Applying behavioural insights to regulated markets

Abstract: Collectively the UK public is overpaying for mobile phone contracts by £355 million a year while in theenergy market millions of households could save over £300 by switching supplier. Taken together these statistics present compelling evidence that markets are not delivering the best outcomes for consumers. The justification for regulatory intervention and the core role of regulators is to correct market failures and the consumer detriment arising from those failures. One explanation for why a traditional regulatory approach has not provided a complete solution in these situations is because it is underpinned by the belief that consumers act in a perfectly economically rational way, when it is clear that this is not the case.

There are two key problems with this approach. First, there is compelling evidence that consumer decision-making systematically strays from what would be expected from a 'rational actor' within economic theory. These systematic deviations, termed 'behavioural biases', can result in 'behavioural market failures', leading to poor outcomes for consumers. Exacerbating these behavioural biases is the reality that people lead busy lives, and the extent to which they are willing and able to devote time and energy to making decisions in consumer markets is limited. Additionally, suppliers are incentivised to play on consumers' behavioural biases in order to discourage consumers from switching suppliers or encourage them to buy unnecessary additional products.

Second, the assumption that consumers are rational actors can lead to unnecessary, complex red tape which is inefficient for business and provides no real benefit for consumers; a good example of this is terms and conditions. Businesses are legally required to provide their customers with comprehensive information on their rights and obligations under the contract they are entering into. However, very few people actually read or understand these documents.

UK regulators are increasingly incorporating behavioural science into their approach. The progress to date is to be welcomed. However, there are real opportunities to build upon the foundations already laid and move towards a model of regulation which puts behavioural insights and securing good outcomes for consumers at its heart. In this paper we introduce a set of principles for a new approach to regulation. We are still advocating what economics has long strived for in market design: good outcomes for consumers. However, instead of trying to make people behave more like rational economic actors, we are arguing that markets should deliver good outcomes by being designed in line with human behaviour.

This is not necessarily about introducing more regulation. Indeed, in some cases this approach may point towards the replacement of detailed regulations with principled-based regulations. These principles would set out the outcomes the regulator expects the market to deliver for consumers, but not the precise mechanisms through which they should be delivered.

Regulators should be designing remedies with behavioural market failures at the forefront of their thinking, to help consumers make better choices for themselves and prevent businesses from exploiting their behavioural biases.

Link to full paper: http://tinyurl.com/jg2raho
Many thanks,

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