Behavioural economics and retail investment

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2nd October 2014

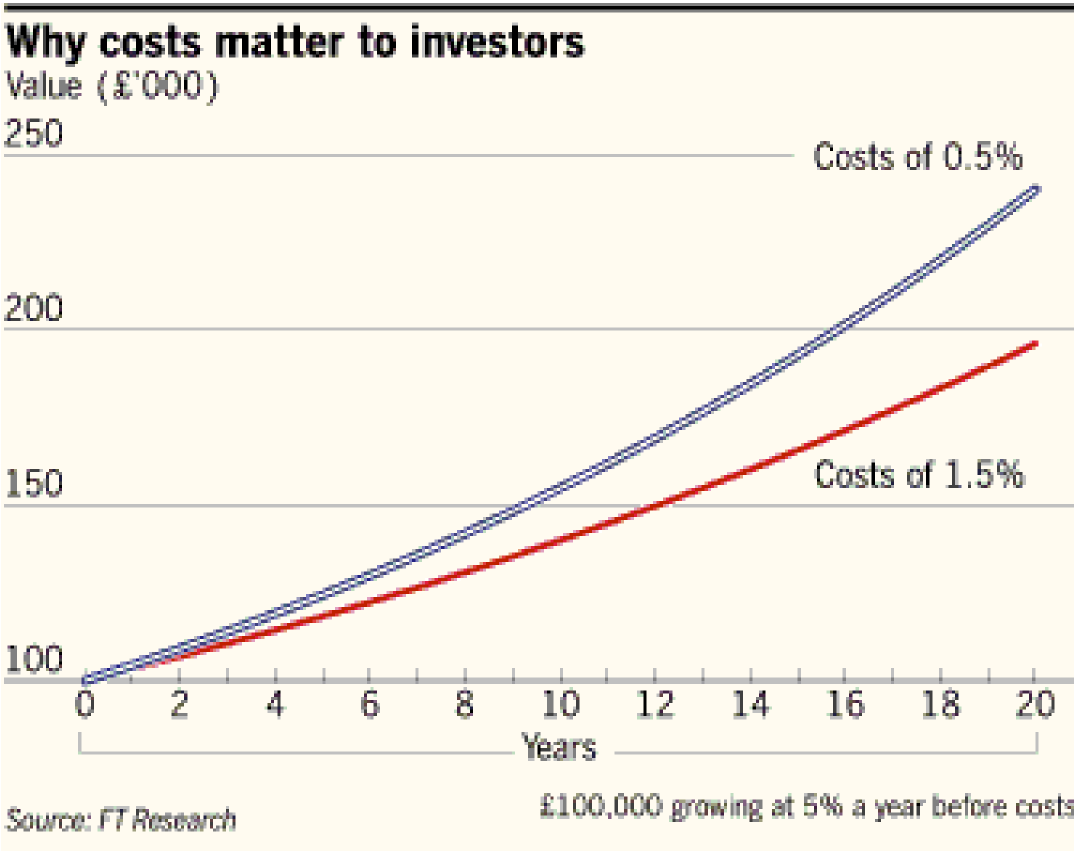
“To err is human”

- Human decisions are imperfect
- Lack of knowledge and behavioural biases lead to common mistakes:
  - we borrow too much
  - we save too little
  - we choose the wrong products
- Understanding how this occurs is vital if we are to improve financial outcomes

Consumer choices and firm responses

- Consumers focus on *immediate* and *prominent* features and rarely notice hidden costs
- Firms respond by increasing complexity: adding features, hiding fees and deferring costs
- Competition acts only on visible features, causing markets to be dominated by products with low visible prices and high hidden fees
- **The result**: competition focuses on the wrong areas, consumers buy the wrong product and end up paying more in the long run

The effect of hidden investment fees



The (old) market for investment advice in the UK

- Consumers tend to not buy from advisors that charge upfront fees (a visible cost)
- Advisors instead pass the cost of advice onto investment providers through commission
- Providers pass this back to consumers through higher investment fees (a hidden cost)
- **The result**: consumers pay more for investment products and receive worse advice as advisors want to sell products that give them the most commission

Exploitation or competition (or both)?

- Firms' responses to consumer biases can increase profits by worsening their mistakes
- But competition can force firms: if consumers won't buy simple, 'honest' products with upfront prices, firms can't sell them
- Are firms knowingly exploiting consumer biases or simply responding to demand? Does it matter which?
- What can regulation do to reduce harm to consumers?

Can financial education help?

- Little evidence that information or education can reduce behavioural biases significantly
- Emerging evidence from Brazil of a small positive impact if financial education is:
  - simple
  - linked to specific actions
  - delivered at an early age
- But even well designed financial education makes only a small impact on behavioural problems – it cannot be the whole solution

Another option: the Retail Distribution Review (RDR)

- RDR resulted in fundamental changes to the market to address long standing problems.
- RDR banned commission for advisors, made the price of advice clear to consumers, and required improvements in advisor professionalism and the clarity of advice
- This should improve the quality of advice by removing commission bias and improving competition
- It doesn't try to change consumers' underlying behaviour – which has proven difficult – but aims to lessen the harm and mistakes this causes

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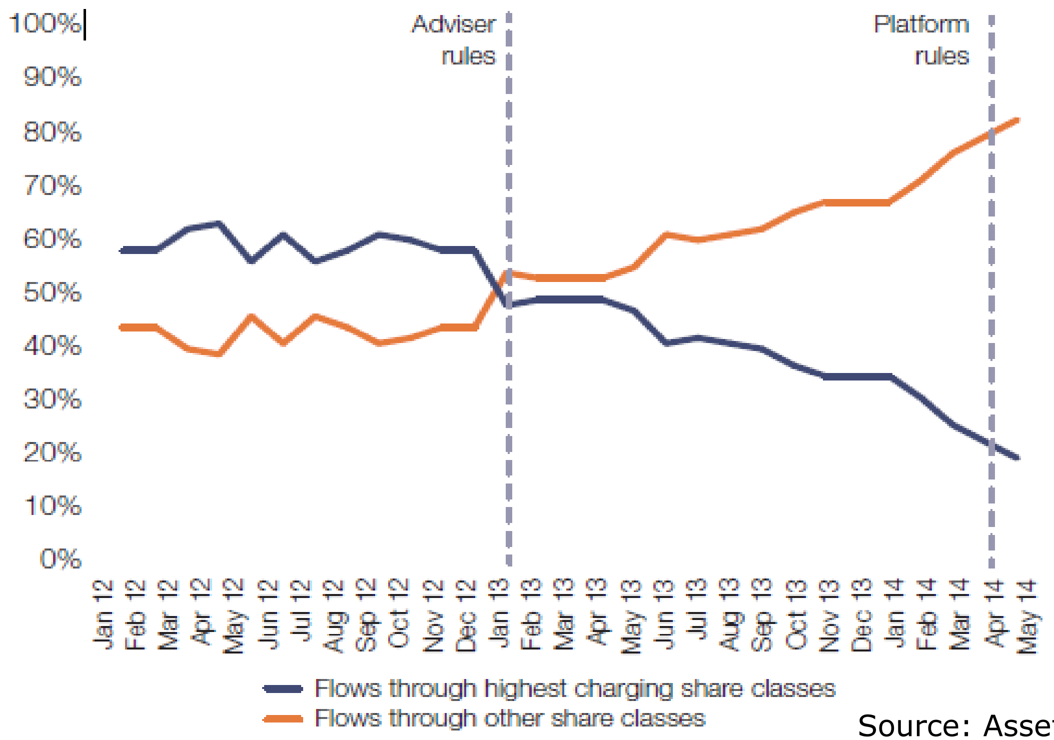
Chart 22: Gross retail sales at share class level (Jan 2012 to May 2014)



Source: Asset Management in the UK 2013-2014
The IMA Annual Survey