



# Decision making and Bounded Rationality: The Relevance of Psychology for EU Legislation with regard to Information Disclosure on the Financial Markets

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## A NEW INFORMATION DOCUMENT FOR CONSUMERS: A BRIEF OVERVIEW

### INTRODUCTION

Consumer investment products have become essential in the daily lives of EU citizens. Some examples:



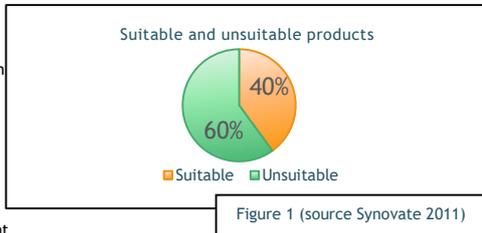
Buying a house (e.g. a mortgage investment fund), making a trip around the world when retired (e.g. a life insurance with investment risk) or saving money for your children's college education.

On the financial markets, investors are making decisions every day. An important question is: How does an investor decide whether or not to buy an investment product or which product is the most suitable given his or her personal circumstances?

A recent study concluded that around 60% of sales in complex financial products across the EU may be deemed unsuitable for consumers (see figure 1).

The EU heavily relies upon information disclosure to solve this problem, e.g. by introducing the so-called Key Information Document (KID).

Insights from Psychology allow for a greater predictability of investors' behaviour and could help to find out whether such an information document would be effective in informing investors and could help to improve the disclosure regulation.



Information documents for financial products: not a new phenomenon.

- National level e.g.:
  - Germany: Produktinformationsblatt
  - United Kingdom: Key Features Document
  - The Netherlands: Financial Information Leaflet ('Financiële Bijluster')
- European level e.g.:
  - Prospectus
  - Key Investor Information Document

2017: Regulation (EU) 1286/2014 introducing a Key Information Document.

Characteristics:

- Maximum of three pages.
- For Packaged Retail Investment and Insurance Products (PRIIPs).
- Standardized and readily understandable.
- About the main features of the product, such as: 'What is this product?', 'What are the risks?', and 'What are the costs?'

Goals:

- 1) Improving the comprehensibility
- 2) Improving the comparability

## THE INVESTOR AND THE KID: THE VIEW OF THE EU LEGISLATOR

EU legislator (European Commission 2012, p. 15):

"Retail investors should be provided with the information necessary for them to take an informed investment decision and compare different investment products."

And the legislator stated that such documents serve as "the foundation" for investment decisions by retail investors (European Commission 2012, p. 16).

However, the question is:

$$\begin{array}{c}
 \text{Investor} \\
 + \\
 \text{Information document} \\
 = \\
 \text{Better investment decision?}
 \end{array}$$

### OVERVIEW

This poster, which is meant as a first exploration of the subject, aims to examine:

- 1) the regulation regarding a new short information document (the KID);
- 2) to what extent the proposed information document is likely to be effective in achieving one of its objectives (improving comprehensibility)
- 3) whether it needs to be improved and
- 4) if so, in what way.

## EFFECTIVENESS OF THE KID & SOME SUGGESTIONS FOR IMPROVEMENT: COMPREHENSIBILITY

A selection of heuristics and biases to predict the likely effectiveness of the KID when it comes to informing investors about financial products. In addition, various recommendations for promoting this effectiveness are formulated.

Heuristic/bias	Implications	KID (rules)	Solution/Suggestions for improvement
Recognition heuristic	Certain preferences (e.g. preferring products of a known provider) are hard to change by a document.	No relevant rules.	No solution.
Confirmation bias	Investors tend to select information which is consistent with their own wants, and ignore other information or mental processing could alter key information in such a way that a specific investment decision is favoured.	Limited size of the document leaves room for interpretation consistent with investors' personal preferences and views.	Promote comparing of financial products and provide concrete information. Important role for financial advisor.
Representativeness heuristic	Investors may consider past performance of a financial product to be a good indicator for its future performance.	No relevant rules.	Make clear in the KID that past performance offers no guarantees for future results.
Availability heuristic	E.g. when risks are presented vividly, investors often consider the risks to be higher than when this is not the case.	Standardization.	Describing risks in various KIDs in a similar manner (same wordings). This could be promoted by a KID generator.
Framing effect	Positive or negative framing of information can have a substantial influence on people's decision making process.	Standardization.	Standardisation of the phrasing of information which could probably be promoted by a KID generator.
Ambiguity aversion bias	Investors tend to choose risks they know over risks they don't know.	Standardization.	Description of risks in a similar manner and clarity level concerning risks the same to the maximum extent possible, promoted by a KID generator.
Overconfidence bias	Investors tend to overestimate their own knowledge and tend to be too optimistic about the future.	KID is but a short document (art. 6 paragraph 4).	Detailed information (Capuano and Ramsay 2011, p. 132-133). However this seems impossible to realise by means of a short document.
Information overload	Investors are flooded with information. The introduction of a KID could increase the information overload.	A KID must be written in a concise manner on a maximum of three sides of A4-sized paper and composed in a language that is clear, succinct and comprehensible (art. 6 paragraph 4).  An explanatory statement underneath the title (art. 8 paragraph 2).	KID should function as an easy-to-read-summary. However, probably this is not a good solution because of the availability of an overwhelming number of products and its complexity. Furthermore, existing documents often contain complicated language and PRIIPs are complex products and could probably not be explained in easy language. In addition, text above or underneath the title may go unnoticed by investors (FSA 2003, p. 260). Furthermore, before noticing the explanatory statement, investors already need to have taken the step to read the KID -> role financial advisors.

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