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IMPROVING CUSTOMER DECISIONS IN RETAIL BANKING

How behavioral influencing adds economic value for both customers and banks

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In this point of view, we explain why retail banking customers are prone to making bad financial decisions and how banks can use specific behavioral nudges to reach better outcomes for both clients and banks. This is important, as customers are challenged more than ever as a result of the COVID-19 pandemic. To unlock these benefits, banks should invest in data and analytics capabilities and test selected use cases that can be rolled out.

RETAIL BANKING CUSTOMERS MAKE BAD FINANCIAL DECISIONS

Retail banking customers often make bad financial decisions — for which is there can be several reasons (see Exhibit 1).

Exhibit 1. Development of Online-Banking in Europe

Products are very complex	• Financial products are abstract and often intangible for retail customers, for example, different investment products • Product features are often complex, for example, derivative products
Products require present/ future trade-offs	• Long-term benefits often contrast with short-term self-control problems (spending now vs. spending later)
Decisions require assessing risk and uncertainty	• Some consumers are incapable of assessing probabilities when confronted with uncertainty and risk, particularly with a view to longer-term investments or insurances (for example, funeral insurance)
Decisions can be emotional	• Decisions are often driven by stress, anxiety or fear of loss rather than rational choices (for example, investors withdrawing money from financial markets in times of crises)
Some products permit little learning from past mistakes	• Some products are only bought once in a lifetime (for example, specific insurances or retirement planning)

Source: Eurostat; Oliver Wyman

Given the complexity and uncertainty of certain decisions, customers typically use specific rules of thumb or biases that help them to simplify more complex problems to eventually make decisions based on smaller, more manageable parts.[1]

We have clustered typical rules of thumb or biases as well as the effects for European customers and European retail banks for the three selected, most relevant financial needs.[2]

1 H. Kent Baker, John R. Nofsinger: "Behavioral Finance: Investors, Corporations, and Markets" (29. November 2011)

2 For all financial needs see Oliver Wyman Report "The Future of Retail banks: From financial advisors to life coaches"

Exhibit 2. Key needs and related biases of retail customers

Need	Bias	Description of bias
Spend	Mental accounting	Usage of mental accounts ("pots of money") to make financial decisions
	Lack of self-control	Lack self-control regards to spending but also saving behaviour
Borrow	Present bias	High impatience in the short run relative to their long-run preferences
	Intuitiveness	Intuitive decisions with limited reflection
	Exponential growth bias	Underestimation of how quickly interest compounds
Grow	Herd mentality	Follow of group behavior and trends
	Snake bite effect	Risk-aversity after experiencing losses
	Illusion of control	Over estimation of ability to control events

Effects on customers

€800 billion
welfare loss[1]

Driven by little or wrong savings, overspending and co-holding of several expensive credit lines

Effects on banks

€10 billion
revenue loss p.a.[2]

Driven by for example, lower investment rates but partly offset by higher credit usage

1. We assume a welfare loss of around 1% on the total wealth in Europe
2. Calculation based on Oliver Wyman European banking Revenue Pools by product

Source: Statista

BEHAVIORAL NUDGES PROVIDE A WAY TO REACH BETTER OUTCOMES FOR CLIENTS AND BANKS

Whereas behavioral biases might prevent customers from taking the best and most beneficial financial decision, the key is to support these customers by influencing their financial decision-making. Doing this helps both clients and the banks themselves by reducing complexity and increasing the perception of being on their side at a difficult time.

Influencing customers' biases can be done by making use of "nudges" — a way to guide people towards choices that are beneficial for them. Supporting the decision-making of customers can then be in the interest of retail banks. For example, moving away customers from deposits and overdraft to investment savings and longer-term loans can have a positive effect, at least in low interest rate environments such as the Eurozone. With investments increasing the provision income of banks, return on equity will improve.

Based on our research, we have identified three existing behavioral approaches that can be taken into consideration when helping customers address their financial needs — this includes adjusting the choice architecture, improving information and optimizing products (CIP).

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C

Choice architecture

Many customers are prone to the status quo bias, which means they stick to the default option on offer. In this example, banks need to make informed decisions about the number of choices presented to the customer, the way these choices are presented, and the selected default option. In addition, banks can also use active choice mechanisms which remove the option of not expressing a preference after a certain deadline. This avoids outcomes that cluster around the default outcome.

Within choice architecture "commitment devices" play a role, describing a commitment to future behavior, whereby customers restrict their future choices by making other behaviors more expensive. An example for such a device could be the commitment to reflect an expected salary increase in a savings plan before coming into effect. In case the savings plan is not changed once the salary level is increased, the bank would charge a penalty, which makes the divergence from the pre-defined commitment expensive.

I

Information

Financial literacy is correlated to better financial decision making, such as retirement planning, stock market participation, and portfolio diversification. Increasing the financial literacy of customers with interactive and gamification elements can therefore improve decision making. Giving customers a better and less abstract feeling about risk might increase a shift from saving to investment accounts, helping to strengthen a banks' commission income in times of low interest rates. In addition, consumers are influenced by the decisions taken by others and mimic the behavior of other people. While positive effects on financial decisions caused by peer information have been proven, the wrong peer group can lead to negative effects. The peer group, therefore, needs to be chosen carefully to avoid adverse effects. For an efficient nudge, simple information paired with educational advice is what works best for customers.

P

Product design

Product design can significantly increase or decrease the use of a product. This is often the case with product characteristics connected to greater interaction and individualization that is strongly influenced by behavioral dynamics. Example features could be virtual accounts, re-naming functionalities and personal financial target setting. Multiple banks gradually implement new design features aiming to increase customer engagement by leveraging behavioral dynamics. Also, the way discounts on prices are presented and promoted influences customer choice. Actively promoting a 50% discount on overdraft fees actually reduces overdraft usage by customers. In contrast, not explicitly mentioning cost of overdrafts to customers while being available to them actually increases the use of these overdrafts.

Banks can make use of potential "nudges" across all those three behavioral levers (see Exhibit 3). Experiments with customers of these behavioral nudges have shown significant quantitative effects demonstrating a clear opportunity for banks to explore the application of behavioral techniques in a more targeted way.[3] Banks can benefit from similar experiments to test and learn on different nudges.

Exhibit 3. Overview on potential nudges and related effects to address biases

		Nudge			
Need	**Bias**	**Choice architecture**	**Information**	**Product design**	**Effect from project experience**
Spend	Mental accounting		Information about pain of paying	**Virtual accounts, renaming, own images**	**+~11%** Customers with aggregated accounts
	Lack of self-control	Suggest saving rates, auto-save unspent budget	**Saving reminders and peer saving rate**	Default emergency account, target setting	**+~13%** Increase in average savings
Borrow	Present bias	Suggest paydown plan	Show paydown information of peer	**Budget set and congratulations**	**+~10%** Increase in log ins
	Intuitiveness	Suggest paydown plan	**Show paydown information of peer**	Budget set and congratulations	**+~30%** Increase likelihood of repayment
	Exponential growth bias		Clear product information explanation	**Show graphical forecast**	**-~15%** Reduction of overdraft usage
Grow	Herd mentality		Awareness	**Quick and auto-enrolment based on behavior**	**+~20%** Participation rate
	Snake bite effect	**Virtual default investment account with default fund**		Suggest risky share based on financial situation	**+~6000%** of savings in default fund
	Illusion of control		Inform about own/others number of trade	Allow to set maximum trade in months	

Source: Madrian & Shea 2001, Choi et al. 2012, Karlan 2010, Beshears et al. 2009, Laudenbach et al. 2018; Oliver Wyman client experience

3 Madrian & Shea 2001, Choi et al. 2012, Karlan 2010, Beshears et al. 2009, Laudenbach et al. 2018

COVID ACCENTUATES THESE ISSUES EVEN FURTHER

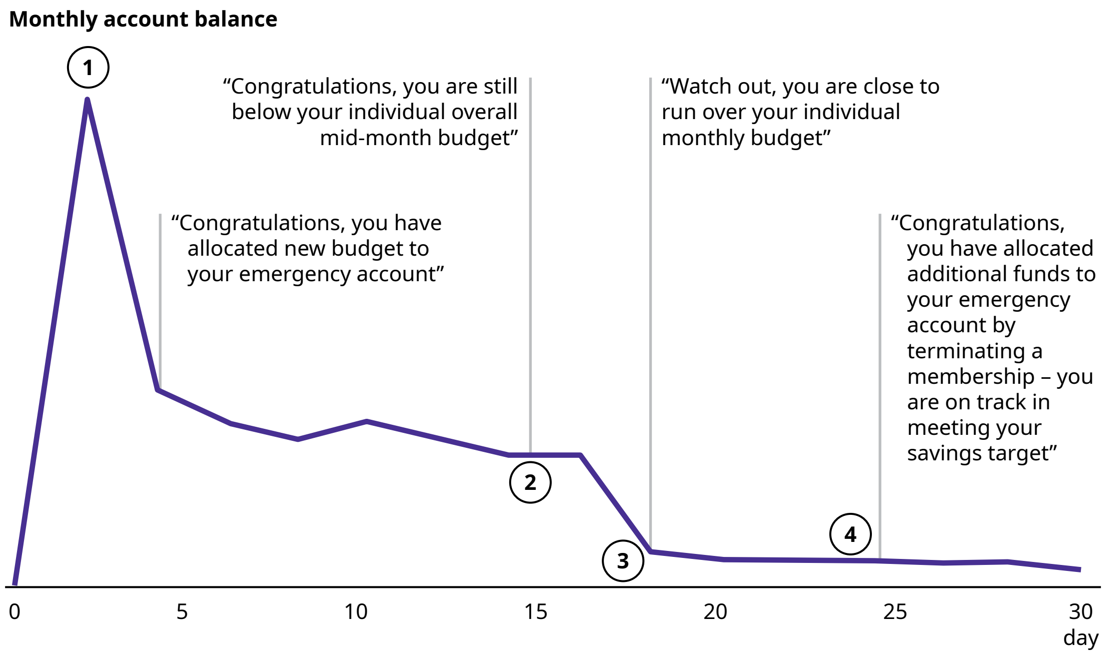
Given the current economic downturn and increasing unemployment rates, retail customers will need to rethink their financial plans and make decisions in an environment of increased uncertainty. This makes customer even more prone to biases. In addition, personal advice is harder to receive and there is a shift to digital channels. However, it also provides opportunities for banks.

DELIVERING NUDGES BOTH STANDALONE AND AS PART OF A COORDINATED EFFORT BANKS CAN GENERATE REAL VALUE FOR CUSTOMERS AND THEMSELVES

While it is possible to develop stand-alone solutions to address financial needs of clients and develop and test single nudges, banks should base their entire digital ecosystem on behavioral insights to connect both financial and non-financial offers intelligently. This is of utmost importance, particularly considering the expected take up in digital solutions. Banks can start with developing stand-alone use cases that support customers in paying down their credit and in building up their emergency funds and savings. Afterwards, they should work on improving customers' investment behavior by providing investment options based on a customer's individuals risk preferences.

In general, banks must increase their touchpoints with customers — for example by informing them about budget changes and congratulating on achieving saving goals. In addition, the need for providing proactive advice increases. Banks can proactively make suggestions to their customers on how to invest unused monthly budget or savings from a new electricity or phone contract. Alternatively, banks can suggest saving unused monthly budget in an emergency fund as default option. Hereby, banks should communicate transparently and present the information in a simple way with the appropriate tone.

Exhibit 4. Potential behavioral customer interactions in one month



1 Salary arrives

- Grow: Virtual emergency account is shown — unused budget of previous month saved in fund
- Spend: Different budget sizes across categories (for example, groceries) on previous behavior suggested

2 Mid-month budget achieved

3 Significant purchase

- Borrow:
  - Spending projections automatically adjusted
  - Allocation to virtual credit card suggested
  - Suggestion on potential categories for savings to meet individual savings target

4 Regular membership canceled

- Spend: Unused membership in fitness club is cancelled, based on automatic suggestion
- Grow: Saving is automatically allocated to emergency fund

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CONCLUSION

In summary, COVID-19 has already shifted customer behavior to be more digital, which can increase the ease of reaching customers. While banks have historically focused on product push, they need to be more pro-active and position themselves as a partner for clients. On the other hand, customers have difficulty making complex financial decisions, especially during times of uncertainty. Our experience suggests that nudges offer one way that benefits both parties. Banks can enhance their image as a partner or life-coach on the side of their clients by reducing complexity that helps their clients make better decisions. They can do this by:

1. Developing overarching vision: Outline the strategic vision of the future and how to proactively engage with customers
2. Prioritizing and connecting use cases: Develop use cases on behavioral insights that are beneficial for customers considering their most pressing needs, connect individual digital offerings and generate value for the bank
3. Testing and learning: Build use cases that are nudging customers into financially desirable behavior

Our research indicates that building up a team of behavioral experts in the data analytics team with the adequate know-how to develop and test potential use cases should be a bank's ultimate goal in future.

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