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Why Do We Make the Choices We Do? Insights from Behavioral Economics

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Agenda

- **Who makes bad financial choices?**
- **Conventional explanations and remedies**
- **Insights from behavioral economics**
- **Implications for housing counselors and financial coaches**

Bad Financial Choices

- ***Everyone* makes bad financial choices sometimes.**
- **Economically vulnerable people tend to make them more often because they face tough challenges and limited choices; the results are especially costly.**
  - **Too much debt**
  - **Costlier kinds of debt**
    - **Predatory mortgages**
    - **Payday loans**
  - **Not enough liquid savings to cover emergencies**
  - **Few assets other than a house or car**
  - **Scam artists promising mortgage relief or quick cash**

Financially Speaking, The Great Recession Hit Economically Vulnerable People the Hardest

Family head is:	Change in median income, 2007-13	Change in median wealth, 2007-13
Under 40	-16%	-36%
High-school drop-out	-12%	-54%
African-American	-18%	-43%
Hispanic	-15%	-42%
Note: All families	*-12%*	*-40%*

Source: Federal Reserve Board, Survey of Consumer Finances; all figures adjusted for inflation.

Conventional Economic Explanations for Making Bad Financial Choices

- **Lack of knowledge**

  "I didn't know that missing payments on my mortgage would hurt my credit score and make it harder to get a car loan."

- **Lack of information**

  "My mortgage banker didn't tell me I had to pay property taxes and insurance separately."

- **Complex or conflicting commitments**

  "I needed a payday loan to make my mortgage and car payments."

Conventional Remedies

- **For lack of knowledge…**
  ⇒ ***Financial education.***

- **For lack of information…**
  ⇒ ***Disclosure requirements.***

- **For complex or conflicting goals…**
  =>More education.
  =>Regulation—for example, banning payday loans.

Why Conventional Explanations and Remedies Fall Short

- **Is it lack of knowledge?**

  =>Financial education doesn't reach many people and may not be remembered when it's needed.

- **Is it lack of information?**

  =>Disclosure requirements lead to "information overload" and don't necessarily increase understanding or change behavior.

- **Is it complex or conflicting commitments?**

  =>Financial education doesn't un-complicate someone's life—you don't have time to comparison-shop in a crisis.

  =>Banning payday loans takes away an option that might be better than nothing in some cases.

A New Approach: Behavioral Economics

- **What is behavioral economics?**
  - **The application of psychology and other social sciences to the study of choice with limited resources.**
  - **Behavioral economics is a hybrid of psychology and economics that hasn't been adopted by the mainstream yet.**

- **When did it begin?**
  - **Research began in psychology departments in the 1970s.**
  - **Behavioral economics entered the mainstream with the 2002 Economics Nobel Prize awarded jointly to psychologist Daniel Kahneman and economist Vernon Smith.**

A New Approach: Behavioral Economics

- **Why has it become more important?**
  - **Behavioral economics can help us design strategies to help people make better economic and financial choices.**
  - **Applications in non-profits, businesses, and government settings.**
    - **Non-profits**
      - **Ideas42: "Using behavioral economics to do good."**
      - **Tools for saving, bill payment, healthy eating, etc.**
    - **Businesses**
      - **Consumers are influenced by emotion as much as reason**
    - **Government**
      - **President Obama's White House Office of Information and Regulatory Affairs**
        - **Simplification of FAFSA, Prescription Drug Plans**
      - **U.K. Behavioural Insights Team (the "Nudge Unit")**

Concepts from Behavioral Economics

- **Rules of thumb**

  Guides to making decisions without having to think about them.

  "My father always told me to live for today."

  "All that matters is your monthly payment."

- **Framing**

  How options are presented to you may influence your choice.

  "My mortgage banker didn't offer me a fixed-rate loan so I didn't know to ask for one."

Scarcity and Bandwidth

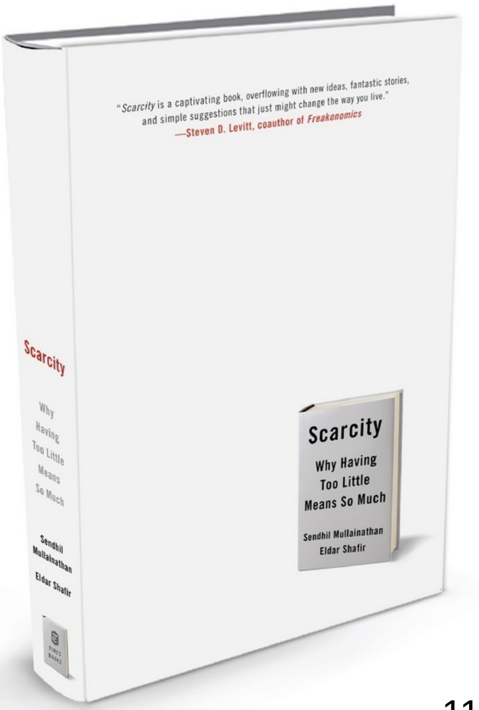
Scarcity: Why Having Too Little Means So Much, by Sendhil Mullinathan and Eldar Shafir (2013)

- **Scarcity**

  A shortage of money, time, or "bandwidth" that makes ordinary mistakes more likely and more costly.

- **Bandwidth**

  Stress induced by scarcity reduces your ability to process information and make good decisions—you have limited bandwidth.



Eliminating Scarcity to Reach Better Decisions

- **Scarcity of money**

  "I don't have enough money to open an IRA."

  Explain that you can open an IRA—or many other kinds of saving accounts—if you earned any income at all.

- **Scarcity of time**

  "I don't have the time to comparison-shop for a mortgage/bank account/tax preparer."

  Show your client a website that simplifies comparison-shopping.

  Talk with your client about stress and strategies for managing it.

Strategies Suggested by Behavioral Economics

- **Provide good defaults.**

  Many employers now automatically enroll new employees in the retirement-saving plan ("opt-out" rather than "opt-in").

  Set up automatic bill payments.

- **Require active, specific choices.**

  Agree how much to save each month and where to put it (in what account).

- **Simplify complex tasks and focus on reducing stress, which contributes to limited bandwidth.**

  Identify specific steps to reach a financial goal.

  Identify smart tools for spending control and saving.

More Strategies

- **Provide planning tools.**

  Show your client how you use your calendar to keep track of your appointments and your to-do list.

- **Require specific commitments.**

  Ask your client to promise to be on time to the next appointment and to follow up on the actions they've chosen to meet their goals.

- **Use reminders.**

  Show your client how to set up automatic reminders on her computer calendar.

More Strategies

- **Frame your client's identity with positive nouns; don't describe her/his actions with verbs.**

I am an earner, a provider, a saver.

I am a mother, a father, a daughter, a son.

I am a neighbor, a citizen, a voter.

Implications for Housing Counselors and Financial Coaches

- **We all are "less than rational" and confront obstacles to making good decisions—but the risks and costs of making mistakes are higher for your clients.**

- **Help your client remove obstacles to good decision-making—i.e., address scarcity—before tackling decisions.**

- **Break down complex financial decisions into manageable pieces.**

- **Continue to educate yourself about obstacles your clients face when making decisions and how you can improve your own program design.**

Who We Are:
Center for Household Financial Stability

- **We conduct research on family balance sheets and financial decision-making.**
  - **Who is recovering from the financial crisis and who is not? Why?**
  - **How can families and the economy move forward?**
  - **www.stlouisfed.org/household-financial-stability/**

- **The Federal Reserve System's Community Development function promotes fair and informed access to financial markets by underserved populations.**
  - **Connecting Communities: www.stlouisfed.org/bsr/connectingcommunities/**
  - **Exploring innovation: www.stlouisfed.org/community_development/exploringinnovation/2013/0513/index.cfm**