The Actuarial Profession
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Financial Consumer Support Committee and Consumer Risk Research

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Financial Consumer Support Committee

Background

The committee has a broad brief, to contribute on behalf of the profession in addressing public interest issues relating to personal finance. In particular:

(i) to contribute to developing the profession's thinking on the role of personal financial planning and the distribution of personal financial products in promoting individual and social welfare through the accumulation of financial assets.

(ii) to contribute, in collaboration with other bodies within the profession, to initiatives seeking to disseminate consumer financial education in the population.

(iii) to comment on proposals from government, regulators, academia, commerce and the voluntary sector that promote the spread of savings and assets in the population.

(iv) to encourage research that examines the social and economic processes that promote or impede the spread of savings and assets.

(v) to examine issues of distribution in retail marketing in the personal financial sector.

This has resulted in active consultation and written comment with a wide range of external bodies during a busy period of discussion papers and consultation documents. It has also involved comment on industry issues where consumer detriment has resulted, or may yet result, from inappropriate marketing and selling practices or a genuine lack of consumer understanding of the products they have bought. The committee's role is to address the issue from the viewpoint of the consumer and present an informed, but impartial, opinion.

The committee was also heavily involved in the Banham inquiry, which exposed issues relating to consumers' access to financial advice and consumers' attitude to risk. In particular, the Inquiry concluded that there was insufficient attention to the subject of risk profiling, and mismatches exist between an adviser's perception of his client's attitude to risk and the client's actual attitude. This was caused by the imperfections in the sales process, consumers' inability to articulate their attitude accurately and a number of psychological and contextual factors that distort the answers.

The actuarial profession decided to commission research to understand better the contextual and psychological factors that affect a consumer in financial decision making.
In doing so, it was necessary to explore the traditional economist and finance view that well-informed consumers should always act in a financially rational manner. Failure to do so has been seen as primarily due to a lack of experience or insufficient information. In contrast, recent psychology and experimental economics research has produced evidence that human behaviour diverges from the predictions of rational choice theory. Our research aims to explore the practical implications of these academic findings.

Consumer Risk Research

The profession has commissioned the University of Warwick to undertake the work, with guidance being provided by members of the Financial Consumer Support Committee. The overall objective is to find ways of improving the process by which consumers' actual attitude to risk is matched by the financial solutions they are offered. In order to do this, the project is being conducted in 3 stages, each of which is dependent on the findings from the previous stage. The first stage has now been successfully completed.

During stage 1, the following work was carried out

- Integrative review of the literature and relevant experiments in the cognitive and experimental economic and psychology fields.
- Identification of key areas for research, focusing on the degree to which the presentation of advice can potentially affect consumers' financial decision making.
- Design and analysis of pilot data on hypothetical pensions advice, from a small sample population.

The review of existing experimental research produced some interesting findings that included:

- Consumers have a poor transfer of learning between education and practical application, and exhibit poor retention levels due to the infrequency of applying their learning.
- As a consequence, education may have limited impact in financial decision making.
- A number of experiments demonstrated the lack of rational behaviour in financial decision-making. When choices are difficult, people often resort to simple rules of thumb to help evaluate the options.
- Consumer decision-making is influenced by the presentation of the information and the range of options from which to select.
- Prospect theory considers consumers' attitude to investment risk by considering the degree to which aversion to losses is considerably stronger than the positive impact of similarly sized gains.
- Research indicates that investors are myopic, i.e. they are sensitive to short-term losses even if investing over the long-term.

The pilot studies were framed in the knowledge of previous experimental research, focusing on testing the effect of different options and presentations, and were conducted using around 100 people.
The results of these pilot studies suggest that simple modifications in the format of the advice by modifying the choice options that people are presented with can have a substantial impact on the amount that people say they are willing to invest, and the level of risk that they prefer. Moreover, informing consumers about the likely outcomes of their investment appeared to increase their propensity to make the investment. Since the results also appear to demonstrate that investors, in principle, are unable to independently and autonomously make optimal decisions about their financial future, a great burden is placed on the presentation of information and advice.
The results of the pilot study have encouraged us to embark on stage 2 of the research.

Proposals for Stage 2

The goal of this stage is to make a provisional estimate of the degree to which the kinds of effects that are revealed in the pilot data could be applicable to real financial advice contexts.

Key issues include:

- How does estimated 'outcome' information from investments affect people's willingness to save?
- How does the range of options presented affect the level of investment that is chosen?
- How does the range of options presented affect the level of risk that is accepted?

The full experimental study will follow the design of the pilot study, but modified to increase relevance to real-world financial advice, using more robust and realistic financial data across a wider cross section of consumers. The sample used will still be relatively small because the principal goal is to corroborate the pilot study findings.

Stage 3 and beyond

If the results of Stage 2 continue to be promising, the actuarial profession may decide to pursue funding for a commercial-scale research project to take this work forward. For example, a sample of consumers might be taken through a full financial advice session using practical applications of the research findings.

An important issue to test is the extent to which advisers can affect the outcome and risk taken, by virtue of the means of presentation of information to customers. This will potentially create important findings that could influence the design of future sales processes. A similar set of experiments could be undertaken where consumers are encouraged to seek their own information and make decisions without any advice. Results from this have the potential to influence our thinking about the relevance of financial education and the means by which product information is marketed.

We could also check whether our current methods for determining a customer's risk profile are the most appropriate for assessing a customer's risk preferences, and test practical alternatives.
Further studies could also consider the extent to which people are likely to invest in risky assets relative to their individual risk preferences if they are offered a free choice along the whole range of possible options, compared with the situation where they are offered only certain sub-ranges that match their individual risk preferences.

In addition, we can also try to assess the potential large-scale economic, regulatory and practical impacts of implementing any modifications to the financial advice process. We can also investigate whether the context effects can be extended to other financial products and forms of advice (e.g. electronic financial advice).
The detail of any such research will be influenced by the significance of the findings in Stage 2 and the appetite of the profession, regulators and industry to embark on more substantive work. We propose wide-scale discussion once stage 2 has been completed.