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Executive Letter

Nudging is the Architecture of Choice in the World of Banking

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O *Nudging* e a Arquitetura da Escolha no Contexto da Banca

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A nudge is a prompt that helps people adopt a desired behavior. Subtle signposts or slight changes in our environment can have a major impact on our choices and behaviors. So, when banks communicate the advantages of retirement savings in their branch windows or on their website, they encourage people to increase the amount they actually save for retirement simply because these prompts and messages are more visible to them.

The aim of targeted nudges in our lives, environments, habits, and processes is to achieve better decisions and outcomes (Thaler & Sunstein, 2008).

It should be noted, though, that nudges never force people to make decisions. Even though such prompts might motivate people to take a certain path, one of the basic principles of nudging is never to limit or eliminate other options. The nudge is neither a rule nor an obligation. The choice, at the end of the day, is always up to the individual. In the architecture of choice, the nudge is a gentle prod that influences people's behavior in a predictable way without impeding the advancement of possible alternatives (Leal & Oliveira, 2020). Communicating the benefits of saving through messaging is merely a nudge that obviously does not intend to exclude the possibility of spending, which is the ultimate goal of economic science reflected in the way people maximize their well-being.

Nudges bring insights within the realm of behavioral science into how we make decisions. Nudges are effective because they are based on heuristics (i.e., straightforward mental processes that make finding appropriate answers easier), or mental shortcuts, and cognitive and emotional biases that affect our behavior.

For example, the 'save more tomorrow' concept has worked because it asks people to make a promise to save in the future, rather than spending immediately, most often when they get salary increases. We tend to place more value on immediate rewards to the detriment of long-term goals. When it comes to financial decisions, or inclination to place greater value on the present, it may have an undesirable effect. Excessive spending today can significantly reduce and even jeopardize our savings for the future. Let us for a moment imagine our attitude toward saving for retirement: it is normal that at the beginning of our professional careers saving money for our old age deprives us of more enjoyable holidays or of spending more on goods and services that may or may not be superfluous to our needs. Besides, no one can guarantee that we will reach old age, and that's why the tendency for us to spend more than we save is normal.

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The interest rate will depend on the period chosen, and vice versa. Delaying spending depends largely on the level of interest rates and the benefits of the pension schemes prevailing in each country and each economy. The higher the real interest rates, the more we are inclined to save, but the price of credit granted to those who choose to spend will be gradually higher and will discourage investment spending and consequently result in lower economic growth. Accelerating economic activity again implies rebalancing the money market, falling interest rates, and consequently discouraging saving and promoting investment and economic growth. This is the cycle of credit and savings between those who delay spending and those who anticipate it, and the rise and fall of prices within that cycle, i.e., interest rates.

The longer we wait before we start saving, the more difficult it is to achieve our objectives of ending up with a nice fat piggy bank. That is why it is so important to employ nudging in the financial sector. We need to encourage people indirectly to save regardless of the interest rate.

We now know more and more about how people make decisions. We know more now about the architecture of choice and the way our brains process information when making decisions. Nudging is a term taken from behavioral economics and refers to gentle interventions that alter people's decisions and change their behavior according to one's expectations. Human beings have bounded rationality and, therefore, often make biased decisions against their best interests. Although most economic models are founded on the principle assumption of the rational expectations of economic agents, the evidence of behavioral economics shows that, in reality, people are not that rational and do not clearly make predictions according to the theories of probability, thereby revealing inconsistencies in their preferences. Such evidence has provided space for the practice of nudging to gain ground gradually.

In contrast to classical theories that assume homo economicus, or the rational economic agent, nudge theory anticipates a 'normal' human being who may be 'myopic' or 'impulsive' by attaching undue weight to short-term results and procrastinating, employing delaying tactics or doing nothing, or otherwise being unrealistically optimistic. In other words, an economic agent who is more emotional than rational.

Can nudges be used for both good and evil? If the truth be told, people can be persuaded to spend much more than necessary or to make investment decisions that are less than ideal. Thaler and Sunstein (2008), authors of the book Nudge, were at pains to emphasize the idea that a nudge is a means to help people achieve their desired goals, which they have in mind but for some reason have not yet put into practice. This is the case with investment banking, where the goal is to save through socially responsible investment (SRI) funds from an ESG (environmental, social, and governance) perspective rather than through traditional investment funds. In short, prompts in the form of nudges in the banking world are intended to help investors move from intention to action rather than persuade or coax them into doing something they did not intend to do in the first place.

There is a wide variety of interventions that can be classed as nudges and all of them involve normally small changes to our 'architecture of choice' to make it easier for us to make the 'right choice.' Many of the most effective prods involve using 'patterns' that lead people to action or a desired activity unless they consciously take action to the contrary.

Today's progressive trends in environmental policies, climate targets, the 2050 carbon net-zero goal, ESG, and sustainability run counter to what most people have internalized for decades about pollution and its harmful effect on the planet. Despite the gradual nature of raising people's environmental awareness, using nudge techniques to get them to adopt sustainable investment funds more often has a certain appeal. Such nudges are always welcome and effective. They raise our current level of environmental awareness and shift us further toward a position of demanding that companies and consumers adopt more planet-friendly conduct.

It is essential to develop nudging tools to push us to invest in equity or debt of those companies whose policies are moving toward being underpinned by ESG or in investment funds that invest in companies with similar sustainability goals. A nudge might induce us to buy bonds in sustainable companies. The growing trend is that rating agencies are attributing a better credit rating to companies based not only on their financial statements but also on environmental, social, and governance criteria. A nudge may remind us that what we want is a more sustainable world, even if we do not always remember this.

Banco Carregosa is gradually encouraging investors to choose socially responsible investments in favor of traditional funds. These nudges made by the bank seek to promote a more sustainable world.

The nudge highlights the difference between economics and finance. For many, economics is nothing more than the cold, hard numbers on a corporate balance sheet or in the nation's budget. Of course, it is this — and much more. The economy is much broader than most of us think. Economics is finance, but finance based on Pareto's theories. The economy is not a zero-sum game. The growth of my personal accounts, those of my company or the GDP, has a domino effect in creating growth in other companies and other economies. All of us contribute to global well-being until a point when one of us (an economic agent, a company, or country) will necessarily harm another if we continue to grow in isolation. With nudges increasingly calling for a more sustainable planet and policies founded on ESG principles, the economy will grow, and the well-being of populations, the object of the economy, will grow accordingly. The nudge is the fundamental aggregating element for a better world based on maximizing well-being through better technology, more employment, more renewable energy, and better healthcare, particularly for the elderly. Nudging adds several dimensions to economics that does indeed go beyond the cold hard truth of numbers and financial results.

Banco Carregosa uses nudging techniques to encourage more sustainable investments and inculcate a greener attitude among its clients. It uses nudges that seek to guide investors toward what they already had in mind, that is, a sustainable planet or future generations.

Nudging enables the adoption of new and better habits. Behavioral economics has implemented successful strategies in pursuit of these objectives. There are smart methods that use rewards to motivate our willingness to do some things that we do not want to do but that generally bring long-term benefits. By way of an example, exercising while watching our favorite program on TV is one way of bringing together something we may not want to do very often with something that gives us pleasure.

Empirical evidence suggests that very few people willingly choose to be human organ donors but when they are automatically enrolled, unless they object, the vast majority agree to do so. Behavioral economists point out that limiting choice is effective in boosting agreement with a cause. Too many choices create confusion and hesitation, and it is less likely that we will perform any action or make any choice, and most probable that we will do nothing. This is known as the paradox of choice, and nudging appears to have corrected it.

More and more, Banco Carregosa uses nudging techniques, which have proven effective in diverse environments to help investors achieve their financial goals. Investors can apply these tools to make better decisions and generate better financial results.

Typically, this could begin by simply making clients aware (nudging them) about common setbacks investors face, which might lead them to make less than ideal decisions. This includes our considerable aversion to loss. Our tendency to assign importance or give weight to losses is far greater than the importance we assign to gain since we have a propensity to overvalue new information that aligns with our beliefs. It is not unusual for a less experienced client who incurs repeated losses from a stock in their portfolio due, say, to profit warnings, to remark that these stocks are 'for their grandchildren.' Many investors find it rather difficult to admit to incurring losses, yet they have a considerable propensity for limiting gains when there is an upward trend.

Suppose a company we are invested in is experiencing successive and ever-growing difficulties. In that case, we need to be disciplined enough to sell the security regardless of the loss because the end result could be much worse. That is why Banco Carregosa always tells its clients that discipline is fundamental in avoiding the greater of two evils. Without discipline, the investor will win the battle but lose the war, so to speak. Through its precision nudges, Banco Carregosa tries to prevent this from happening. Portfolio diversification is another key factor we constantly mention to clients in Banco Carregosa's sphere of influence, although they are ultimately the ones who make their own decisions.

Banco Carregosa also seeks to maximize discipline in investment, another fundamental.

Before making an investment, it is imperative for the bank and its clients to understand their risk profile and the investment time horizon. Clients of Banco Carregosa who show themselves to be risk-averse should not have significant exposure to the stock market. Clients also have to be aware of the investment time horizon and consider whether the capital invested might be needed to meet their usual liquidity requirements. If the time horizon of an investment is five years, clients should not invest capital that they may need for day-to-day commitments; otherwise, they risk jeopardizing the whole architecture designed for that investment.

If the risk profile analysis shows that a client only allows a maximum exposure of 10% in shares, and that the client wishes to buy EUR 100,000 worth of shares, then he should increase his risk-free investments by roughly EUR 1 million to keep his exposure in shares in line with the 10% limit in his risk profile. The risk profile varies according to the circumstances of each client, and it should be updated if there are facts pertinent to the client's life that justify doing so. However, the risk profile should not be adjusted regularly merely to corroborate or validate a recently made investment. Investments should be adapted to the risk profile, not the other way around.

In summary, Banco Carregosa uses a series of nudges to understand whether what investors want is in keeping with their investment profiles. To this end, it has introduced investor and investment profile questionnaires, which might be the 'nudge' that leads clients to adjust their investments in line with their desired risk/return profile. For example, inserting a section in each quarterly survey that asks investors to reiterate their long-term investment goals and objectives, as well as their short-term needs, can help keep them on track.

When faced with complex choices, as is the case when investing, nudges can be useful in preventing us from making decisions based simply on hunches or previous behavior. Gentle nudges can help ease the mental burden and emotional difficulty associated with making decisions. The first step is usually the most difficult, but it can trigger a set of lasting savings habits once taken. For example, setting up a direct debit or standing order from our current account to ensure regular top-ups of a savings account is fairly simple to do — and from then on, the saving is executed automatically.

Nudge techniques are slowly employing technology more often to encourage people to develop good savings habits. Banking apps help us analyze our spending patterns, calculate what we can set aside, and transfer surplus funds automatically to a savings account of our choice.

Sad to say, “when the wise man points to the sky, the fool looks at the finger” (Chinese proverb). Even so, nudge seeks to correct thought processes and behaviors, alerting our mind to focus on the most important points rather than defer to attitude and thought biases.

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Paulo Monteiro Rosa was born in Luanda in 1972. He is married and has two daughters. He has a degree in economics from the Faculty of Economics of the University of Porto, having also attended the financial analyst course taught by the IESF in 2000. Since January 2020, he has been part of the information production team of the Investment Department of Banco Carregosa. Paulo Monteiro Rosa started in the world of financial markets in 1997 as a freelancer and technical analyst. In 1999 he worked at Lisconsult, from Grupo Melo, where he performed auditor duties. In 2001 he opened the financial agency of the Central Banco de Investimentos in Vila Real, being responsible for it for 3 years. In 2004, he opened the brokerage agency L.J. Carregosa in Vila Real. Between 2001 and 2004 he was an internship advisor for the economics course at UTAD. In January 2006, he was invited to join the team of traders in the trading room at Banco Carregosa, in Porto, where he worked as a Senior Trader for about 15 years. In the course of his professional career, he has written several hundred economic-financial articles, most of them specific in terms of financial and capital markets, published in the most diverse media of reference in Portugal: *Vida Económica* stands out; *Jornal de Negócios; Jornal Económico; Dinheiro Vivo; Jornal Público; Voz-de--Trás-os-Montes*; and *Funds People*. Reference should also be made to the regular collaboration with opinion articles in prestigious publications in the Order of Economists; Luso-American Chamber of Commerce; Mises Portugal Institute; and at ATM / Capital Markets Analysts. He also collaborated with Rádio Antena Minho, Rádio, Fundação and Rádio Universidade with several daily items related to the balance of the day of national and world scholarships. Finally, since 2010, he is the author of the blog "Omnia Economicus".

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