, as can the device on which they review that information. Timing matters. The messenger matters. Context matters.

We are also developing our own thinking about how behavioural economics can help us respond to problems. There is no doubt that it has provided us with new tools, with 'nudges' and defaults being two particularly prominent examples. However, when is a behavioural intervention, such as a nudge, the right response to a problem? When do we need to look to other tools in our regulatory toolkit? These are important questions, because a nudge is not a new panacea to all regulatory problems or consumer harms.

While ASIC is really just starting on its behavioural journey, I'd like to touch on some of our recent projects and trials:

- Particularly relevant, given they're our hosts today, we ran two behavioural laboratory experiments with QuBE in 2014. One looked at how biases affect an investor's decision to invest in hybrid securities and the other looked at how to improve compliance by directors of failed companies.

  The latter trial, run with our Insolvency Practitioner team, has actually led to ASIC reviewing a long-standing form filled out by directors when their business fails, taking into account the behavioural context in which people approach this task.
- We commissioned qualitative consumer research to understand the experience of consumers who bought add-on insurance products when buying a car through a dealership. This research, published earlier this year, showed how decision fatigue, information overload and price-framing contributed to consumers purchasing products that we have often found to be of low value or even negative value.
- We commissioned a review of behavioural literature and research about biases relevant to consumer decision making around financial advice. We are using this to better inform staff about the challenges for consumers seeking, getting and evaluating financial advice.
- We conducted our own review of the behavioural literature and research about biases relevant to consumer credit card decision making and behaviour. This has informed our submissions to the recent Parliamentary Inquiry into credit card interest rates, and was reflected in the remedies put forward by Treasury in response.
- We have also worked internally to encourage teams to integrate behavioural principles where applicable, particularly in the area of communication. We have developed a set of resources that can be used, for example, when teams are reviewing letters to consumers prepared by firms during refund or remediation processes, to try to improve consumer engagement and outcomes.
- We have also done exploratory qualitative testing of various forms of online disclosure (e.g. online superannuation 'dashboards' for Treasury and 'key fact statements' for investment products with industry partners).

This list demonstrates that a suite of quantitative and qualitative research methods can be applied – and indeed are needed – to understand problems, design well-targeted interventions and test them over time. And increasingly the behavioural field is drawing in social science experts beyond economics and psychology – for example, anthropologists and data scientists.

An essential part of the skill set that a modern behavioural regulator needs, therefore, is the ability to work out what sort of research is needed and is feasible to tackle a particular problem.

Lessons for a behavioural regulator

One of the key lessons that resonates with ASIC is from David Halpern, who set up the British 'Nudge Unit' within Downing Street and now runs the Behavioural Insights

Team. And that is to have *humility* – we won't always know in advance what interventions will work, and at times some policy actions may have perverse outcomes.

Also, regulators seeking to apply behavioural sciences need to be willing to test, learn and adapt interventions (policies, programs) iteratively, over time. On this point, I want to acknowledge that it is not always going to be possible or feasible to test every intervention or new policy in advance – so I think the challenge for regulators is to also get better at:

- prioritising where we should focus the limited resources we have for testing and trials
- monitoring or evaluating the ex-post effect of interventions and adjusting them according to observed behaviour and outcomes.

On prioritising, I suggest this means we need to go back to understanding the problem: developing an evidence base to decide where the greatest harm or risk exists or, to put it in a positive sense, where we can identify the greatest opportunity to improve consumer outcomes.

In developing this evidence base you need a broad range of people with a broad range of skills. Similar diversity is also needed in employing multiple research tools, including a range of qualitative and quantitative methods. For instance, being able to make use of representative statistical data to understand where there might be a problem and then being able to use qualitative methods to take a 'deeper dive' and understand *why* we are seeing these problems.

It may be a surprise to some that regulators don't always have access to data sets that people assume we do, and our resources may sometimes constrain the extent to which we can carry out in-depth qualitative research. However, we can only continue to search for and make use of these tools when we have an evidence base to support the regulatory narrative.

Future opportunities

We believe that there are many opportunities for regulators to apply behavioural economics and insights from behavioural sciences.

On the demand side, one particularly interesting area is the emerging literature and research about how consumers behave in the digital environment.

Some early findings include that:

- *some biases appear to be amplified on screen* – we process on-screen information at faster speeds and the faster we think, the more likely it is that visual biases will affect our decisions. Seemingly minor design and timing details can make a big difference to our level of attention, and what we take in
- *different devices may have different effects* – we don't process information at the same pace on mobile phones as we do on larger devices. In one study, people did worse on financial literacy tests on smaller screens than on larger ones

- *screens feel more anonymous* – people may be happier to give private information and admit to mistakes or socially undesirable behaviour on screens than on paper (they also order and eat more food when ordering from a screen!).

There is also some compelling work on scarcity and hardship. Academic Eldar Shafir and his team have established solid evidence that poverty itself has cognitive costs that can compound the cycle of disadvantage – for example, asking people to fill out complex forms and convoluted application processes can be a fast track to poorer outcomes and thwart people's ability to build resilience and get back on track.

It's therefore opportune to remember that Australian consumers are consistently being asked to make informed, smart decisions in increasingly complex environments in relation to financial services, energy providers and energy use, heath, health insurance, aged care, education … the list goes on.

This means that as regulators we are also competing to engage consumers and their finite attentional resources, and we need to keep this in mind. Richard Thaler, co-author of *Nudge*, has said that one of his two mantras in 'selling' behavioural approaches to governments was that 'if you want to encourage someone to do something, make it easy'. (The other one, for the record, is 'we can't do evidence-based policy without evidence'.)

My final message would be to create networks and collaborate broadly with academics, practitioners, other regulators and end users. We need to share results and lessons – both successes and failures, as they are all lessons – and work together.