Issue Briefs
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Using Behavioral Economics to Improve Financial Counseling and Coaching

Behavioral economics integrates findings from psychology and economics into the study of human behavior. This research reveals a range of biases in decision-making. Behavioral economists have documented dozens of ways that these biases can lead to problematic behaviors and outcomes, especially regarding financial management.[1]

This brief summarizes five ways that behavioral economics can inform the work of financial counselors and coaches.[2]

1. Reminders

Our ability to process information is limited. The part of the brain that manages 'executive' functions—high priority active decisions—often takes a back seat to more automatic or habitual processes. The number of items can we can pay attention to at a given time is limited. Thus, important but non-immediate concerns lose precedence to more pressing matters. Contributing to a savings account or paying a bill is just not top of the mind. Someone facing a financial crisis (e.g. job loss, unsustainable debt) may be even less able to pay attention to mundane details like paperwork or due dates.

Simple reminders can make otherwise forgettable information salient again. For example, taking a survey about bank fees is associated with decreases in over drafting of accounts. The reminder re-focused attention to overdraft fees and this ended up being related to fewer overdrafts (and related fees).[3] Reminders that mention specific behaviors *and* refer to an overarching goal may have stronger effects than just reminders alone. Reminders may be more effective when they promote one-time actions that people tend to put off yet have longer term consequences (such as signing up for a retirement plan).[4]

Tip for Counselors/Coaches: When you meet with clients, if there is a follow-up task that the client needs to remember to do in the future, consider sending an email or postal mailed reminder, or even making follow-up phone calls/voice mails. One online tool to consider is www.ohdontforget.com. This website allows you to set up reminders

[1] Corporation for Enterprise Development. "Behavioral Economics 101."
[2] Brooks, David. (2013). "Beware Stubby Glasses." New York Times. Shafir, Eldar. *The Behavioral Foundations of Public Policy*. Princeton, NJ: Princeton University Press, 2013.
[3] Stango, Victor & Jonathan Zinman. (2012). "Limited and Varying Consumer Attention: Evidence from Shocks to the Salience of Bank Overdraft Fees." Working Paper.
[4] Karlan, Dean et al. (2011). "Getting to the Top of Mind: How Reminders Increase Saving" (January 2011). Working Paper.

to be sent by text in the future.

2. Goal Setting

Many of our behaviors are directed by goals, but goals can take a variety of forms. As counselors/coaches work with clients, discussions of the clients short, medium and long-term goals are common. One mnemonic device to develop SMART goals—Specific, Measurable, Actionable, Relevant, and Timely. The 2010 book *Switch* by Chip and Dan Heath, however, suggests that while SMART helps people avoid setting vague goals, the most successful goal engage people emotionally. Thus, the authors advise that goals need to be inspiring and point to a "destination postcard," which is a motivating shorter-term vision of a future.[5]

Another strategy involves using "implementation intentions" which specify when, where and how clients propose to take action. Implementation intentions are stronger predictors of goal attainment than goals in the absence of concrete action steps.[6] An example of a generic goal might be "I will save my tax refund." A goal with an implementation intention would be "if receive a tax refund of more than $1,000, I will direct deposit the extra money into a savings account at the time I file my taxes."

An important factor for following intentions is to introduce some form of monitoring or accountability. Promising to follow-up creates an expectation that someone else will hold a client accountable for their actions. Check-ins and reminders can help create an environment where clients are more likely to adhere to their plans and actually change behaviors.

Tip for Counselors/Coaches: When working with clients on goal setting, to pay attention to ensuring that the goals are not just SMART, but also engage clients at an emotional level. A goal is much more powerful if it is closely tied to an inspiring vision. It is also important to talk through implementation steps and then develop a process to for following-up with clients over time and holding them accountable. Make sure the client expects follow-ups, and then be sure to contact clients at the agreed upon time. These steps can boost the client's likelihood of action. Even counselors who only meet with clients once can introduce accountability into the relationship through follow-ups, even by email or text message.

3. Reference Dependent Choices

We all make choices by comparing alternatives. A common question is 'compared to what?' If a choice feels like it has a gain or benefit, you will behave differently than if a choice involves a loss or penalty. A common behavioral trait is to try and avoid losses, also called "loss aversion." Studies show people will work harder to avoid losses than to realize similar gains. For example, the pain of losing $500 is much greater than the relative benefit of gaining $500. In general, people will work twice as hard to avoid a loss than to realize an equally sized gain.[7] This also results in a tendency to prefer not to change at all (why risk the loss?). The disadvantages of a change are weighted more heavily than its advantages.[8] The relative reference point

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[5] Heath, Chip & Dan Heath. (2010). *Switch: How to change things when change is hard*. New York: Broadway Books.

[6] Gollwitzer, Peter M. & Paschal Sheeran. (2006). "Implementation Intentions and Goal Achievement: A Meta-analysis of Effects and Processes." In P. Z. Mark (Ed.), *Advances in Experimental Social Psychology*, 38, 69-119.

[7] Benartzi, Shlomo. "Behavioral Finance in Action: Psychological challenges in the financial advisor/client relationship, and strategies to solve them." Allianz Global Investors Center for Behavioral Economics.

[8] Kahneman, Daniel Jack L. Knetsch & Richard H. Thaler. "The Endowment Effect, Loss Aversion, and the Status Quo Bias." *The Journal of Economic Perspectives*, 5(1), 193-206.

ends up strongly influencing how changes are perceived. But a reference point can be manipulated by aspirations, expectations, norms, and social comparisons.[9]

Tip for Counselors/Coaches: Clients may continue to engage in financially harmful actions because the pain of 'cutting one's losses' is so great. People may fail to change course because of the perceived pain or losses involved, even if it could prove beneficial in the future. Try and frame not taking needed actions in terms of potential losses (rather than gains). Shifting the point of reference can change perceptions of losses and gains.

4. Default Options

Making decisions is hard. Finding and assimilating information takes time and effort. Not deciding is often much easier than making an active choice. Of course, not deciding also is a decision, leaving you with the status quo. Therefore, whatever is the default outcome in the case of no decision often becomes the primary outcome (the path of least resistance). A famous example involves organ donation registries in Austria and Germany. In Austria, people can opt-out of the registry if they decide to, but otherwise are included on the donor list. In Germany, people are by default not organ donors but can opt-in to the registry. The default turns out to matter: nearly 100% of Austrians are organ donors, versus 12% of Germans.[10]

Defaults must be set with care and reevaluated regularly. Studies of people at jobs with employer-sponsored defined contribution retirement plans show that people will usually stick with the default savings rate and asset allocation (for example, 3% of income into a bond fund), even if this is not ideal for their age or profile.[11] The more all clients are better off with a particular default, the better can defaults work. To the extent people's circumstances and preferences differ, defaults may present problems for a greater share.

Tip for Counselors/Coaches: First, default clients into beneficial services or activities. For example, default clients into text reminders with the option of opting out, rather than asking them to opt in. Second, explore how defaults are working against a client's best interest. For example, a credit card company may default a client into paying automatically paying the minimum balance rather than a larger amount that the client prefers.

5. Mental Accounting

A dollar is a dollar, right? Yet we all categorize our money into different mental categories or accounts. A bonus from work is "fun money" but take-home pay is for the bills. Mental accounting treats the bonus funds differently. In one study, participants were told either that they had received a $50 parking ticket earlier in the week or that they had spent $50 on a basketball game. In both cases the person was out $50. But when offered the chance to buy a ticket to go to the theater, people who had spent $50 on a basketball game had spent their mental account for entertainment and were not as likely buy a theater ticket.[12] People treat money differently depending on the buckets they create.

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[9] Tversky, Amos & Daniel Kahneman. (1991). "Loss Aversion in Riskless Choice: A Reference-Dependent Model." *The Quarterly Journal of Economics*, 106(4), 1039-61.

[10] Johnson, E. J., & Goldstein, D. (2003). "Do Defaults Save Lives?" *Science*, 302(5649), 1338-1339.

[11] Madrian, Brigitte, and Dennis Shea. 2001. "The power of suggestion: Inertia in 401(k) participation and savings behavior." *Quarterly Journal of Economics*, 116 (4): 1149–87

[12] Chip Heath and Jack B. Soll. (1996). "Mental Budgeting and Consumer Decisions." Journal of Consumer Research, 23(1), 40-52.

People often budget their current sources of income into mental accounts; changing their accounts may be difficult. One strategy is focus on funds that are not yet labeled into any account. One example is *future* income, as suggested by the Save More Tomorrow (SMaRT) model. In this program people pre-commit that a portion of their future income will be allocated to savings (for example, half of any raise).[13] Another example is at federal income tax filing time. Tax refunds come once a year and may not be part of people's mental accounts, so there may be some flexibility in how people decide to use their refunds. Making plans for next year's refund now might help people to label these funds for a beneficial use.

Tip for Counselors/Coaches: Look for opportunities to help clients to re-label their existing mental accounts, especially as part of budgeting exercises or spending plans. Tax time may be a promising opportunity for to incorporate mental accounting into savings or debt repayment goals.

Conclusion

Findings from behavioral economics can help develop more effective ways to work with clients. In some cases, the implications are practical and make sense, in other cases the approaches may seem counter to conventional wisdom. Reviewing these suggested readings and resources is one way to continue learning about how to apply these ideas to your work.

[13] Richard H. Thaler and Shlomo Benartzi. (2004*). Save More Tomorrow™: Using Behavioral Economics to Increase Employee Saving*. Journal of Political Economy. Vol. 112, S164-S187.

Additional Resources

Benartzi, Shlomo. "Behavioral Finance in Action: Psychological challenges in the financial advisor/client relationship, and strategies to solve them." *A leading scholar in behavioral economics covers challenges that can arise when working with clients.*

Brown, Amy. (2008). "Behavioral Economics and Asset-Building: How Understanding the Psychology of Financial Behavior Can Empower Participants and Improve Program Outcomes." *Three-page overview of behavioral economics and its application to asset-building.*

Corporation for Enterprise Development. "Behavioral Economics 101." *Brief overview of additional concepts from behavioral economics.*

Datta, Saugato & Sendhil Mullainathan. (2012). "Behavioral Design: A New Approach to Development Policy." Center for Global Development Policy Paper 016. *Despite its primary focus on development policy, this paper is highly relevant to interventions in the US. Overviews numerous real-world applications of behavioral economics and provides concrete guidance on creating behaviorally-informed interventions.*

Davis, Kimberlee & Ryan Halley. (2011). "Behavioral Finance and Counseling: Blunder and 'Whys.'" *Slides from a presentation on applying behavioral economics to financial counseling*.

Hernandez, Mindy. (2011). "Applying Behavioral Research to Asset-Building Initiatives: Lessons from a Year of Experimentation." Corporation for Enterprise Development. *Introduces behavioral economics, discusses how to implement and evaluate behaviorally-informed interventions, and highlights three applied research projects.*

ideas42. "The Behavioral Perspective: Behavioral Examples." *Discusses 16 concepts from behavioral economics and includes audio and video to illustrate those concepts in action.*

Mullainathan, Sendhil. (2009). "Solving social problems with a nudge." *18-minute TED presentation on the application of behavioral economics to persistent social problems.*

Reid, Carolina. (2009). "An Apple or a Donut? How Behavioral Economics Can Improve Our Understanding of Consumer Choices." Federal Reserve Bank of San Francisco Community Investments. *Discusses how financial knowledge may be necessary but not sufficient for good financial decisions.*

Thaler, Richard & Cass Sunstein. (2008). *Nudge: Improving Decisions about Health, Wealth, and Happiness*. New Haven, CT: Yale University Press. *Classic book on the potential of behavioral economics to improve policy and practice*.

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The University of Wisconsin-Extension (UWEX) Cooperative Extension's mission extends the knowledge and resources of the University of Wisconsin to people where they live and work. Issue Briefs are an ongoing series of the Family Financial Education Team. This brief was drafted by J. Michael Collins, Assistant Professor in Consumer Finance and Extension State Specialist, Center for Financial Security and Collin O'Rourke, Outreach Specialist, Center for Financial Security,