Behavioural biases and consumer detriment

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Today's presentation

- How behavioural economics adds to our understanding of the fully rational consumer.
- The main types of behavioural biases and their influences on consumer decision-making processes.
- Examples from economic experiments and implications for consumer decision-making in retail financial markets.

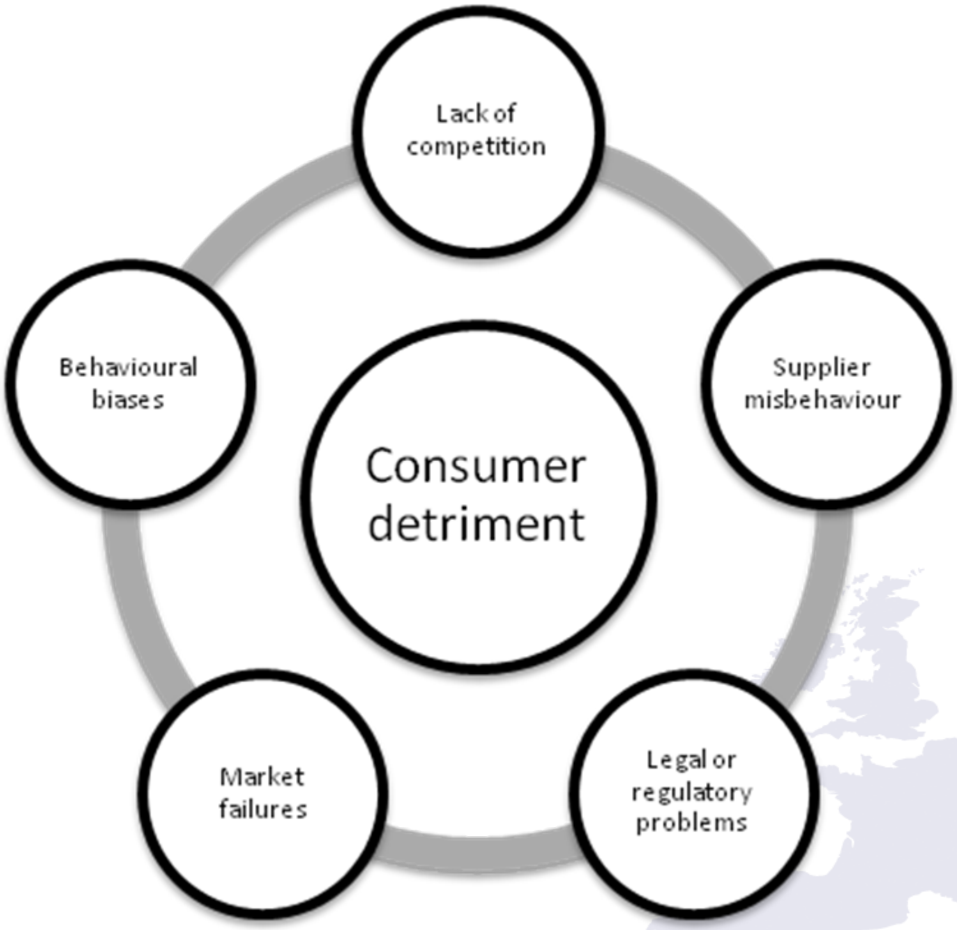
Sources of consumer detriment

- **Ineffective or weak competition in markets:**
  - Regulate sectors with (natural) monopolies
  - Ban anti-competitive behaviour: Cartels, Other anti-competitive agreements, Abuse of dominance
  - Ban mergers that may lead to reduction in the level of competition
- **Information problems:** **Asymmetric and incomplete information:** Consumers may make suboptimal decisions if they lack information arising from
  - *Incomplete information* on the **price** of the product's substitutes and complements
  - *Asymmetric information* about **quality** between the firms and the consumer
  - Information may be **undersupplied** as information can be costly to provide
- **Legal and regulatory problems**: Includes regulatory uncertainties and grey zones which impact consumers.
  - Consumers may be unaware of loopholes in legislation and their interests may not always be well protected.
- **Supplier misbehaviour:** Use of unfair commercial practices, unfair contract terms and poor service.
  - Most consumer protection law and enforcement is focused on stopping supplier misbehaviour

Sources of consumer detriment

- **Behavioural economics:** A relatively new framework of behaviour that recognises that individuals do not always behave in a fully rational way.
  - While this recognition of *bounded rational behaviour* is not new, behavioural economics formalises these deviations from the fully rational model of behaviour, and experiments in economics and psychology have helped to isolate when and how these deviations may arise in markets.
  - These behavioural ‘biases’ can lead to *poor* outcomes in markets for consumers.

Sources of consumer detriment



Behavioural economics

- Behavioural Economics is concerned with deviations from rational decision making.
- Informational remedies, corrections of market failures and competition interventions may not always improve outcomes for consumers.
- Behavioural economics has been driven by *experimentation* in economics and psychology.
- Complements our understanding of consumer behaviour and market outcomes using the rational framework.
- There are a set of known ways that consumer behaviour is likely to deviate from fully rational behaviour.

Consumer behavioural biases

- Important behavioural biases that cause deviations from fully rational choice are:
  - **Cognitive limitations:** Individuals can only handle a limited amount of information and a limited number of alternatives
  - **Default positions:** Individuals are influenced by their default or status-quo; they use it as a reference point
  - **Inertia:** Not switching when it is optimal to do so
  - **Framing**: Decision making is influenced by how information is presented
  - **Discounting**: Individuals overvalue current effects compared to future effects and may fail to optimally account for future consequences
  - **Loss aversion**: Individuals are overly concerned about losses compared to potential gains

Impact of biases on decision making process

Accessing information:

Bias	Effect
Cognitive limitations	• Consumers search less and stop searching when they find a good enough (rather than the best) solution
Default bias + loss aversion	• Reduced search effort because of reluctance to switch and fear of potential losses

Suboptimal search effort

Assessing and analysing information:

Bias	Effect
Default bias	• Too much emphasis on 'reference points'
Hyperbolic discounting	• Mis-prediction of future demand
Loss aversion	• Overemphasis on potential losses
Cognitive limitations	• Adoption of rules-of-thumb
Framing	• Sensitivity to framing

Suboptimal analysis: mis-estimation of WTP and misperception of quality

Impact of biases on decision making

Acting on information and analysis:

Bias	Effect	Outcome
Default bias	Failure to switch and inertia	Decision errors and failure
Discounting	Wrong choices and may put decisions about future events off	
Loss aversion	Excessive weight on switching costs	
Cognitive limitations	Failure to choose or wrong choices if too many alternatives	
Framing	Wrong choices	

Complaints and remedies

Bias	Effect	Outcome
Loss aversion	Excessive weight on potential losses associated with complaining and seeking redress	Suboptimal complaint activity

Economic experiments

- A relatively new method in policy
- Collect data on **actual/ observed** behaviour
- Can be used to detect problems consumers have in decision making and identify the root causes of these problems
- Can be used to road-test remedies and policy interventions
- Three main types of experiments:
  - **Controlled lab experiments**: high levels of control, low costs and generally quicker than field experiments – useful for comparing relative outcomes.
  - **Online experiments**: increased 'realism' and broader subject pools (possibility to draw from a population of interest), but only suitable for relatively simple tests.
  - **Field experiments**: high level of 'realism' and broad subject pool, but control can be reduced and more costly/difficult to implement.
    - More 'realism' can generate greater noise in data – requires larger data sets/sample sizes and more time

Examples of experiments to:

(i) Identify problems consumers have in markets; and,

(ii) road-test remedies

Problems consumer have understanding contracts

an experiment by London Economics for the UK Office of Fair Trading

- Behavioural biases can lead to - discounting future costs ‘too much’, cognitive limitations and framing can lead to poor choices for financial products:
  - Ramsay (2005), consumers underestimate future costs, Ausubel (1999) underestimate future use of credit, Bertrand (2005) additional information tends to distract and lead to poorer choices.
- Test consumers’ ability to compare between <u>two contracts</u> and select the best contract.
- Concern that consumers cannot compare and select the best contract.
- Contract fees varied in presentation
  - Probabilistic (the fee may be incurred if a future event happens)
  - Percentage
  - Delayed (fee incurred at future point in time)
  - Time pressure on choice
- 560 consumers, online experiment in the UK

Problems consumer have understanding contracts

- In this simple environment: Only two choices, contracts were short, presented side by side
- Consumers’ struggled to identify the best deal
  - Probabilistic fees, e.g. overdrafts
  - Delayed fees, e.g. Pay day loans and credit cards with ‘teaser’ rates
  - Heightened when combined with time limit on choice
- Percentage fees did not influence ability to choose optimally
- Learnings for field environment (external validity): Problems in choice will most likely be more pronounced than observed in the experiment as there are more products, and products are presented in more complex ways.

Switching in consumer markets

an experiment by London Economics for OFCOM, telecommunications

- If we consider the Market Monitoring Survey, and the EC Consumer Market Scoreboard. Banking markets are ranked in the 10th lowest grouping out of 50 surveyed consumer markets (2010).
- Measures of problems with market functioning include actual switching and perceived ease of switching.
- Large proportion of consumers are not switching provider.
- Competition on the demand side of the market is not working as well as it could.
- How can the switching process be modified to make switching easier?
- Similar issues arise in the market for telecommunications.
- Controlled experiment that compared a set of alternative switching processes their attributes.

Switching in consumer markets

- Measured consumer welfare and probability of settling on the optimal provider across the alternative processes
  - Switching led by the gaining or losing provider
  - Verification before switch or possibility of slamming
  - Early termination charge warnings if still in contract
  - Time delays (being kept on hold during the process)
- Gaining provider led process – consumers more likely to switch when best to and to choose the best provider
  - Most simplified process with minimum ‘hassle’.
- Slamming – consumers make poor choices of provider once slammed
  - Negative shocks led to poorer future choices.
- Early termination charge warnings did not help consumers in their choice to switch or not
  - Warning that costs will be incurred did not improve choice
- Behavioural driver: Cognitive limitations in complex environments

Learnings and recommendations

- Behavioural economics complements our traditional understanding of consumer decision-making, the drivers of problems consumers have in markets, and can help to improve remedies.

- Economic experiments are useful for identifying when and why consumers may suffer detriment.

- Economic experiments are also useful for pre-testing, fine tuning and comparing alternative remedies and interventions.

- Laboratory experiments have benefits in terms of tight control but the learnings can be asymmetric in terms of field application knowledge.

- Field experiments are growing in usage.

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