

## Consumers' Understanding of Risk

Workshop A11

A study into the attitude and behaviour of UK consumers of financial services.

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## Background

- PFPC concluded that financial decision making was often sub-optimal
- Banham Inquiry encouraged Actuarial Profession to investigate
- Decided to view from mathematical and psychological standpoints
- Project undertaken with cognitive science academics at Warwick University
- Research undertaken between 2002 and 2004
- 20 Page Summary Report prepared outlining the findings

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## Methodology

- Reviewed relevant experimental research in UK and US
- Designed own experiments based on earlier research
- A number of experiments conducted as pilot studies
- More substantive quantitative and qualitative experiments conducted based on pilot findings

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## Relevant Experimental Research

- Role of Education
- Presentation of context and language
- Loss aversion and myopia
- Probability weighted function
- Payment decoupling
- Diversification heuristic
- Prospect relativity
- Discounting
- Gain-loss asymmetry
- Investor's autonomy

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## Presentation of Context and Language

You are given four cards, each with a letter on one side and a number on the other.

The exposed faces read X, Y, 1 and 2

What is the minimum number of cards (and which cards) would need to be turned over to test the rule:

"If there is an X on one side there is a 2 on the other"

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## Pilot Study

Can people be motivated to increase their savings and their investment risk by manipulating the context in which the options are presented and decisions made?

- Does the range of options offered affect judgments and decisions?
- Does the rank order of the offered options affect judgments and decisions?

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## Main Research Project Study 1

- The goal was to make a provisional estimate of the degree to which the kinds of effects that were revealed in the pilot study could be applicable to more realistic financial decision-making.
- Results demonstrated that the choices were strongly influenced by the set of choice options offered.

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## Main Research Project Study 2

- A qualitative study focussing on people's understanding of financial risk and suggestions on how to communicate investment risk to UK consumers of financial products.

Questionnaires were issued to evaluate:

- Relative importance of key risk factors
- Means of presenting risk, ranked according to usefulness, clarity and suitability
- The degree to which respondents would be affected by various risk factors

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## Practical conclusions drawn from the research

- General approach to advice
- Importance of understanding time horizons
- Choice structure
- Presentation of gains and losses
- Charging structures

The overall conclusion is that product providers and financial advisers can push and pull people into behaving in a way that is expected to maximise their welfare. This places huge responsibility on the industry, particularly given the fact that investors, in principle, are unable to make optimal decisions about their financial future.

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# The next steps?

- What further research should be done?
- Who should take the next steps?

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The Actuarial Profession  
making financial sense of the future

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