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

<table>
<thead>
<tr>
<th>Family head is:</th>
<th>Change in median income, 2007-13</th>
<th>Change in median wealth, 2007-13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 40</td>
<td>-16%</td>
<td>-36%</td>
</tr>
<tr>
<td>High-school drop-out</td>
<td>-12%</td>
<td>-54%</td>
</tr>
<tr>
<td>African-American</td>
<td>-18%</td>
<td>-43%</td>
</tr>
<tr>
<td>Hispanic</td>
<td>-15%</td>
<td>-42%</td>
</tr>
<tr>
<td><strong>Note: All families</strong></td>
<td><strong>-12%</strong></td>
<td><strong>-40%</strong></td>
</tr>
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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.
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**
  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