# Behavioural insights for conduct supervision

Introductory Remarks by Luigi Federico Signorini
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It is my great pleasure to open the International Seminar on Financial Consumer Protection, jointly organized by Finconet and the Bank of Italy.

The theme of this seminar is the subject of much discussion and a driving force in the evolution of business conduct regulation and supervision. Behavioural economics has provided important insights. We would be well advised to take them into account when framing regulations and performing supervisory tasks in the financial sector.

Understanding how people make economic choices is central to economics. Economic models, however, will never be able to do justice to the full range of motivations, reasoning and impulses behind human behaviour. Economics needs to simplify and select. At the same time, it needs to remain open-minded enough to see the pitfalls of simplifying assumptions. Economic models have always been challenged over time, with new approaches subverting the conventional wisdom of the day; as in all sound science, progress in economics has been driven by people challenging received wisdom, pointing out its flaws, and proposing corrections. Yet it has always retained the basic concept that agents will respond to incentives and that in most circumstances the collective wisdom resulting from innumerable fallible individual choices is superior to comprehensive top-down planning, enlightened as the latter may be. Adam Smith did not have to invoke utility maximisation to conceive of the invisible hand, nor did Ricardo to discover comparative advantage: two of the most counterintuitive, and most enduring, cornerstones of economics. Ronald Coase famously stated that "there is no reason to suppose that most human beings are engaged in maximising anything unless it be unhappiness, and even this with incomplete success"; yet this (half tongue-in-cheek) assertion did not prevent him from formulating a theorem about the superiority of private contracts even with externalities, provided property rights are carefully laid down.[1]

[1] Actually, as is well known, Coase did not formulate a "Coase theorem", but he did lay down the theoretical foundations to what is known by that name.

Contemporary mainstream economics makes abundant use of formal models that specify what precise quantity is being maximised, and assume that agents make efficient use of whatever information is available. While such assumptions are extremely useful for developing insights into how the world actually functions, nobody believes them literally. "Utility" for instance, (sane) economists will accept, has no well-defined physical counterpart. This means that, while recognising the usefulness of this or that formal model in many cases, one should remain alert to its limits.

Consumer behaviour is a case in point. Utility maximisation by consumers has proved to be a fantastic tool for developing compact, elegant models to describe many interesting and crucial features of the real economy. Yet it cannot provide all the answers, especially when you look at consumers' choices in a concrete environment and reflect upon the best ways to regulate market conduct in legal detail. Converting a useful simplifying modelling device into an article of faith about how the human mind works would be nonsense. One does not need to throw away a century of economic thought to recognise that human behaviour is much subtler and more elusive than that; one needs only some reasonable human heuristics, as it were, and the ability to adapt one's tools to the task at hand.

Nevertheless, it took a while for economists to recognise in full that actual consumer decision-making is rather different from what is expected from a rational agent who single-mindedly maximises a utility function – a major exception being the studies on bounded rationality.[2] By contrast, marketing experts developed an understanding early on of how buyers actually make decisions, and found ways to profit from it. Regulators that fail to recognise this asymmetry, and act upon it, would not do a good job.

This is not a theoretical point, and the audience today will need no convincing. There is even a plausible claim that the delay in tackling certain financial consumer protection issues contributed to the financial crisis ten years ago.[3] Be that as it may, the day-to-day task of ensuring the fair and efficient functioning of the market for consumer finance requires a richer model of consumer behaviour than one based on "utility" maximisation and the full use of information. Hence, the increasing attention now devoted to behavioural economics by financial regulators and supervisors, with the aim of designing and implementing policies that help consumers take financial decisions they will not regret.

This seminar will benefit from contributions from the academy and from supervisors. The Bank of Italy strongly supports this interaction.

Before leaving the floor to our speakers, let me briefly recall some well-known insights from behavioural economics that have been significant in the evolution of regulation in the field of financial consumer protection, and provide a quick overview of the approach to financial consumer protection adopted by the Bank of Italy.

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[2] Simon, H.A., "Models of Man, Social and Rational: Mathematical Essays on Rational Human Behavior in a Social Setting", New York: Wiley & Sons, 1957.

[3] G20 High-Level Principles on Financial Consumer Protection, October 2011 (www.oecd.org).

Behavioural economics relies heavily on the seminal studies by Daniel Kahneman and Amos Tversky,[4] two psychologists, one of whom (Kahneman) got a Nobel Prize in economics for it (Tversky, sadly, did not live to get the share he deserved). This is, by the way, not an isolated case; it bears witness to the fact that the economics profession, in its best moments, is open to contributions from other disciplines to refine its understanding of human behaviour and interactions.

Behavioural economics has provided evidence that, when taking decisions, people regularly deviate from certain accepted canons of rationality, as intuition often prevails over reasoning.[5] Such deviations are not random. Laboratory experiments, though mostly confined to simulated environments, do provide rather convincing evidence that biases affect the decisions of consumers in a systematic way.

For financial services providers, knowledge of this can make competing on quality and prices less attractive relative to leveraging on these biases in their marketing activity using opportunistic business practices.

The list of biases is an evolving one; here, I will only mention a few of those that are most relevant from a financial consumer protection perspective and represent a common background for business conduct supervisors. They include:

*I)* mental shortcuts used to generate approximate answers to questions (*heuristics*);

*II)* the influence of the way information is presented on the way decisions are taken (*framing effect*)

*III)* the fact that outcomes are usually assessed against a reference point (*reference dependence/anchoring effect*), implying that different reference points affect the perception of gains and losses;

*IV)* a preference for immediate gratification, resulting in decisions that do not maximise long-term net effects (*present bias*) – e.g. people overestimate their ability to repay loans, resulting in over-indebtedness;

*V)* the fact that people often demand much more to give up an object than they would be willing to pay for it (*endowment effect*); this helps explain, e.g., why switching rates among products from different financial services providers are low even when there are no legal obstacles to or monetary costs in doing so.

While biases are deeply embedded in the human mind, they have not prevented humans from becoming (for better or for worse) the dominant species on Earth. In fact, in many circumstances, biases and mental shortcuts will "do the trick" and help us to

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4 D. Kahneman and A. Tversky. "Prospect Theory: An Analysis of Decision under Risk." *Econometrica*, vol. 47, no. 2, 1979, pp. 263–291.

5 Kahneman, D., "Thinking, Fast and Slow", New York: Farrar, Straus, and Giroux, 2011; Kahneman, D. "Maps of Bounded Rationality: Psychology for Behavioral Economics." *The American Economic Review*, vol. 93, no. 5, 2003, pp. 1449–1475.

take decisions instantly and without effort that we would not later regret, by and large.[6] However, the jungle of finance is in many ways different from the environment where humans have evolved over hundreds of thousands of years. When it comes to financial decisions, mental shortcuts that were efficient for escaping lions or capturing gazelles may prove inadequate to make (say) choices on long-term financial retirement plans. They may prompt consumers to take decisions that they would not have taken based on a more thorough assessment.

The evidence from behavioural economics should be enough to convince regulators and supervisors that it is crucial to complement the traditional regulatory approach – based on pre-contractual disclosure to overcome information asymmetries – with behavioural insights. Policy makers have started testing new instruments, examples of which include:

*I)* standardising pre-contractual documents, so that they selectively provide (or highlight) only those pieces of information that are most relevant to the consumer;

*II)* prescribing the use of the most effective channels for interacting with customers: for instance, evidence exists that text alerts and mobile banking apps are much more effective than periodic reports for attracting the attention of consumers that are incurring overdraft charges;[7]

*III)* focusing on the overall fairness of contractual relationships, e.g. in order to limit any over-indebtedness induced by *present bias*;

*IV)* establishing cooling-off periods, i.e. the possibility for consumers to withdraw from contracts, especially in the event of cross-selling practices and distance selling (thus neutralising possible temporary emotional effects), to allow for legitimate and sufficiently timely regret.

All these tools are mainly intended to remove information and cognitive asymmetries, and their undesired consequences for the proper functioning of financial consumer markets. In this sense, one could say that they do not depart from the traditional paradigm, whereby the individual’s choices should not ultimately be replaced or unduly influenced by those of the regulator. The aim is to *supply* consumers with the necessary tools to make informed judgments, rather than to *supplant* their ability to decide for themselves.

Some go further. Proponents of *libertarian paternalism* maintain that regulators, while still refraining from direct coercion, should endeavour to influence the choices of

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6 In a sense, it has been argued that *sentiments* and *intuition*, rather than reasoning, have provided the most enduring tool for decision-making in the history of humankind; see Harari, Y.N. “Homo Deus: A Brief History of Tomorrow”, London: Harvill Secker, 2016.

7 FCA, Occasional Paper No. 10, “Message received? The impact of annual summaries, text alerts and mobile apps on consumer banking behaviour”, available on the FCA website (www.fca.org.uk).

affected parties in a way that is expected to make them better off[8] – an approach also commonly referred to as *nudging*.[9]

This view also provides a strong argument (not the only possible one) for regulators to exploit the alternative between the "opt-in" and "opt-out" approaches for financial schemes; when the regulator considers one alternative to be in the best interests of consumers, it can "nudge" them in that direction by making it the default (or "inertial") choice. The opt-out approach has proved to be quite effective in promoting participation in pension schemes, for example, where it is seen as an effective tool against "present bias".

How far one would go along this road will ultimately depend on one's view of society. Some would balk at the idea of treating citizens as perennial minors, to be gently prodded, or "nudged", by a benevolent regulator, to do whatever the regulator considers to be in the consumer's own best interest. Yet even if one thinks that the individual must remain ultimately responsible for his or her own choices, the insights of behavioural economics remain central for framing those choices in a way that is consistent with known cognitive bias, so as to empower the consumer to make such choices in full awareness.

Whatever your approach, the landscape is evolving rapidly. A growing body of experimental research is developing on the effectiveness of regulatory initiatives based on behavioural insights. At the frontier, a series of studies is flourishing on the physiological reaction of financial consumers to external stimulus (*neurofinance*). What will come out of that, and what one is to do with whatever the results might be, must be the subject of future reflection.

For the framework of consumer protection to be effective, it needs more than regulation alone. It must be complemented with supervision, enforcement, and financial education. Let me elaborate briefly on the approach of the Bank of Italy.

Based on the understanding that too much information is as potentially harmful as too little information, and that such "information overload" can lead consumers to take financial decisions that they will consider inappropriate in retrospect, the traditional regulatory approach based on a *full disclosure regime* has evolved. Reflecting changes in the EU legal framework too, regulation of the most common products now provides for standardised pre-contractual information that makes key information adequately salient. The regulator plays a delicate role in selecting the most relevant information, based for instance on the size of the revenues from certain fees and tariffs, and finding ways to increase its visibility. One application of this concept is to require banks to disclose standardised cost indicators for the simplest forms of bank accounts and the most common types of consumer loans.

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8 Thaler, R.H. and Sunstein, C.R., "Libertarian Paternalism." *The American Economic Review*, vol. 93, 2003, pp. 175-179.

9 Thaler, R.H. and Sunstein, C.R., "Nudge: Improving Decisions about Health, Wealth and Happiness." New Haven and London: Yale University Press, 2008.

Again on the regulatory side, recognising that biases are always in action, and that financial services providers – including banks – may actively seek to exploit them, has led us to introduce – in compliance with the applicable EU legislation – certain business conduct requirements, aimed at increasing the overall fairness of contractual relationships. We abstain, however, from interfering directly with individual decisions of consumers or firms. A few examples of such requirements are:

*I)* provisions concerning the assessment of creditworthiness, to address over-indebtedness;

*II)* product governance requirements, concerning the design of new products, consumer-testing activities, as well as distribution;

*III)* sound remuneration policies for sales staff, to mitigate the risk of perverse incentives for misleading the consumer.

As regards supervision, since the establishment of a dedicated Directorate in 2014, the Bank of Italy has been moving steadily from the assumption that more information is always better to a focus on salience as opposed to sheer quantity; from mere disclosure to a broader range of issues (including governance and strategy); and from a box-ticking approach to an approach that includes cooperation and guidance.

We have thus complemented our supervisory action by issuing Guidelines to clarify supervisory expectations. This approach has proved to be fruitful in addressing issues that are highly significant for consumer protection, such as the remuneration of overdrafts and overrunning, the unilateral variation of contracts, the handling of complaints, and the conditions for consumer credit.

For enforcement, we start from the assumption that customers harmed by unfair business conduct and non-compliance with regulatory requirements should be in a position to seek redress in a way that is simple, fast, and inexpensive. To this end, in 2009, the Bank of Italy established an alternative dispute resolution mechanism for the banking sector (the *Arbitro Bancario Finanziario* or ABF), which has proved to be effective, has become increasingly popular with customers, and has somehow become a benchmark for other regulated sectors. While the ABF's decisions are not binding, "naming and shaming" is applicable in the event of non-compliance and has proven an effective deterrent. Furthermore, as financial services providers are required to take the ABF's decisions into account when dealing with complaints from their customers, this enforcement system contributes to increasing the overall fairness of contractual relationships in the banking sector.

Finally, a few remarks on financial education. While regulation and supervision may help to address *indirectly* some of the major flaws in consumers' choices, there is broad consensus that the empowerment of consumers also requires strategies aimed at increasing their basic financial knowledge.

Nowadays people are probably facing increasingly complex financial decisions more often than at any other point in humankind's history. Ageing and the evolution

of welfare imply an enhanced role for life insurance and private pension schemes. The increased range of financial investment choices provides better potential opportunities, but may appear baffling to non-experts. Technological development in payments are transforming, beyond recognition, the way we conduct even the most common transactions. Individuals need to take financial decisions throughout their life, including decisions inherently involving long-term outcomes that are very difficult to predict and assess (e.g., investing early for one's retirement), which are exactly those where the usual mental shortcuts are most likely to fail.

Neither pre-contractual information, nor business conduct requirements will provide the desired policy outcomes if people are not able to grasp at least the fundamentals of finance. International evidence shows that this ability, while perhaps generally unsatisfactory, is even less developed in Italy than in many other countries. This is why the Bank of Italy has devoted a great deal of effort to designing and implementing financial literacy programs. These strive to take into account behavioural biases and to make consumers aware of how they influence their decisions.

The Bank also supported the establishment of a National Committee in charge of steering and coordinating financial education initiatives, where we cooperate with many other public and private institutions providing financial education schemes.

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Effective business conduct supervision is challenging. Insights from behavioural economics contribute to its theoretical foundations, and provide useful suggestions for improving the regulatory and supervisory framework. The lessons we are going to learn today will be of great help in shaping our financial control architecture to make it more effective and to contribute to a financial system that is fairer, sounder, and safer for consumers.

I wish you all a fruitful discussion and a pleasant stay in Rome. Thank you!