



Applying behavioural insights to promote better credit decisions

Impact of the choice architecture on decision-making

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The Dutch Authority for the Financial Markets

The AFM is committed to promoting fair and transparent financial markets.

As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

Conduct supervision of consumer credit firms

As an independent market conduct authority, the AFM supervises the way in which consumer credit firms advise their clients, apply the rules which intend to prevent excessive borrowing, fulfil their legal duty of care, and the information they provide. These measures must ensure that firms appropriately consider their consumers' best interests, and stimulate responsible lending behavior. The AFM recently published how it combines traditional forms of supervision and policy making, with the application of behavioural insights.¹ This paper shows how these insights may be applied in practice, and to consumer credit in particular.

We describe a number of elements in the choice architecture which influence decision-making. Credit firms may apply these insights, in combination with additional research, to design their choice architecture in such ways in which it stimulates better credit decisions. The AFM will from now on focus its attention to the choice architecture more often.

Transparency supervision

The AFM supervises a specific set of rules and regulations regarding consumer credit. We can apply numerous supervisory tools, among which the supervision of the information provided by firms to consumers. Fair, correct, and not misleading communications enable consumers to make well-considered financial decisions, but do not prevent ill-advised or suboptimal decisions by itself. People do not use every single bit of information to which they have access to, and are easily influenced by the way in which options are presented to them.

Choice architecture

The amount of research on decision making behaviour is ever increasing. As a result, our understanding of the limitations of our traditional supervisory approach is becoming better and better. The AFM therefore encourages alternations of the choice architecture as well. The choice architecture consists of the way in which information is presented, in combination with the product or service offered and the distribution channel used. For instance, the number of alternatives, any default options (e.g. type of loan or instalment amount), preference settings, wording, the design of a website, and saliency of specific product features. Given its large influence, the AFM will critically assess how firms design their choice architecture, and may ask for evidence that their design is not (unknowingly) harming the interests of consumers. This renewed approach and broadening of our conduct supervision is in concurrence with a recent recommendation by the Netherlands Scientific Council for Government Policy (Tiemeijer, 2016), in which policymakers were encouraged to take behavioural insights into consideration more often and look for interventions which encourage behavioural change.

Changes in the choice architecture may direct ('nudge') people's decisions in the right direction, without unnecessarily limiting their options and freedom of choice. Whenever people's decisions

¹ AFM and the application of behavioural insights (2016).
<https://www.afm.nl/~/profmedia/files/rapporten/2016/application-behavioural-insights.ashx?la=nl-nl>

are directed towards decisions which are not in their best interest, we call these 'evil nudges'. Such nudges may actually be profitable for firms, e.g. higher loans, smaller repayment instalment amounts, or longer contract duration, but not to consumers. The AFM wishes to prevent such 'evil nudges', and promote the design of choices which appropriately consider people's best interest.

The following example illustrates the strong influence of the choice architecture on decisions.

Small change, large effect

The Education Executive Agency of the Dutch Ministry of Education, Culture and Science (DUO), responsible for coordinating student loans in the Netherlands, made two simple changes to its website: removing a check box next to 'maximum loan', and changing the default loan amount after a student has completed its studies. Both changes resulted in a significant reduction (50%) in the number of students borrowing the maximum amount (Van der Steeg & Waterreus, 2015).

Considerations when designing choice architecture

Research can help determine how decisions may be designed such that people take decisions which are in their best interest. The impact of certain elements in the choice architecture may differ significantly between different contexts. What works for people making health-based decisions may not work for financial decisions. In order to increase our understanding of consumer behaviour and to develop our supervisory approach effectively, we run experiments with financial firms into different elements in choice architecture. For example, we have recently assessed the impact of default options on decision-making.

Based on existing behavioural research, we have compiled evidence of the impact of several elements in the choice architecture on credit decisions. These elements illustrate how behavioural insights may be applied in practice.

1. The use of default options

A default option is the automatically selected option when someone fails to actively decide otherwise (Johnson et al., 2012). For instance, the type or duration of a particular loan. People are particularly sensitive to such options, and tend not to deviate from them (Kahneman, 2003), either because of inertia or because they are perceived as implicit recommendations (Soll et al., 2014; Smith et al., 2009).

If default options are used, they should therefore be cleverly chosen so that they serve people's best interests. Selecting a higher, instead of the lowest possible instalment amount as default might ensure that people are not unnecessarily carrying the burden of repayments longer than needed. The same goes for stimulating active decisions by eliminating any pre-filled amounts. A recent AFM survey indicated that 93% of the respondents would have chosen the higher of the two instalment amount for a particular loan. By no means does this mean they would have actually followed through on this intention in practice, but does suggest we must test the influence of certain defaults experimentally.

2. The use of anchoring

People make use of all sorts of heuristics; simple rules of thumb that result in faster and more easily made decisions. When these heuristics systematically lead to incorrect or irrational decisions, we refer to this as a cognitive bias (Tversky & Kahneman, 1974). Anchoring is an example of such a bias; a pre-defined amount which is used as a reference point (anchor) when choosing a loan amount. Although seemingly irrelevant, behavioural research suggests that the higher an anchor, the higher the amount consumers borrow.

In order to stimulate better credit decisions and promoting responsible borrowing, the AFM has been assessing the use of anchors by firms since 2014.

3. The display of total costs

Communication from firms to their consumers typically highlight particular details of a loan, such as the monthly instalments, or the interest rate. Less salient are the total costs or the duration of the loan, which may lead to people underestimating the actual impact of their credit decisions.

A recent study from Ireland (Lunn et al., 2016) has found that people's decisions differ whenever they have been presented with adverts in which the total costs of a loan, instead of the monthly instalments was highlighted. An AFM survey suggests that people would much prefer shorter contract lengths, and would choose as such whenever they are asked to select the preferred duration, instead of the preferred monthly instalment. Preliminary results suggest the importance of such design choices on credit decisions. The AFM expects firms to test whether they inadvertently steer people's decisions negatively.

4. Balanced communications

People tend to be much more focused on the short term. Fixating on receiving credit with which to buy a certain product may deviate attention to the consequences of their decision. If communication to consumers is unbalanced, such behaviour may actually be exaggerated. For example, when leaving out or hiding important information about the costs and risks involved, or using temporarily discounted rates.

The same applies to language used in adverts; credit firms have the natural tendency to avoid words like 'borrowing' and 'credit' in order to positively influence people's emotions and which may result in wrong perceptions. For example, qualitative research by the FCA (2014) found that overdrafts were typically not perceived as loans. It is therefore important that both the advantages and disadvantages of a product or service are presented equally.

5. Stressing the available balance

A revolving credit facility allows people to use funds whenever they are needed. Advertising the available balance plays into people's tendency to underestimate future consequences and overestimate short term gains. The way in which the available balance is presented, must be

equally balanced with the way in which the used funds are presented. This may prevent a nudge towards ill-favoured decisions.

6. Taking down unnecessary barriers

Taking out a loan or requesting a service is typically easier than terminating a contract or arranging early repayment of credit. One click on a button is often enough to extend your credit limit in a mobile app, or buy goods on credit when shopping online. Early repayment of credit often includes much more steps. As is the case with unbalanced communications, this introduces barriers which may result in undesirable outcomes. For example when people inadvertently take out more funds than necessary, or unnecessarily stick to long contracts.

7. The use of whole numbers

People have difficulty understanding or applying percentages. Research indicates that whenever loans are compared using whole numbers, instead of percentages, people have a better understanding of the differences and adjust their behavior accordingly (Bertrand & Morse, 2011). To stimulate responsible borrowing and better credit decisions, additional research may be conducted in order to find whether such results may be found in our contexts as well.

Conclusion

Based on existing behavioural research, we have compiled evidence of the impact of several elements in the choice architecture on credit decisions. These elements illustrate how behavioural insights may be applied in practice. As described in AFM and the application of behavioural insights (2016), such insights may prove useful in stimulating decisions which are in people's best interest and preventing 'evil nudges'. The application of behavioural insights in supervision is still being developed. In order to develop our approach effectively and more quickly, we invite firms, consumer organisations, regulators, supervisors and scientists to contribute their ideas research proposals related to this topic.

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