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Why Behavioral Economics Matters

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Nathan: Christine, you have the call.

Christine: Thanks, Nathan. Welcome to all of you who've joined us today for this month's installment of the Informed Banker series. The series is designed to bring you succinct, timely information on topics that are critical to community financial institutions. Today's session, Why Behavioral Economics Matters, will be presented by Alix Patterson of Callahan & Associates. She'll demonstrate how hidden drivers like framing, anchoring, decision paralysis, and loss aversion are used by both employees and account holders to make decisions on a daily basis.

Alix is a partner at Callahan & Associates. She's a life-long credit union member and has over 15 years of professional credit union experience. I'll turn it over to Alix now. Alix, the floor is all yours.

Alix: Thank you so much, Christine. Let me start by saying that behavioral economics is clearly too big a topic to tackle in just one 30-minute webinar. My goals today are three-fold; the first is to provide a few nuggets of insights that you guys can then use to apply to community financial institutions, both your account holders and your employees. Then also inspire a couple of next steps for your continuing exploration of this topic. Let's go ahead to the first slide.

What is behavioral economics? There's a lot of ways to describe it, but I really like to say that behavioral economics is the intersection of economics and psychology, although it also brings in cultural, emotional, and social factors. Behavioral economics looks at the common errors that people make in their decision making and then tries to understand the why behind those mistakes in order to help people achieve better outcomes. Really, behavioral economists are trying to close the intention gap. There's a reason why we commit to say losing weight at the New Year but then we don't actually do it. What are those reasons, and why don't people act in the ways they want to?

If you guys think back to your economics class in college, there was this notion of a rational actor who was all knowing. This is really the way most economists build their models. You have to assume certain things and the assumptions are that everybody knows all the information at the same time. The traditional economists have built their models on this notion for decades. This assumption is that if you know the best price or the healthiest food, that a human will always make a rationale choice. Behavioral economics does not make this assumption but contrary to what some people believe, the field doesn't assume

that humans are irrational either. It's not an either or. You're not either rational or irrational.

This is why Richard Thaler won the Nobel Prize for economics last year because he was able to show that people are, to use the phrase of Dan Ariely, predictably irrational. He was able to suggest ways to help people make better decisions. In Thaler's own words, his findings found that supposedly irrelevant factors are actually, in fact, relevant to how people make their lives. In 2008 he and Cass Sunstein wrote a book called *Nudge* in which they pioneered this idea of using small nudges, as the book's title indicates, to promote alternative courses of action that promote good, long-term decision making and still maintain freedom of choice.

Let's go to the next slide. That brings me to the most common concern or objection that many people may have about behavioral economics, and that's the assumption that it's designed to take choices away. In fact, Thaler describes his version of behavioral economics as "libertarian paternalism." Don't take away choices; rather, help people not make choices that will hurt their own best interests.

It's really critical to understand that that is the intent of these behavioral economic nudges is really getting people to act in their own best interest, not something that we as community financial institutions think is in our best interest as an institution. There's a distinction there. Saying I'm going to use these concepts to help people take on more credit card debt or buy my product that they may not need is really just manipulation. That's not behavioral economics. In Thaler's view, what these concepts do is help people do what they want to do. Again, close that intention gap.

In a recent *Freakonomics* podcast, Thaler used a GPS analogy that I thought was really helpful to get people to understand what this concept of libertarian paternalism might be. Let me tell you what he said. When you use a GPS, you start by saying where you want to go. That's your intention. Sometimes along the way you may take a detour.

You may decide you're hungry and stop at a McDonald's off the side of the road or you see something in a store that catches your eye. The GPS, like behavioral economics, will help you recalculate a route to get back to your original suggested address. It's not going to tell you to go somewhere else. It's just telling you how to get there if you maybe have gotten off course along the way.

One other quote of Thaler's that I thought was really important is that behavioral economics doesn't assume that people are dumb. The world is hard, and this is really important because personal finance is such an emotional issue, as is physical health, which is another area that behavioral economics is very

helpful with. Because of this emotional nature, people are reluctant to talk. They don't want to be perceived as dumb.

That's really the whole point of the way he writes his books and his suggestions. Life gets in the way of saving for retirement or life gets in the way of your best intentions to lose weight. How can we create small nudges using the concepts of behavioral economics to get you back on track, to do what you want to do, not what somebody else wants you to do? Why is this so important?

Next slide, please. This slide shows there is a tremendous amount of need in America today for people to improve their financial well being. These statistics are from a variety of different studies over the last couple of years, and they really underscore the point about life getting in the way. The middle one you may have heard. I hear it on the evening news quite frequently that almost half of American consumers cannot cover a $400 emergency without selling something or borrowing money. The top one is also shocking; 76% of Americans are living paycheck to paycheck. We're going to get back to that $400 emergency savings idea in a couple of concepts.

Let's go to the next slide because there's one other thing I want to underscore here, and that is this is not about income. The left side of the slide shows that 43% of consumers who took this CFSI study were declared financially healthy. Only 43% of Americans are considered financially healthy. Notably, a third of those make less than $60,000 a year. That's not considered high income by any stretch of the imagination.

If you look over on the right side of the screen, 57% of consumers are considered not financially healthy, yet many of them make more than $60,000 a year. This really isn't about how much money you make. The need is really about how we're all managing our financial lives.

Next slide, please. Let's dive into three concepts to illustrate the power of behavioral economics. We're going to cover mental accounting, commitments and pledging, and defaults. Let's go to mental accounting.

Mental accounting refers to the idea that people put their money in both real and mental buckets in their heads, even though, according to the traditional economics, all money is the same. This is where economics and behavioral economics really diverge. In economics, it shouldn't matter where your money comes from. It is all the same. Behavioral economists have found that people treat so-called found money – this might be tax refunds, work bonuses, or gift money – very differently than they treat money that they have earned.

We're going to try and recreate here one of the original studies that was done by Kahneman and Tversky, who are really considered the grandfathers of behavioral economics, Kahneman having won the Nobel Prize back in 2002. He

beat Thaler by about 15 years with this. By virtue of you being here, we may already be one step up on the original participants in the study. Consider this first scenario, and then we're going to put a poll up after I describe the scenario.

Imagine that you've decided to go to the movies, and you bought your ticket in advance. You spent $10 on this ticket. It's in your pocket. As you enter the theater you discover you lost the ticket. Will you decide to pay $10 more to go in the movie?

Let's go ahead and put the poll up and see what people say. Again, the scenario is you bought your ticket in advance for $10, you lost it, and now you're standing in the lobby of the movie theater. Will you buy another ticket?

We're only going to spend about 30 seconds on this. As a mentioned earlier, by virtue of your being here, you're probably already starting to understand where this poll is going. Let's see what the results say. We had yes, 69%, and no, 31%. Let me describe a different scenario now.

Imagine you decided to go to the movie theater, and you have a $10 bill in your pocket for the movie. You haven't bought your ticket yet. As you enter the theater, you discover you lost your $10 bill. Will you still buy another movie ticket for $10? You lost your $10 bill. You didn't lose your ticket. You lost your $10 bill.

Go ahead and select yes or no. Are you more likely to buy a ticket for this movie at all? You know this case study is probably pretty outdated given that you can't go to any movies for $10 anywhere, at least not here in D.C. We're just going to go with the original intent. You probably wouldn't have lost your ticket now that I thought about it. We replicated the results that Kahneman and Tversky found; 86% of you, which is higher than the other example, said yes, you would buy this movie ticket a second time.

What are we trying to illustrate here? In both cases you're out $20. Why are you more willing to spend $10 in the second scenario when you lost cash than you are when you lost the $10 ticket? What Kahneman and Tversky found is that people have a mental bucket in their head. They have an entertainment budget. The act of buying a second ticket means you've taken $10 out for the first ticket and $10 out for the second ticket. You've spent $20 of your entertainment budget.

In the second scenario, you lost $10 out of a general bucket. It wasn't your entertainment budget, so you're more likely to go ahead and now say I'm going to spend $10 out of my entertainment budget. The $10 I lost is coming from somewhere else. This irrationality as economists would say really laid the foundation for the field of behavioral economics. In these examples, mental accounting is often prescribed a negative value. It's considered bad.

When mental accounting can be good is when it can be used to incentivize savings discipline that is very difficult when all your money is sitting in one account. It can help consumers close their intention action gap. We already see this concept in action in what are often called round up accounts at credit union and community financial institutions. This is when consumers can choose to round up usually a debit purchase to the next dollar, and the institution will sweep that money into a separate savings account.

Note the value of that savings account is for the individual. We're doing this on behalf of a consumer. We aren't nudging them to act against their best interest. They still have access to their money, but it's that sort of out of sight, out of mind approach to savings. You're less likely to spend it if you don't see it in your transaction checking account.

As a side note, in this era of tightening liquidity, we just finished our trend watch call 30 minutes ago talking about how the loan to share ratio is at one of its highest levels in almost a decade. These small acts of savings will actually help the institution as well because you're building up a higher liquidity base.

Another example of this is the buckets that Rogue Credit Union out in Medford, Oregon created. It created a separate ownership account for all members into which they pay their annual loyalty dividend. Rather than sending a check or depositing this found money, getting back to that concept that money from different sources is considered found money, they put it into a separate savings account where it segregated and earned a 2% interest rate. The members can't just deposit any money there, but they can add their 1% cash back from their Visa program and also the debit round up feature as well. You can read the full interview with Gene Pelham, their CEO, on creditunions.com that describes the program. This is an example where mental accounting becomes actual physical accounting where you're putting money into two separate buckets. It's a great way to reward members and help them build that emergency savings that we showed was in such need on the second slide.

Let's go to the next one, commitments and pledging. That was the psychological angle, mental accounting. Now let's look at a social one. This is the act of committing to a future action that is in your best interest. The more publicly you do it, the better.

Thank goodness we have lots of social media avenues that give us plenty of opportunity to share our New Year's resolutions or our savings goals. In fact, there's a whole genre of phone apps that have been built around this idea of commitment and making public commitments. It really ties in well with this idea that we talked about of found money by having people pledge found money in advance. How does this work? Thaler wanted to see if this would work back in 2004. He helped design a child program called Save More Tomorrow.

As an employer, they gave all employees the option of pre committing to save a higher percentage of future raises. If you make $50,000 today and you're going to get a raise to $55,000 next year, they asked you how much of that you would like to go ahead and save before you actually earned the money. Eighty percent of the employees who were made this offer took them up on it, and they tripled their savings rates in four years. Why did this program work? This program works because it avoids the perception of loss that would be felt if you actually felt a reduction in your deposable income.

They weren't asking consumers to take more out of their paychecks today. They were saying we're going to take it out before you notice it's missing tomorrow. Today you are living on $50,000. If you were going to get a raise to $55,000, maybe you can live on $52,000 next year, and you're not going to miss the $3,000 that you're committing to put away.

It also works because of people's inertia. That's kind of a polite way of saying lazy, but it makes people more likely to stick with the program because you now have to take an action. You have to opt out of a program that you've already committed to over the course of the future. It's really easy to envision ways that this can help you and your fellow employee.

You could consider having your human resources department create a pledge program before annual review time. What percent of your raise do you want to put towards retirement? Maybe it's bonus time. You get people to pre commit a straight dollar amount or a percentage of that total savings towards either a want, say a trip they want to take next year, or towards a need, which would be their retirement. Again, you're giving away future money that you don't have so you don't miss it.

What does this mean for account holders? Using this internally at our organizations, I can come up with 50 examples. What can we do for account holders? Consider that concept we talked about of found money and the tax refund.

Here's a statistic that's really interesting. In 2018, 84% of people making less than $50,000 expect a tax refund of over $2,000. I'm just going to repeat that because that was a lot of numbers. Most people, so 84% of people making less than $50,000 will get a tax refund of over $2,000. The Common Cents Lab at Duke University decided to see can we get people to make public commitments to save some of this $2,000 tax refund that they are going to get. What can they do?

They tested a number of approaches, so it wasn't any one thing. There wasn't a silver bullet, I would say. They tested a number of approaches and found that the most successful approach resulted in account holders saving an average of 35% of their tax refund. Multiply that out; 35% of $2,000 is $700. That is almost

double that statistic that we saw at the beginning where they were saying consumers cannot find $400 in an emergency. By making a pre commitment, people getting a tax refund were able to put aside more than double the amount that was needed.

Let's go to the third example, defaults. The power of defaults in decision making is really important. This gets back to that slide, the cartoon I showed earlier that says by not making a decision, you're making a decision. In scientific terms, default options are preset courses of action that take effect if nothing else is specified.

Let's just give a classic example here. When 401(k) programs were introduced, there was this assumption that everybody would opt in, especially when there was free money involved when there's the corporate match. They found that wasn't really the case. They decided to implement the opt out option on 401(k). Most companies today automatically enroll you in a 401(k) option, so default is now participation.

Participation rates have risen to over 80%. It was dramatic. You see the same thing in European organ donor programs. Spain has the highest rate of organ donors. It's almost 40% because they just assume everyone is going to by default opting into the program.

Setting defaults is really effective in choice architecture when two conditions are present. We've already talked about one, effort. Inertia is particularly strong if taking action requires effort. That's kind of the case with 401(k) paperwork. If you didn't opt in right away, then getting the paperwork, finding your forms, all of those things that you were doing when you started your job anyway becomes much more of a hassle later on. Getting people enrolled immediately creates a much higher benefit.

The other condition that makes defaults much more promising is uncertainty. Individuals may be unsure of their own preference. For example, with 401(k)s, many credit unions today that I work with and also some community banks default to a set level contribution to the 401(k) program with increases over time to get to the maximum donation. People are unsure what to do or what is in their best interest.

Organ donation is another example. It's generally perceived to be a personal choice, so by presenting a default opt out, it's creating almost a social expectation or norm that you should donate your organs. This concept can be used internally in your organization or externally with account holders.

I'm just going to give one example here, and then we can go to some questions. Here's an interesting industry default that is driven probably by our business needs. Whenever an account holder opens an account with direct deposit, it

generally goes to their checking account. This works in their interest because they need to transact. That's why they're earning a paycheck, presumably. It works in our interest too.

We get interchange income, maybe even overdraft income, things like that. It works for both. It's a logical default. Many financial institutions do offer ways for consumers to bucket their money upon opening an account. That's back to the concept of mental accounting as we first discussed. It may help you set up sweeps, for example, from your checking account into savings.

In fact, one credit union that I work with, American 1 in Jackson, Michigan, has their branch staff always ask members who are in front of them who are depositing a check how much of this do you want to save today? They're defaulting to the assumption that you want to save something. Back to the actual default concept here, one credit union went one step further, and they tied together this idea of mental accounting and flipped the norm on the default. In fact, their default options for direct deposit is into savings. After that you designate the amount of the paycheck you want to send to your needs account, your wants account, and your giving account. It is a faith-based institution, so tithing is essential to the mission. They tied that into this account.

Think of that; the default option for your direct deposit is savings. You're assuming you want to save, and then you transfer the money that you need to spend into the needs and wants accounts. I want to leave the concepts there and turn it over to Christine. I think we may have had a few questions.

Christine: Thanks, Alix. This has been so interesting. We definitely got some questions here for me to read out, but I also just wanted to let the folks know who maybe haven't been able to enter a question that if you go to the questions box in your webinar panel you can enter a question there. We'll be happy to get to it if we can. Alix, the first question I have here is is there a down side to these concepts that people should be aware of?

Alix: That's a good one. I addressed that a little bit upfront with this idea that many people think behavioral economics is too paternalistic, that we're telling our customers what to do. It really is important to understand that the intent is to remove barriers to good choices rather than dictate that people act in a certain way. The best example I can give on a possible downside might be with this mental accounting discussion that we had. People can go overboard.

What if people rack up overdraft fees in their checking account because they're putting all their money into savings? That would be probably working against purposes. What if you're carrying a really high interest rate credit card debt while you're saving money that's really only earning ten basis points in a savings account? Financial institutions need to consider, monitor, and use analytics to see maybe when this is happening and reach out to consumers that may not be

acting in their own best interest. If you see someone with a lot of overdraft fees, for example, but they have $5,000 sitting in savings, they may need some help in understanding that that savings isn't doing them as much good as it could, if it could cover some of their overspending problems in their other mental bucket that they have.

Christine: Thanks, Alix. I have a couple more. The next question is these concepts seem to be used outside the financial realm as well. Could you give a different example for the listeners that could be used outside their own institution?

Alix: This works great for institutions who self-insure by helping employees maintain healthier lifestyles. This is a great example of where behavioral economics can work. A lot of institutions today may have a self-insurance pool, so making your employees healthier is important. Google did this by adding friction to promote healthier living. This is another concept.

Google offers all the free food you want all day long, and this is not altruism. Let's be clear; they want their employees at the office 24-7. They offer lots and lots of free food. They also discovered that their Googlers were getting a little bit testy. They decided to redesign their cafeteria using the concept of choice architecture.

They put healthy food first, so the default options were salad and things that were healthy for you. That also created a social norm that that's where you start. Then they added friction around items that weren't good for you. When they first opened the cafeteria, they had candy and snacks in those cereal dispensers that you may have seen in your college dorm. They decided to put them in jars with lids and dramatically decrease the number of calories that the Googlers were eating.

Just putting a little bit of friction in place, not making the candy so easy to see and also to dispense really changed the dynamics. They also changed the size of desserts to three bites or less and put out smaller plates to advocate portion control. The key thing on all of these is you need to take note that they didn't take away any of the choices.

hey didn't take away the soda. They didn't take away the candy. They didn't take away the desserts. They just made the default choices much easier to see and put friction in between you and the more unhealthy choices. You can still make those choices, but it's going to be a little bit harder. I think that's a really good example of behavioral economics outside the financial services realm.

Christine: Thanks, Alix. This is unfortunately coming to a close. This has been a really interesting conversation. If folks on the phone want to know more about this topic, what would you recommend?

Alix: I have five books that I would really quickly recommend. I know we're out of time. *Nudge*, of course, by Richard Thaler is a great read and his more recent *Misbehaving* is another one. Two books that you may not be aware of, one is called *Scarcity*, which really looks at the scarcity of time and emotional energy and why that impacts the way consumers make financial choices. It really shows this is not about intelligence when we're making choices that are not in our best interest, but a function of not having enough resources at our disposal.

If you're hungry in school, you can't learn. If you're stressing about your next car payment, you don't have the chance to make other healthy choices in your life. *Scarcity* is a fantastic book, and Eldar Shafir spoke at a conference that I went to a couple of years ago. *Hooked* is another one. This is a great book that you can use for good or for evil, so be very careful reading this one. It's all about gamification and what makes apps addictive.

He found a pattern of trigger, action, reward, and investment that really drives addiction. I think the key finding I got from this one was that the anticipation of rewards is almost more rewarding than the reward itself. That's sounds counterintuitive, but if you think about it, you think about looking forward to a big vacation. You anticipate and you get joy and happiness from that anticipation well before the vacation itself. They show that in a lot of different avenues.

There's ways, for example, with this debit round up idea that we talked about earlier that if you did unscheduled matches, consumers may not know when you're going to match their debit round up. They're still going to anticipate that it's going to happen, and they get joy out of that. Then that's just one way that you can use the concepts in that book with the behavioral economics books to really drive better consumer behaviors.

Christine: Thank you so much, Alix. For those of you who are scrambling to get those books written down so you can get right out and order them, we will be following up this presentation probably next week with a link to a recording of the call as well as a transcript. The information in the presentation will be there as well for folks that want to share that with their colleagues or may have missed something that they want to get from the presentation.

Feel free to share that information amongst your colleagues and make sure that you come back and see us again on September 27th for our next Informed Banker presentation called Disruptive Strategy. That's going to be presented by Jay Johnson, also of Callahan & Associates. Alix, thanks again for all you shared with us today. I would like to extend a very sincere thank you to the many financial services professionals who made time to be with us today. I definitely hope to see you in the future. That concludes today's session. Thank you for joining us this afternoon.