Behavioural interventions and iterative policy-making

Geoffrey Myers reflects on behavioural insights-oriented remedies in economic regulation

The limits of 'homo economicus' and the significance of behavioural biases in consumer decision-making have long been recognized, but recent years have seen a burgeoning of research by both academics and policy-makers. Regulation is no exception with a growing literature and a developing body of experience from testing and evaluating interventions based on behavioural rationales – often called consumer-facing or demand-side remedies (Cavassini et al., 2018).

The range of behavioural biases by consumers are well established. They include: loss aversion, bias towards the present over the future, disproportionate effects of anchors or targets, that different framing can substantially change consumer choices, over-confidence, and limited attention. Such biases can lead consumers to make decisions that do not seem to be in their own best interests or open them up to exploitation by suppliers. These biases are also increasingly at the heart of regulatory interest; after all, there is a tendency of economic regulators to focus on creating conditions for informed consumer choice, enabling individuals to partake in markets (see also Lodge and Mennicken, 2018).

In this vein, a recent **carr** workshop focused on the design of regulatory interventions; if we assume that consumer harm based on behavioural biases has been established, what are the opportunities and regulatory failure risks associated with consumer-facing remedies? Workshop participants were drawn from a range of regulators, academic disciplines and industry, who shared their respective experiences and perspectives in sectors as diverse as energy, financial services, online hotel booking, and telecommunications.

Opportunities arising from the behavioural insights agenda build on the potential to empower consumers through the three 'A's: access to relevant and useful information, which allows them meaningfully to assess their options, and then make well-informed decisions to act. The pivotal key to the success of these remedies is achieving the desired demand-side responses by consumers. In turn, this can be reinforced by supply-side responses by providers, especially if they compete against each other to gain the business of more informed and engaged consumers. This, in turn, can lead to a virtuous cycle.

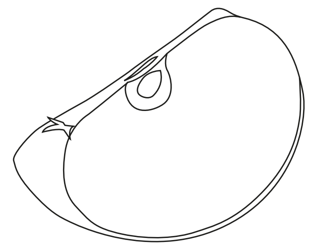
But how can regulators identify the most effective consumer-facing remedies? Best practice involves empirical testing of proposed remedies, such as through consumer research, 'laboratory' experiments, field trials (randomized control trials) or natural experiments (UKCN, 2018). Such techniques have been used extensively in some regulated sectors, such as financial and energy markets.

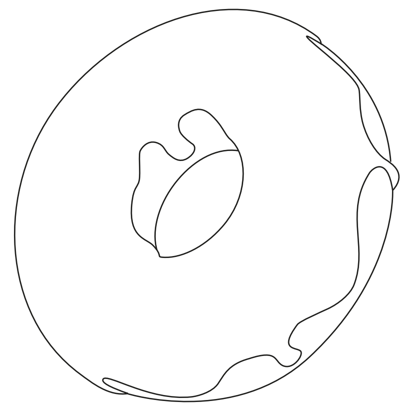
Workshop participants emphasized the importance of an evidence-based approach – not opining from an ivory tower how consumers could or 'should' behave, but instead gaining insights from real-world testing to identify which approaches are best suited to gain consumers' attention and engagement. Results of empirical testing are often unpredictable because consumer behaviour can be very context specific, so that it can be unreliable to read across the past experience in one market to predict the effect in another.

Remedies based on providing better or more accessible information to 'nudge' consumers often have a positive but modest impact. But, in some circumstances, they can be more effective if they are well designed. A good example is that of a recent trial by Ofgem in the context of encouraging greater consumer switching. Energy markets have been the subject of much investigation by academics and regulators, with the adoption over time of a range of consumer-facing remedies and ongoing experimentation to stimulate greater consumer engagement in terms of consumer choice in the marketplace. The evidence suggests slowly rising rates of consumer switching in the sector. However, more than half of energy consumers still remain on expensive default (or 'standard variable') tariffs despite large savings being available by moving to a fixed-term tariff, e.g. typically £300 per year.

Ofgem conducted one trial with 55,000 customers of a large supplier who had been on standard variable tariffs for three years or more. The remedy being tested included sending three letters to set out the offer of a single collective switch tariff, with helpline support available both online and via telephone. In the trial the remedy had a clear and substantial impact on behaviour in terms of increasing consumer switching rates to 22.4% compared to only 2.6% in the control group that did not receive letters (Ofgem, 2018). The greatest impact in this trial was from using letters (which in an increasingly online world were seen as novel) and the supplier's branding (which had a larger effect than the letters that used the branding of the regulator).

The workshop also discussed how regulatory failure can arise due to ineffectiveness or unintended consequences. First, there can be a lack of demand-side response, such as a small change in consumer behaviour (e.g. another Ofgem trial with a single letter offering three cheaper tariffs from other suppliers





only increased switching from 1% to 1.5% for one supplied with an Ofgem-branded letter (although the average across three suppliers and trial variants was higher at 2.9%) (Ofgem, 2017). Or there is the risk of a fading impact over time since switching once does not guarantee future consumer engagement.

Second, there is a risk that remedies can even have the opposite to the intended effect. For example, disclosure of broker commissions on cheaper mortgages led participants in an experiment in the USA to increase their take-up of mortgages that had no such disclosure even though they were more expensive. Similarly, well-intentioned remedies to protect consumers can inadvertently limit competition, such as improved rights and information about doorstep selling potentially creating undue over-confidence, thereby reducing consumer search and competition (Fletcher, 2016).

Third, there can be offsetting demand-side responses. An example is a field trial conducted by the Financial Conduct Authority (FCA) about consumer-facing remedies to encourage larger credit card debt payments than the contractual minimum. On one measure, the remedy superficially appeared to be successful as it led to a large increase in the use of direct debits for automatic fixed payments at levels chosen by the consumer (up from 29% to 50% of credit cards). However, this increase in automatic payments was matched by an offsetting decline in irregular manual payments, leading to no overall effect on consumers' debt (FCA 2018). This experience emphasizes the importance of casting the net broadly when seeking to measure success.

Fourth, there can be offsetting supply-side responses by suppliers that can find creative ways to evade or bypass the remedy, or they can react to one price being pushed down by increasing another – this is often called a 'waterbed effect'. Supply-side responses are harder to test empirically in advance but there is well-established empirical evidence and theoretical models suggesting how they can arise, e.g. the 'ripoff externalities' analysed in Armstrong (2015). Their relevance is also recognized by regulators, such as the Competition and Markets Authority (CMA) which recently noted that remedies to address the so-called 'loyalty penalty' of higher prices to longstanding customers can lead to a waterbed effect. Declines in these higher prices can reduce the incentive and ability of suppliers to offer low upfront prices to attract new customers. As a result, these upfront prices may rise, and the overall strength of competition could be weakened (CMA 2018).

The range of possible positive and negative effects suggests that a desirable approach for regulators is 'iterative policy-making': after identifying consumer harm arising from behavioural biases, to conduct careful research, tests or trials into effective interventions, which can then be implemented, monitored and evaluated, leading to refinement in the light of evidence of their practical success or failure.

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