SUSTAINABLE FINANCE

New applications for the behavioural economics toolkit

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NEW APPLICATIONS FOR THE BEHAVIOURAL ECONOMICS TOOLKIT

EXEC SUMMARY

Public demands for action on global warming are shaping the commercial and regulatory setting in which all businesses operate. Banks and other financial institutions have come under increasing pressure in recent years as critics have questioned their support for companies in polluting sectors. Banks are now being asked to do much more to actively speed the transition to a low-carbon world. Paula Papp, associate director in Frontier's Financial Services practice, explains the central part that the behavioural economics can play in helping banks to bring about the required changes in people's habits.

FINANCE PROBABLY ISN'T THE FIRST SECTOR THAT COMES TO MIND WHEN THINKING ABOUT CARBON EMISSIONS. WHY IS IT NOW MORE IN THE SPOTLIGHT?

Rightly or wrongly, banks are judged to have been slow to wake up to the climate crisis. By continuing to finance carbon-emitting activities, they're increasingly seen as being part of the problem rather than part of the solution. There's a recognition that all businesses require financial services to operate effectively, so it was maybe inevitable that as well as creating tools and incentives aimed *directly* at changing the behaviour of those sectors responsible for emissions, policymakers would look to do the same *indirectly* through the financial system.

SO BANKS CAN'T REMAIN NEUTRAL IN THIS DEBATE?

Banks are committed to eliminating their own net carbon emissions. They also point out that they're doing their bit to mitigate climate change by financing renewable energy and clean technologies. But while that's true, it's unlikely to be enough to satisfy the court of public opinion. Banks urgently need to change these perceptions. To a large extent banks trade on their reputation as trusted institutions with values consistent with those of their customers. If a perception builds that the industry as a whole, or certain institutions within it, are part of the problem, customers will soon take their business elsewhere. That means reputational problems can quickly have serious commercial consequences.

WHAT ARE SOME OF THE MAIN CHALLENGES TO ACHIEVING THIS CHANGE?

Essentially banks are being asked to accelerate the shift in the balance of their business away from 'polluting' to 'clean' sectors. There are some obvious economic barriers in the way of this transition. For a start, traditional sectors remain important for the economy and still generate positive financial returns for banks. But digging deeper, I think behavioural economics can shed some light on why old habits may die hard.

An *aversion to loss* is known to be a powerful behavioural driver. Banks understandably don't want to lose established clients, and knee-jerk reactions like blacklisting polluting industries (as some more extreme commentators have called for) would be counterproductive. Also, there remains a tendency for *attention* and *reward* to focus on quarterly earnings updates and annual reviews. The industry will need to break out of this short-term thinking. The battle to curb global warming will be fought over several decades. Mindsets will have to adapt to this new timeframe.

MANY IN THE FINANCIAL SERVICES INDUSTRY WILL BE AWARE OF THESE CHALLENGES. WHAT MAKES THESE BEHAVIOURAL BARRIERS SO STRONG?

Bankers of course, aren't blind to what's happening around them. Some have moved quicker than others, and positioning on this issue has become a point of differentiation for banks and other financial institutions competing with one another. We already see banks making vast efforts to quantify the risk to their portfolios from the switch to a low-carbon economy. The intention is to translate these new risks into pricing and incentives to nudge customer behaviour. Sustainable investment funds have grown hugely in popularity. It would be unfair to suggest the industry has been asleep at the wheel.

But there's a long way to go. As of the end of 2018, fully 60% of surveyed lenders in the UK said they were taking a "responsive" approach to climate change, meaning they were assessing it as a financial risk over a three- to five-year horizon. Only 10% of banks had adopted a "strategic" approach – in other words, they were building climate-related factors into their financial management as part of a strategy set at board level. Short-term incentives outweighing longer-term best interests is a very powerful factor in decision-making. In fact it goes to the heart of the climate change challenge as a whole, so this is definitely not an issue restricted to financial services.

IN YOUR VIEW, WILL THE INDUSTRY BE ABLE TO MAKE THESE CHANGES ALONE?

No, for two reasons. First, there's a fundamental coordination problem. Change will require the entire industry to shift, but financial services markets are competitive and individual firms will always have a short-term commercial incentive to keep taking on profitable business in traditional sectors. The experience of economic regulation over the past 30 years is that without regulatory coordination, these incentives will prove too strong, given the pace of change being called for.

This means regulators have a crucial part to play to catalyse the shifts needed at industry level. They have to change the competitive environment and reduce the power of these short-term incentives – for example, by incorporating climate-change risk in banks' stress tests and capital requirements. There's also a need for stronger supervisory oversight of the conduct of individual firms.

Second, effective action will require partnerships between financial services and the sectors that generate the economic activity that we're concerned about - energy, transport and so on. Where bankers are making the greatest environmental headway today is in supporting large corporate clients to reduce their greenhouse gas emissions. They're doing that, for example, by including climate risk in their lending and financing decisions and by developing green bonds and loans linked to ESG criteria. Banks working in partnership with clients will be the way forward, not trying to impose changes on them.

As is already the case today, financial services firms will address their own carbon emissions. But the scale of the changes being asked of the industry - and of the economy as a whole - will require every part of the system to work together: both the private and public sectors, and businesses across entire supply chains.

IT SOUNDS LIKE THAT WILL INVOLVE A LOT OF ALIGNMENT BETWEEN DIFFERENT ORGANISATIONS. HOW OPTIMISTIC ARE YOU THAT THIS CAN BE ACHIEVED?

What gives me most confidence is that there's a general consensus around the direction of travel and the importance of the issues. All the relevant parties are broadly aligned. Financial services institutions already work in partnership with their clients, and competitive forces are pushing towards relationship building. In other words, the incentives to meet these challenges are already in place, and so is much of the infrastructure.

So I think the main barriers to achieving these changes are behavioural in nature. We're really talking about the speed at which the changes will come about, rather than whether they'll be made at all. We have a decade of experience applying behavioural insights to the diagnosis of problems and the design of solutions in financial services and beyond. So we now have much better mastery of the toolkit that will be needed to support and accelerate the shift.

For example, behavioural economics has a clear role to play in understanding and shaping the behaviour of retail clients and of small and medium-sized enterprises. About half of the UK's SMEs say they want to do more to tackle climate change but are put off for various reasons. A lack of time and money are the chief barriers, but others include a lack of attention and awareness and the perceived difficulty of taking action. A behavioural economics framework can provide a deeper understanding of these barriers. Financial services providers can then take these insights, work with their clients and tailor services in such a way as to influence how SMEs reach their decisions.

SO IN YOUR VIEW, HOW MUCH IS THIS ABOUT ACCELERATING THE USE OF EXISTING TOOLS AND THINKING, RATHER THAN INTRODUCING RADICAL NEW APPROACHES?

As I've said, there's a range of things that will need to happen, including regulatory changes and developing partnership across sectors. That means drawing up and implementing a whole set of policies. It won't be easy, but I'm optimistic it can be done.

In addition, it seems clear to me that greater application of behavioural tools will have a role. Obviously, how those tools are used will differ across institutions, but they're generally well established. These days it's pretty unusual to meet someone who doesn't know what a 'nudge' is, and increasingly people have seen these methods being applied in their business.

For example, Frontier has worked on two projects recently that illustrate how the tools have been used to understand decision-making process and design ways to change people's habits accordingly.

In helping a bank to cut costs, we found that many of its active online customers chose to stick with paper statements. Why? Because paper statements were familiar and linked to deeply ingrained record-keeping habits; some customers used them to tick off items, giving them a sense of reward; many saw them as a more official record that had to be kept for the taxman; and if they were printed on high-quality paper, statements signalled to customers unconsciously that they were valuable.

In other words, the bank learnt that it wasn't enough to nudge customers to change their ways. Its own online statement service had to become smarter, easier to use and more rewarding. The bank acted on these findings and was able to save a lot of money, helping the environment in the process.

Away from banking, in researching why UK homeowners don't invest more in smarter heating, we found that people generally don't think about their heating. It's something they take for granted. So in six out of 10 cases they wait until their system breaks down or is near the end of its life before deciding what to do about it. Not surprisingly, in such circumstances they want to solve any problems as quickly and easily as possible. That means sticking with the system they know.

The common lesson from both of these examples is that businesses need to overcome a lack of interest or awareness on the part of their clients by engaging with them at the appropriate time. This lesson has much wider application in the context of climate change.

ANY FINAL THOUGHTS? WHAT ACTIVE DEBATES ARE YOU ENGAGED IN WITH FINANCIAL SERVICES CLIENTS ON THESE ISSUES?

I've been stressing the importance of the external narrative and how quickly it's changing. Given that they are at the heart of the economy, banks in particular must work harder to become active agents of change. That means changing both their own behaviour and that of their customers.

The reality is that banks are now being held to a higher standard. It's no longer good enough for a bank to be a passive lender or adviser. It can't afford to be agnostic about the environmental consequences of the financial services it provides. Banks are being asked to shoulder more responsibility for the *purposes* to which those services are put.

This social pressure is already quite strong, and it's a trend that's only likely to pick up steam. This points to the importance of getting ahead of the curve if possible: both commercially and in engagement with regulators and Government. The behavioural economics toolkit is designed to help diagnose and influence people's habits. it will undoubtedly come into its own as we address climate change, which will require the biggest behavioural shifts in a generation.

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