

Acting on Impulse: **A Chance to Double Profits *and* Help Society**

The human trait of impulsivity is fundamental to retail finance. Basically, impulsive customers require very different products and services to thrifty ones. Yet this segmentation currently receives little attention from the industry, even though successfully assisting impulsive people would both double savings profitability and help sort out the pensions crisis.

To design services around this segmentation, providers need to understand the cognitive causes of impulsivity and the strategies people can use to manage it. Accordingly, this brief explores some of the latest research in this field, and describes several examples of how well-studied shortcomings in human decision-making can be, and have been, used to help impulsive people stack the cards in their favour.

For those who can remember the British seventies, the phrase “can’t help acting on impulse” will revive wistful memories of some hapless guy chasing after what looked like Farrah Fawcett. Impulsivity, this deodorant advert said, means living for the moment, taking risks and making romantic gestures. True^a. But without wanting to be curmudgeons, we feel compelled to point out that the reckless gratification of urges can also have unhappy results. It is generally agreed that Western consumers aren’t saving enough. There are various figures available, but an often quoted UK estimate from a project we worked on at the ABI identified a £27Bn savings gap, with 70% of households not saving enough for a comfortable retirement. People are acting too impulsively--enjoying the moment at the expense of the future.

This brief is about the causes of impulsivity and what financial providers might do to help consumers redress the imbalance. By doing this providers will garner two main benefits. First, they will help solve this pensions crisis, a hefty political issue, and in the process both improve customer satisfaction and reposition their brands as more caring and friendly. Second, as described below, they will increase profits. Whilst this brief is too short to lay out a complete solution, we aim to outline the opportunity. The next section details the business case for developing “impulsivity services”. Then, the mental mechanisms that produce impulsivity are reviewed. Finally, the brief examines some applications and addresses some objections.

Financial Personality

Is developing products for impulsive people a good investment? After all, they could be an unattractive segment. Figure 1 investigates this question. In a recent study of savings behaviour we identified two influential customer traits. The first is the amount of involvement people have in the details of their finances (a hands-on factor). The second is their desire for more self-control over spending (an impulsivity factor).

Figure 1. Four Savings Segments: Average Interest Rates, Balances and Revenues

	Low Impulsivity	High Impulsivity
Low Hands-On	2.8% <u>£13,700</u> £230	2.2% <u>£5,400</u> £120
High Hands-On	2.9% <u>£20,500</u> £330	3.0% <u>£3,300</u> £50

The table shows the resulting four segments. For instance, impulsive hands-on people (bottom right)

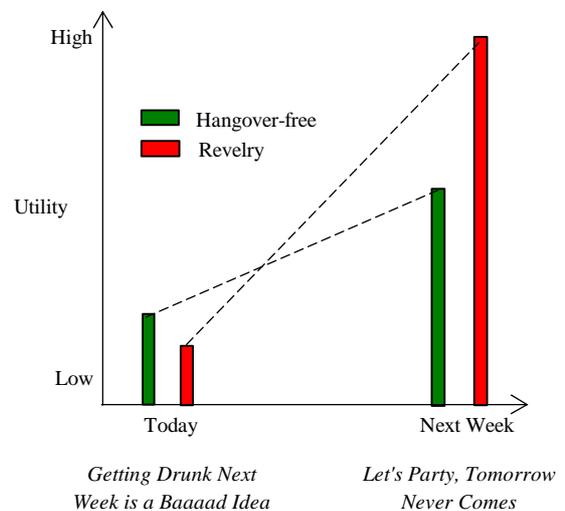
have £3,300 of savings that earn 3.0% interest. This means the deposit taker receives a 1.5% margin or £50 per year (at 4.5% wholesale rates). The table shows that hands-on people obtain higher interest rates and impulsive people have lower balances. Consequently, the impulsive half of the market generates under a quarter of the total revenues. Impulsive people are indeed unattractive customers.

But the table also underlines the benefits of helping “impulsives” get their life under control. The average customer revenue in the table is £185. But if the balances on the right hand side were like those on the left, then that average would rise to £295, a 60% increase which, when combined with operating leverage, would double pre-tax profits^b. So helping impulsives to help themselves benefits both parties. Moreover, pay-as-you-go mobiles, weight loss spas, and small cigarette packs all demonstrate how people are willing to pay a premium for greater self-control.

In Two Minds

Before considering what providers can do about impulsivity, it is worth examining the underlying mechanics. Figure 2 details how people discount the future and behave impulsively.

Figure 2. Cognitive Perspective of Impulsivity



Intuitively, impulsives apply too much weight to the present in their decision-making. For example, unless it’s the Veuve Clicquot Christmas party, you may want to avoid getting drunk next week. The left hand side of the figure shows how the attraction of carousing next week (red) is smaller than the benefits of a hangover-free morning (green). Note how both outcomes are discounted in this decision, because they lie in the less tangible future. However when next week comes around (the right hand side), tomorrow’s hangover is still in the future, but the pull of revelry is now in the present. So if the future is discounted enough, an impulsive preference reversal occurs^c.

In this way, people act as if there are two selves fighting over the wheel, similar to the notion of heart versus mind. The first is a fast and shallow intuitive system that makes reflex decisions. The other is a slow and thoughtful cognitive system that makes conscious decisions. Decisions about the future are made by the deliberating system because they involve hypothetical thinking. By contrast, the intuitive system doesn't support such reasoning, but rather reacts to the moment^d. So the discount rates underlying Figure 2 are a blend of two forces, one extremely short-term and the other much more balanced. The relative potency of these two systems will make some people more impulsive than others.

Tampering with Temptation

Having outlined a theoretical framework, it is time to consider the applications. Essentially, the idea is to provide people with the means to influence the temptation calculations in Figure 2. We review three example strategies. Firstly, they can adjust the timing of the decision, because taking the decision further in advance will lessen impulsivity. Secondly, they can reduce the red bar's size and vice versa by playing with the way the decision is presented. Thirdly, they can reorder the timing of the various considerations and have impulsivity act in the opposite direction. Three applications illustrate these three strategies^e.

The first example involves pushing the decision away from the present. Instead of asking people how much they want to save this year, ask them about next year. Of course, like Odysseus and the Sirens, this strategy then requires a means of (ethically) locking them into the decision to avoid the possibility of an ensuing preference reversal (chaining to the ship's mast in Odysseus's case). So at one extreme, this could entail a binding pre-commitment. At the other extreme, it could simply rely on inertia. In between there are various other approaches, such as cooling off periods and the like. This approach has been shown to substantially increase pension contributions.

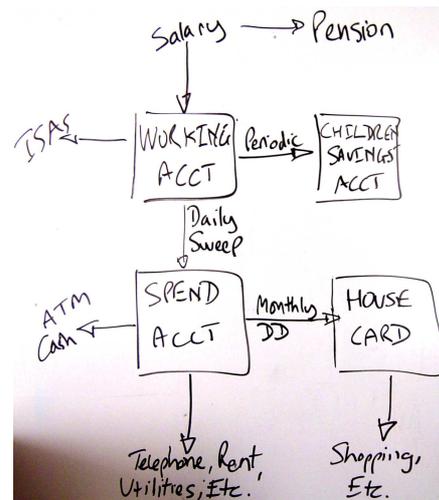
The next example involves manipulating the decision itself. Many decision-making anomalies offer ways to reframe questions that will alter preferences. One such anomaly is the status quo bias--things are less attractive if they are seen as a departure from the norm. For example it has been shown that US 401(k) pension administrators can powerfully influence employees' contributions just by moving the default from having to join a scheme to having to leave. Likewise, mental accounting and loss aversion mean that it is more painful to take money from pay than from a payrise (the former is perceived as a loss while the latter, a lowered gain). Accordingly, it has been shown that pension contributions are greater when taken from a payrise, rather than from post-rise pay^f.

Finally, the third example concerns expenditure, the other side of the savings equation. It has been shown that people's behaviour is very different depending on how consumption and payment are distributed in time. For example, credit cards act to increase expenditure in two ways. Firstly, they move payment to after enjoyment, meaning that impulsivity acts to increase consumption. When this situation is reversed and consumption requires prepayment, impulsivity has the opposite effect. Secondly, by aggregating expenditure into a monthly bill, cards dissociate the pain of paying from the fun of buying. Impulsive people should therefore avoid payment mechanisms that have this decoupling effect.

Retail Financial Systems

The prior examples illustrate how to design products that will assist impulsive people. But providers can also help people join products up into functioning financial systems. Basically, such financial systems have two characteristics--the configuration of the accounts and the rules by which they are operated.

Figure 3. Example Consumer Financial System



Even though providers don't explicitly offer this service, people are already creating such financial systems of their own accord. In one study we asked participants to sketch diagrams of their finances. Figure 3 shows an example output. In this case, income and capital are managed through the "Working" account, but all the day-to-day expenditure goes out through "Spend". This consumer then managed expenditure using a "keep Spend spending below salary" rule. Likewise other people operated rules such as "Draw £50 cash each Monday", "Save the annual bonus", and so forth. Notably some of these were extremely expensive (e.g. "spend until the card is declined"), supporting the notion that people will benefit from having better designed systems.

So providers can help consumers in two ways. Firstly, they can devise new products that help people to achieve their savings objectives. This will involve providing features and services that they can use to manipulate Figure 2. Secondly, they can help people assemble these products into workable financial systems. This should include configuring accounts in ways that are easy to operate and giving guidance on what rules of thumb to use in their management.

Conclusions

Naturally, these ideas will raise concerns. We consider three. The first is that by meddling with the finances of impulsive people, the provider will be appreciated by the deliberating system but resented by the reflex system. Is this not a brand risk and, indeed, can such paternalism ever be justified? This objection seems to miss the point. The aim is to provide impulsive people with the tools they need to manage *themselves*, not be managed by the provider. Does anyone resent WeightWatchers for trying to help them lose weight? These new products should clearly leave people responsible for their actions, be they bouts of bohemian self-indulgence or painful self-discipline.

A second concern could be that this will undermine overall profitability, for example by reducing loan volumes. But the profit increases described in the first section are so great that any such lending cannibalisation would need to be drastic, possibly total. Moreover, the savings gains arise from new balances to the banking system (because they come from avoided consumption). Hence, there should be additional profit improvements from market-share gains driven by these new products and the associated brand image improvements. Meanwhile, taking the opposite view basically means choosing to exploit rather than assist customers. This is hardly a sustainable long-term strategy.

The third potential objection is that these products will be hard to sell. For example, impulsive people can't be identified from their demographics. Frankly, we have never understood why some people are so rigid about segmentation. Firstly, why should there only be one? Surely every important marketing initiative should be supported by a tailored segmentation? Secondly, why does segmentation have to be built around observable characteristics, like demographics? For example, what if breakfast cereal manufacturers decided not to offer different products because customer preferences aren't associated with visible traits? Naturally, these new financial products will be bought rather than sold, but their success and popularity will be none the worse for that.

In summary, it is suggested that financial providers should design more customer-relevant variation into their offering. Closer observation of consumers

reveals some critical differences in their needs, like impulsivity or being hands-on, and yet these differences remain underserved. Providers' products should address these requirements and providers' sales channels should unearth these needs and help customers tailor their financial systems accordingly.

Many consumers are currently acting on impulse and sweating it out. Financial providers have both the means and the motive to help. We can picture the ads now--some hapless lad chasing after what looks a bit like Claudia Schiffer, with that geezer from the Halifax in hot pursuit⁸.

References and Footnotes

- a. A great treatise on the adaptive value of impulsivity is Zuckerman, M. (1994) *Behavioral Expressions and Biosocial Bases of Sensation Seeking*. Cambridge University Press: Cambridge, UK.
- b. Consider that the £185 of revenues has about £90 of associated overheads (i.e. a 50% cost-income ratio) yielding pre-tax profits of £95. Assuming costs don't rise with balances then increasing revenues to £295 will raise profits to £205. Achieving left hand column balances is credible as the quadrants are identical in terms of size, income, etc.
- c. We've spared you the underlying cognitive theory. Essentially, there is a formula for how people discount the future in decision-making and impulsivity occurs because those discount rates don't compound constantly (because they're hyperbolic), unlike discount rates which do preserve the relative bar sizes (because they're exponential). One of the original papers to raise the alarm was Kirby, K. N. (1997) Bidding on the future: Evidence against normative discounting of delayed rewards. *Journal of Experimental Psychology*, 126 pp: 54-70.
- d. The reflex system operates Pavlovian associative learning. There is substantial research into this dual-system model. A lovely example is Shiv, B., & Fedorikhin, A. (1999) Heart and mind in conflict: Interplay of affect and cognition in consumer decision making. *Journal of Consumer Research*, 26 pp: 278-282. They asked people to memorize either two- or seven-digit numbers (i.e. low or high cognitive load) and then walk to another room to report them. On the way they were offered a choice of chocolate cake or fruit salad. The cake was selected by 63% of the high load participants versus 41% of the low. Tying up the deliberate system passes the reins to the reflex one.
- e. These three examples come from i) Thaler, R., & Benartzi, S. (2004) Save more tomorrow: Using behavioral economics to increase employee savings. *Journal of Political Economy*, 112 pp: 164-187. ii) James Choi, J., Laibson, D., Madrian, B., & Metrick, A. (2006) Saving for retirement on the path of least resistance. In McCaffrey, E., & Slemrod, J. (Eds.) *Behavioral Public Finance*. Russell Sage Foundation Press: New York. Authors. iii) Prelec, D., & Loewenstein, G. (1998) The red and the black: Mental accounting of savings and debt. *Marketing Science*, 17 pp:4-28.
- f. How income is allocated to expenditure was originally explored in Thaler, R. H. (1985) Mental accounting and consumer choice. *Marketing Science*, 331 pp: 199-214. For a list of other potentially useful biases see http://en.wikipedia.org/wiki/List_of_cognitive_biases
- f. Halifax, part of UK bank HBOS, features branch employee Howard Brown in their advertising.