VIEW POINT

UNDERSTANDING BEHAVIOURAL ECONOMICS FOR PERSONAL FINANCE MANAGEMENT

Abstract

Navigating the complexities of personal banking and finance management can be difficult, especially if you fail to account for how the different experiences, biases, emotions, and social influences affect financial decision-making. Behavioural economics – combining the principles of economics and psychology – can help you understand how various factors like cognitive biases, loss aversion, anchoring, gambler's fallacy, and herd behaviour affect your financial decisions and how you can overcome them. Leveraging the understanding of behavioural finance, finance accounting service providers can tailor the services for their consumers, helping them overcome the hurdles and achieve their financial goals.

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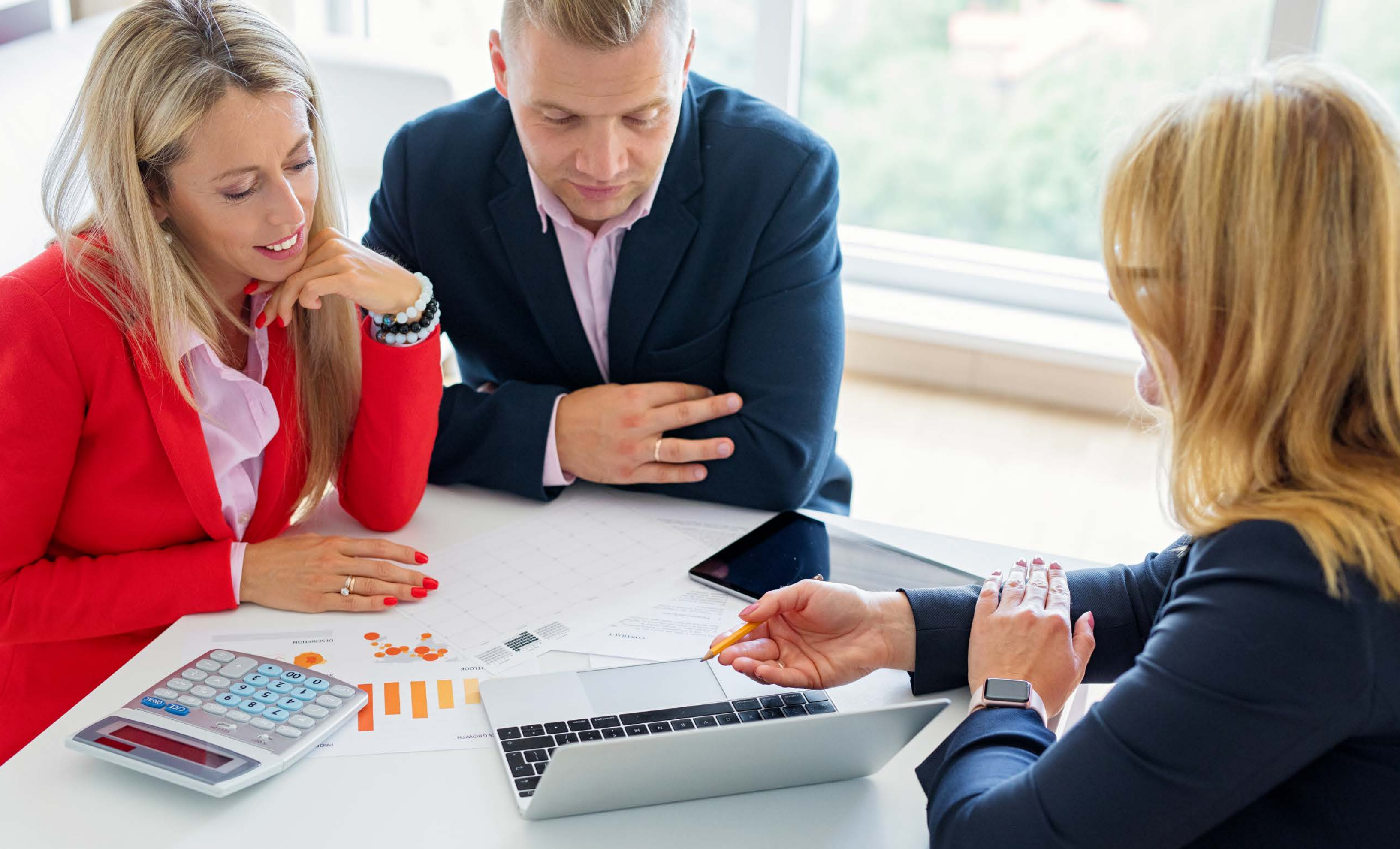

Personal banking and personal finance management are two of the most complicated and difficult-to-understand topics within the finance and accounting industry. Many factors affect an individual's financial behaviour – including experiences, personal biases, and socio-economic conditions – making it difficult to understand how one makes financial choices, how they impact personal finance management, and how they can improve their financial health.

Behavioural economics and – its subfield – behavioural finance can help us understand how people make financial decisions and how different factors – cognitive and psychological – affect these decisions. Understanding such behavioural patterns can be the first step in helping finance accounting services providers devise practical strategies that can facilitate better financial habits and enhanced financial health.

What is behavioural economics?

Before diving deeper into how understanding behavioural economics can aid in enhanced wealth and personal finance management, let us explore what exactly behavioural economics is. Richard Thaler – a University of Chicago professor – popularised the concept of behavioural economics as an integration of the discipline of economics and psychology after his Nobel win. The underlying idea is simple – buying anything is never simply a matter of numbers, and psychology always plays a critical role in people's economic decisions. Behavioural economics tries to explain why people make certain financial decisions and why these actions sometimes do not match the predictions of economic models.

Behavioural finance – a class of behavioural economics – focuses on the various emotional and psychological elements and biases that affect the financial behaviours of different investors (individuals and institutions). Additionally, the implications of behavioural finance go beyond individual investors. They can also play a part in explaining different market anomalies, making it critical for financial institutions to focus on and understand behavioural finance when offering personal finance management services.

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How does behavioural economics differ from traditional economics?

Due to its consideration of psychological and emotional factors and individual biases, behavioural economics is fundamentally different from traditional economic theory. Some of the key ways the two principles differ from each other include:

Assumptions about rationality

The underlying assumption in traditional economics is that every individual is rational and makes consistent decisions that optimise self-interest. However, behavioural economics acknowledges the impact of various biases, emotions, and cognitive limitations that can often deviate people from rational decisions.

Decision-making factors

Elements like price, cost, and benefits are the key decision-making factors when it comes to traditional economics. However, in addition to these objective factors, behavioural finance also focuses on subjective factors, like social influences, emotions, cognitive biases, and other psychological elements when considering the decision-making process.

Prospect theory

The prospect theory in behavioural economics challenges the traditional idea of "utility maximisation". The theory suggests that an individual uses reference points when assessing the potential gains or losses. As a result, things like perception of risk or loss aversion can influence the decisions.

How does behavioural finance read people's financial decisions?

As behavioural economics tries to figure out why people choose one thing over the other, it considers various biases, social influences, emotions, and psychological factors. If you understand these factors, you can be in a better position to make sound financial decisions and ensure better personal finance management.

Here are some factors you can consider to use behavioural finance to understand and shape your financial decisions:

Availability bias and delayed gratification

Availability bias says that the proximity and ease of finding something can be some of the biggest factors influencing an individual's financial or purchasing decisions. This also ties into the tendency of individuals to prioritise immediate gratification – giving in to the "fear of missing out (or FOMO)" when making impulsive financial decisions. This bias can hinder one's ability to plan, invest, and save for the future; as a result, many fail to consider long-term financial goals. Awareness of this bias can be a first step in personal finance management as you can implement strategies and use tools to overcome it.

Anchoring

Anchoring bias is when an individual relies heavily on the initial information when making financial decisions and judgments without considering all the available information. For example, a consumer electronics retailer may initially price a new phone at $800 and then drop the price to $500. Here, anchoring bias leads people to think they are getting a good deal irrespective of the objective facts. Corporations often use anchoring to their advantage, and it is crucial to be aware of this bias and work around it.

Confirmation bias

Confirmation bias is when one pays attention to only the information that backs up their existing opinions and tends to ignore anything that goes against that belief. Almost every aspect of our lives has some confirmation bias, but it is especially harmful when it comes to personal finance management, as you may end up missing any warning signs.

The gambler's fallacy

The gambler's fallacy is when you rely on the outcomes of past events to predict future outcomes when each event is independent. For example, in a coin toss, if "heads" comes up multiple times in a row, the gambler's fallacy says the outcome of the next toss is more likely to be "tails". In reality, each coin toss is an independent event, and the probability always remains 50/50. When it comes to behavioural finance, people tend to make the same mistake when a stock has gone up (or down) consistently for several days. This can lead to you buying low or selling low, resulting in lost money.

Herd behaviour

Social influences have a strong power to sway us, leading to herd behaviour in many cases. The idea is that if everyone is doing something – buying a stock, for example – then it has to work, and it cannot go wrong. Acknowledging the power of social influence can help you be rational, focus on objective facts, and stay away from such herd behaviour.

Automatic enrolment

The other side of availability bias and instant gratification is often auto-enrolment. As more people are becoming aware of the availability bias, they are trying to plan and save money for the future. As a result, many are opting for

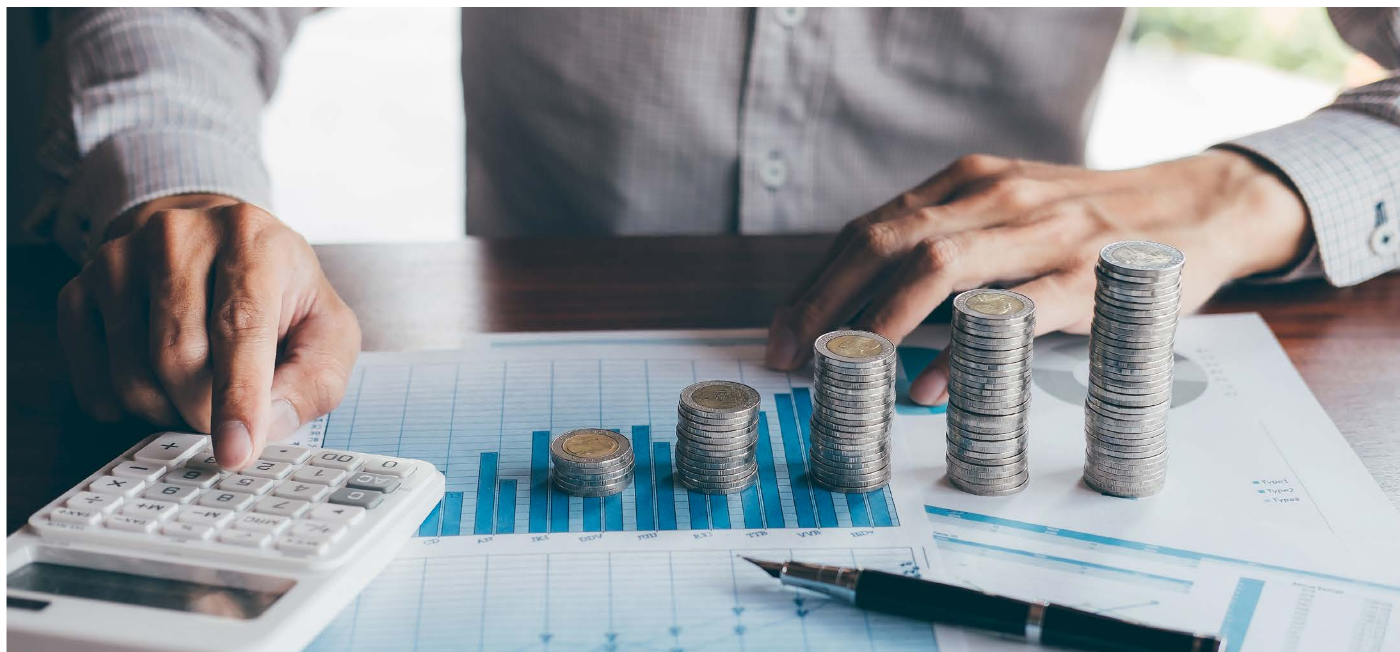
automatic enrolment into various pension plans. However, if there is an opt-in option, people are still more likely not to do anything and continue to focus on instant gratification.

Loss aversion

Behavioural finance highlights the feeling of loss aversion, the tendency of individuals to be more concerned about losses than enjoying the pleasures of gains. This can make people overly cautious and make them reluctant to take risks that can lead to potential improvements. Understanding the loss aversion tendencies can facilitate a more objective risk evaluation and help pursue profitable opportunities.

Emotional factors

Last but not least, emotional factors also play a crucial role in personal finance management. Knowing and understanding how emotions – like fear or greed – can impact your financial decisions can help you stay balanced and make rational and objective decisions.



The impact of behavioural economics on personal finance management services

Behavioural finance offers us insight into how different aspects influence an individual's financial decisions. But how do they help policymakers when it comes to delivering finance accounting services to your customers? It tells about how human emotions, biases, and cognitive limitations influence the objective and subjective processing of available information, which, in turn, offers insights into various decisions surrounding investments, personal debt, risks, and overall financial health.

But how can this help in personal finance management? Here are some ways behavioural economics can have an impact when it comes to delivering finance accounting services:

Improved policy design

By understanding the actors that drive individual financial behaviour, policymakers can design and suggest interventions that can help individuals overcome their biases, look at the available information objectively, and practice healthy financial behaviours.

Financial markets and investments

Behavioural economics has changed how finance professionals view market and investment behaviour. It has shed light on various biases and social influences – like herd behaviour or overconfidence – that can lead to market inefficiencies. With this information, they can build more intelligent investment strategies that account for behavioural insights.

Consumer behaviour and marketing

Behavioural finance offers keen insights into consumer behaviour – how they make choices and what factors influence these choices. Marketers can leverage these insights to design a marketing strategy, messaging, pricing structure, and product placement strategy that aligns with consumer preferences.

Personal finance and wealth management

One of the key areas behavioural economics has impacted is personal finance and wealth management. Understanding the common biases and tendencies that affect their financial decisions has empowered individuals to take the necessary steps to be objective and make well-informed decisions about

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their financial health. Financial advisors and finance accounting services are using these insights to help their clients navigate the complexities of their finances and achieve their financial goals.

With an understanding of the biases, emotions, social influences, and other psychological factors affecting financial behaviour, you can apply behavioural economics to achieve financial success by:

- Recognising and overcoming biases
- Setting clear goals and priorities
- Automating savings and investments
- Designing effective budgeting systems
- Seeking financial education and advice
- Building accountability and support

Conclusion

Behavioural economics combines the principles of psychology and economics to understand how different biases, emotions, social influences, and other psychological factors affect the financial decisions of an individual. This plays a crucial role in effective personal finance management as it can help recognise various biases and take necessary action for objective and informed decision-making. Finance accounting services can leverage behavioural finance to understand their consumers better and design superior policies that can help them achieve financial success.

For more information, contact infosysbpm@infosys.com

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