

ETHICAL MARKETING

BEHAVIOURAL ECONOMICS AND COGNITIVE BIAS

BY PETER BUROW AND MYKOLAS BYRNE

With the ethics and conduct of the Australian financial planning sector actively under review, many consumers are now questioning the integrity of financial institutions in general. Financial regulators are also now searching for more rigorous frameworks to define ethical practice. In this article, we review the emerging evidence that behavioural economics can help define a balanced view of what constitutes ethical practice in the development and marketing of financial products, grounded in a more informed understanding of the consumer brain.

THE RISE OF ETHICAL MARKETING

As consumers of financial products, we may like to think that we make decisions rationally most of the time. Sadly, however, evidence from psychological and neuroscientific research demonstrates that this is not the case. Instead, inherent biases in our decision-making can lead to consistently poor choices with far-reaching consequences for the consumer and their financial position.

The field of behavioural economics has been around since the early 1980s but has increased in profile since the global financial crisis, when many financial institutions came under the spotlight for employing questionable sales tactics; the high prevalence of consumers making misguided financial decisions (leading to dire individual and systemic outcomes) became a burning discussion topic around the world. At around the same time, neuroscientists were discovering more about the important role that cognitive bias plays in our decision-making.

In this paper we examine:

- The rise of ethical marketing,
- How it draws on the insights of behavioural economics,
- Its potential for helping us understand consumer buying decisions,
- Its present influence and application around the globe, and
- Its potential impact in Australia.

WHAT IS BEHAVIOURAL ECONOMICS?

'Behavioural economics takes us beyond intuition and helps us be precise in detecting, understanding, and remedying problems that arise from consumer mistakes.'

- Erta, Hunt, Iscenko & Brambley (2013),
UK Financial Conduct Authority (FCA)

It is common for consumers of financial products to make decisions that may not be within their best

interests. Yet being able to quantify consumer mistakes has traditionally been problematic. Why do we want to quantify them?

Findings from neuroscience have helped explain why we think and behave the way we do. They have shown, for example, that when making many decisions human beings consistently rely on intuitive, automatic decision-making rules grounded in emotion rather than 'spend the brainpower' on engaging in rational, deliberate thought. Moreover, emotions have been shown to be central to the decision-making process even when we have all the facts and data at hand to make so called 'rational' decisions.

Much of the time, these thought processes take place without significant consequences. Indeed, the many hundreds of 'emotional decisions' we each make are what help us get through life. But what happens when we are faced with important decisions, either private or professional? At these times, especially when we are under pressure (be it from time, a salesman, or financial pressure), the 'cognitive bias' that drives our automatic, emotional responses may lead us to misjudge situations, make mistakes or choose to venture down a path with unwanted outcomes.

Behavioural economics applies this insight to try and understand the financial decisions consumers make. Because the human brain relies on heuristics (experience-based rules) to enable effective real-time decision-making, all purchases we make are subject to bias in one form or another.

The purpose of behavioural economics is to better understand the biases affecting consumers' buying choices, to identify why mistakes are made and to help solve the problems presented by poor choices.

Essentially it seeks to answer these two key questions:

1. Why do so many consumers make 'sub-optimal' decisions when selecting financial products?
2. Why do they sometimes choose products that do not deliver what they are seeking over products that are better suited to their needs?

HOW VALID ARE THE THEORIES?

The work of Nobel prize-winning psychologist Daniel Kahneman and an army of renowned economists provides the basis for the theories of behavioural economics. These were first developed in the early

1980s and, since then, the field of neuroscience has added much to this body of knowledge.

Economists and psychologists have been working together to establish well-documented, independently-reviewed approaches and replicated insights that are relevant to the finance industry.

An important factor to bear in mind here is that, to a behavioural economist at least, not all cognitive bias is bad. Each of us regularly makes good decisions based on emotional or automatic judgements - and at least as often as bad ones. Moreover, in many circumstances throughout our lives, the more emotional a decision is, the more strongly an individual will defend it (and many will - and have - argued that it is the consumer's right to make bad decisions that satisfy them).

Despite this, however, the emerging evidence is clear that biases in decision-making, when intentionally or even accidentally exploited, lead to consistently bad decisions by consumers that tip the playing field well into the seller's advantage with little benefit to the purchaser.

To a behavioural economist, a key question therefore has to be asked: where do we draw the line between effective marketing and 'unfair', or 'unethical' manipulation of consumer decision-making biases?

WHAT IS THE SIGNIFICANCE OF BEHAVIOURAL ECONOMICS TO FINANCIAL MARKET REGULATORS?

Some financial institutions have been accused of attempting to exploit the way people make decisions by appealing to their biases primarily by presenting financial products in a way that knowingly leads consumers to a choice that leaves them worse off (than if they had chosen an alternative or competing product).

For this reason, behavioural economics has caught the eye of financial regulators around the world; it seeks to 'demystify' the often deliberately complex presentations of financial products and services that can lead to irrational choices being made (even by so-called 'sophisticated' decision-makers).

The insights from behavioural economics have the potential to help regulators investigate the biases that affect consumers' financial decisions and to test the need for more market regulation to protect them. The integration of behavioural economics into financial regulation paradigms began building momentum in

Scandinavia eight years ago. Since then, it has been the focus of intensive research in the US and has become central to the Financial Conduct Authority's (FCA) strategy in the UK, driving the development of both policies and methodologies to assess biases and regulate their impacts.

As the CEO of the FCA, Martin Wheatley, commented:

'I believe that using insights from behavioural economics, together with more traditional analysis of competition and market failures, can help the FCA assess problems in financial markets better, choose more appropriate remedies and be a more effective regulator as a result.'

The concern for regulators is that market forces alone will not provide the necessary 'checks and balances' to keep the potential for poor decision-making about financial products under control. Unscrupulous financial institutions have profited in the past from the fact that their products are either poorly understood in the first place or have been deliberately designed to appeal to the emotional 'triggers' of potential customers, thereby manipulating the decision-making process in their favour.

WHY IS COGNITIVE BIAS MORE OF A PROBLEM IN FINANCIAL SERVICES THAN OTHER INDUSTRIES?

FCA have identified a number of reasons why consumer choice in retail financial products and services is particularly susceptible to misjudgement in comparison to other retail products and services:

- **Financial products are complex.** For most people, financial products are inhibitingly complex, with overwhelmingly detailed variations in features and pricing structures. This is very different from most everyday consumer products, where even uneducated consumers can easily understand both the product they are buying and the price they are paying.
- **Payoffs are usually over the long-term.** It is common for consumers to make decisions based on immediate issues, rather than thinking about their long-term interests, but many financial products are weighted to long-term returns
- **Effective decisions require sophisticated risk assessments.** Most people lack the skills, practice or intuition to assess risk and uncertainty when making big decisions.
- **Past mistakes are too far gone for learning.** For mums and dad consumers, big financial

decisions are usually made under infrequent and exceptional circumstances (e.g. taking out a mortgage, choosing a retirement fund etc). The consequences of these decisions are often only revealed long after the decision has been made, with little opportunity to learn and correct past decisions.

- **Emotions take over.** Money is inherently emotional, and so triggers our emotional core beliefs leading to decisions that may align more with how we would like things to be than how they actually are. Emotions, whether positive (like optimism or excitement) or negative (like stress, anxiety, fear and regret) can bias our decisions, leading us away from logical cost/benefit analyses.

In order to correct or avoid consumer mistakes, financial institutions need to be able to identify the cognitive biases that drive them.

Adapted from Professor of Economics at UQ Berkeley Stefano DellaVigna's list and classification of biases¹, the following list categorises ten cognitive biases according to the component of a decision they affect: preferences, beliefs and decision-making processes.

Preferences: Our preferences are influenced by emotions and psychological experiences.

1. **Present bias** e.g. immediate gratification you get when buying something on your credit card the day before payday
2. **Reference dependence and loss aversion** e.g. believing that an insurance add-on to the main product is an affordable purchase because the cost of the base product is much higher
3. **Regret and other emotions** e.g. purchasing an insurance add-on to avoid later regretting that you didn't buy it

Beliefs: Rules of thumb can lead to incorrect beliefs.

4. **Over-confidence** e.g. an extravagant belief in one's ability to pick winning stocks or investments
5. **Over-extrapolation** e.g. inferring from just a few years of investment returns that a product will continue to deliver at the same rate in the long-term
6. **Projection bias** e.g. taking out a loan without considering payment difficulties that may occur in the future

Decision-making: We use decision-making short-cuts when assessing available information.

7. **Framing, salience and limited attention** e.g. overestimating the value of a financial product because it is presented in a way that is particularly attractive to you
8. **Mental accounting and narrow framing** e.g. disregarding the whole investment portfolio and making decisions on an asset-by-asset basis
9. **Decision-making rules of thumb** e.g. an investment may be split equally across all available funds, rather than making a careful allocation decision
10. **Persuasion and social influence** e.g. following financial advice from someone who is likeable, compared to disregarding advice from someone you don't like

DellaVigna's categorisation helps us consider whether or not consumers are making errors when purchasing a financial product.

HOW DO BIASES AFFECT STRATEGY, COMPETITION AND OTHER MARKET PROBLEMS?

Financial institutions play an integral role in shaping consumer choices. Consumer mistakes can arise when an institution chooses a particular product design, marketing or sales process that triggers a consumer's cognitive bias. Institutions can respond to each of the ten biases in different ways.

Because of this, cognitive biases have an impact on competition within the financial market. Cognitive biases let institutions compete in ways that may not be in the consumer's best interest. In their defence, however, it can be said that some institutions may not know that their products are playing to consumer bias and causing problems. From the business' perspective, they are not intentionally playing to consumers' cognitive biases, but are merely responding to observed consumer demand.

THE RISE OF BEHAVIOURAL ECONOMICS IN THE AUSTRALIAN REGULATORY MINDSET

'Behavioural economics is quickly becoming a game changer. Not just for firms, not just for consumers but potentially for the shape of regulation for many years to come.'

- Michael Wheatley, CEO of Financial Conduct Authority, in a speech to ASIC, March 2014.

In Australia, we would predict, it is a case of 'when', not 'if', behavioural economics will feature more heavily on the radar.

The Australian Securities and Investments Commission (ASIC), which is responsible for the regulation of financial institutions and market integrity, includes consumer protection as one of its chief mandates. The global financial crisis, which Australia mercifully escaped the worst of, taught us that the traditional reliance of regulatory bodies on people making 'rational' financial decisions is no longer enough; there needs to be more of an understanding of how people really make their financial product choices and how biases can be overcome and decisions improved. This is where behavioural economics comes into its own and why we can expect its influence to start gathering momentum here.

Martin Wheatley of the FCA delivered a speech to ASIC in Sydney earlier this year entitled 'Making Competition King'. The thrust of the speech was about the benefits of incorporating behavioural economics into the financial services market and how, by focusing on the ability of the consumer to make a fair and accurate assessment of the quality of the products and services themselves, it would promote competition. The main question here, as identified by Wheatley, is:

'How do we use this science to encourage organisations to compete more determinedly on price and product quality?'

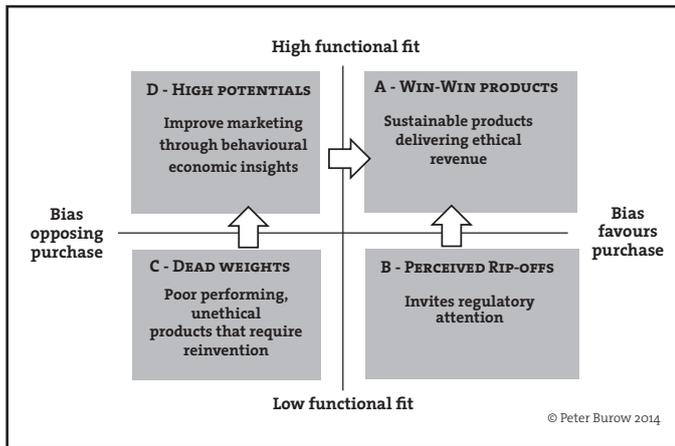
As this thinking matures in Australia, there will be increasing demand for local organisations to enhance their understanding of behavioural economics in order to meet the new regulations without it adversely affecting their bottom lines. Many will want to pre-empt upcoming regulation by examining and adjusting their own products and services.

There is likely to be increasing engagement between the financial industry and regulatory bodies, in order to balance any regulatory measures between suitable protection of the consumer and avoidance of widespread market disruption.

AN ETHICAL APPROACH TO MANAGING BIAS IN THE CONTEXT OF A FINANCIALLY SUSTAINABLE COMMERCIAL ORGANISATION

Since the insights of behavioural economics and neuroscience clearly indicate that all our decisions are inherently biased, we propose that an ethical approach to marketing cannot seek simply to 'remove

Applying behavioural economics in a commercial environment



all bias'. Such an approach would be both ineffective and impractical. Instead, the onus on an ethical organisation is to consider both the impact of the bias on decision-making (*Does the prevalent bias encourage purchase or discourage it?*) and the degree of functional fit between the actual product and what the consumer needs (*Is the product going to deliver on the consumer's expectations?*).

When both these questions are considered, a product and its marketing approach will generally fall into one of four outcomes (as illustrated above):

- **Win-Wins** - Products that provide what the customer functionally wanted and which also tap into implicit consumer biases - typically leading to sustainable revenue.
- **Perceived Rip-Offs** - Products that inadvertently or intentionally exploit consumer bias without functionally delivering what they wanted. These will increasingly attract regulator and consumer group focus. The imperative here for the organisation is to either: increase consumer benefit (improvement in product selection support), demonstrate existing value through validated research (validation) or adjust marketing practices to ensure that consumers are purchasing with informed consent and full awareness of what the product does and does not deliver. (Where action is not taken, regulator-led intervention is likely.)
- **Dead Weights** - The risk to a financial organisation is that currently performing products that have poorly-defined functional alignment may become 'dead weights' as a result of externally-mandated controls.
- **High Potentials** – These products may currently be performing below expectations and represent an

opportunity for ethical growth through leveraged consumer insight.

PUTTING ETHICAL MARKETING INTO PRACTICE

So what do companies need to do to examine their own products and marketing practices in order to satisfy both their own governance and the regulator's spotlight?

Without a clear understanding of the bias involved in its consumers' purchases, organisations will struggle to develop strategies that anticipate future regulatory measures. A significant risk in this situation is the brand damage associated with unexpected investigations that suggest organisational ethics, discipline and consumer commitment.

The FCA in the UK has leveraged behavioural economics to propose three broad steps in the journey²:

Step 1: Identify and prioritise risks to consumers

- How can we identify consumer risks caused by biases?
- How can we prioritise these risks?

Step 2: Understand root causes of problems

- Are consumers choosing reasonably?
- If behavioural bias is at play, what do consumers truly want and need?
- How should we analyse institution-specific issues?
- How should we analyse market-wide issues?

Step 3: Design effective interventions

- Are there interventions available that protect consumers?
- Should we intervene and, if so, how?
- How can we assess the impact of interventions?

With these aspects clarified, an ethical organisation becomes more equipped to consider the merits of their products in a way that is transparent for both regulators and consumers, and to adopt appropriate strategies to address genuine problem products and document why others, while impacted by bias, are not working against the interests of their valued consumers.

ABOUT THE AUTHORS



Peter Burow has authored a series of books exploring the interplay between behavioural economics, marketing and organisational leadership. He is the author of the NeuroPower framework and draws on over 25 years of financial services research into consumer behaviour.



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FURTHER READING

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