Consumer Choice on Savings Accounts: Bounded rationality

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"*A fully rational man is a mythical hero who knows the solution to all mathematical problems and can immediately perform all computations regardless of how difficult they are.*"- Reinhard Selten

Given the falling returns in share markets and the comparative safety of savings accounts protected by the deposit insurance provided by the Australian Government, there was a significant surge in deposits made in savings accounts. According to an article published in *The Australian*, Australian households deposited an estimated $38 billion into savings accounts over a period of six months ending on the 31st of March, 2009. Among the various deposit-taking institutions, Westpac received the largest part of this growth. (Jimenez, 2009). Interestingly, there have been no major changes in the interest rates offered on savings accounts by the major banks recently.

If the savings account market is examined, the first thing that one notices is the large number of options available to a prospective customer. There are more than fifty savings accounts on offer by various banks, building societies and credit unions. These include regular savings accounts, high interest savings accounts with more stringent conditions on deposits, withdrawals and usage and exclusively online savings accounts. Any given savings account product can have different combinations of attributes apart from the interest rate offered such as the minimum balance requirements, the minimum lock-in period, etc. For an average consumer who wants to open a savings account, there is a plethora of choices available. This paper considers how a typical consumer might make a choice among so many options and whether this choice is "right".

The Neoclassical Approach

Neoclassical economics, the accepted mainstream economic paradigm around the world, explains the decision making process of economic agents such as households and firms. We can employ neoclassical consumer choice theory make use of this theory to explain the factors that would govern the choice for a household in the market for a savings account. It states that all economic agents seek to maximize their utility by choosing an outcome where their marginal benefits equal their marginal costs. This theory, according to Weintraub (2002), is based on three fundamental assumptions.

a) People have rational preferences among outcomes.
b) Individuals maximize utility and firms maximise profits
c) People act on the basis of full and relevant information.

As is evident, this approach implies that agents are capable of rationally calculating their benefit optimizing effectively, without cost and without error.

Problems with the Neoclassical Approach

Let us consider the decision making process of a household that has to choose from among the various savings accounts that are on offer. The two features that it would certainly consider as paramount would be the security of its deposits and the interest rate offered. These two features describe the risk-return profile of the savings account product thereby allowing the household to select which product offers the best tradeoff. In order to make a good choice, it must have the correct knowledge about the quality of each account. In collecting this information, the household may compare interest rates in newspapers or in person and solicit advice from acquaintances to gauge the reliability of a bank. However, if the household were to be making a truly rational decision as defined by neoclassical economics, it would have to do much more than that. To fully understand the features and quality of all bank accounts will require it to undertake a massive information gathering exercise. This would involve a comparison of the balance sheets of all deposit providing institutions, factors that might cause changes in interest rates, thorough understanding of online banking laws and much more. Even the quality of his friends' opinions must be examined. The customer should have a precise understanding and knowledge of the possible social processes that took place for the general perception to be shaped the way it is. And all of this has to be done efficiently and costlessly for the household to be a rational agent.

Alternative Approaches to Explain Customer Choice

Bounded rationality

It doesn't take long to understand that in the real world the neoclassical assumptions of rationality are severely violated. Partly in recognition of this, the concept of bounded rationality thus came into existence in the mid 1950s to explain consumer behaviour. The psychologist and economist, Herbert Simons did seminal work in this area. Bounded rationality implies that there are limits or bounds to a person's rationality which do not allow him or her to take a fully optimizing decision. Among others, there are strong cognitive and emotional bounds on consumer's rationality. (Gigerenzer, 2001)

The cognitive abilities of a person are limited. He or she can only synthesize a given amount of information at a time. Savings bank accounts have numerous features like minimum balances, differences between promotional and regular rates, limits on the number of transactions, and so on. These features are subtly different for all the different bank accounts on offer which essentially make them all quite distinct products with overlapping features. The lack of uniform comparison criteria makes it difficult to immediately decide which account would suit a consumer's needs better. Owing to a consumer's cognitive bounds, the task of deciphering all this information toward calculating his optimizing decision becomes dauntingly complex.

There are other violations of the rationality condition in this case apart from man's calculative capabilities. The perception that he has of a bank will have a bearing on his choice of account. Many conscious and subconscious things and happenings might have taken place for the perception to become what it is. Advertising has a big influence and can be misused by banks too. A misleading advertisement might influence a person to make a poor choice of savings account. In a bid to attract customers, many banks promote their respective high interest savings accounts with high promotional rates. These rates are subject to stringent conditions which are not advertised, like a minimum lock-in period of funds or offers to new customers only. As a matter of fact, the Australian Securities and Investments Commission had addressed the issue by initiating an inquiry on the advertisements of high interest savings bank accounts that provide misleading information. (Kavanagh, 2009)

Many bank accounts that provide one of the best interest rates are online savings accounts. Most of these accounts are solely managed online with no dedicated bank buildings or staff providing face-to-face assistance supporting them. Since the cost of managing such accounts is low for the banks, they are in a position to provide relatively higher rates of return. Examples of such accounts are Bankwest Smart eSaver, NAB iSaver, ANZ SmartyPig Account etc. (Infochoice, 2009). But there are many customers who are wary of online bank accounts as they fear for the safety of their money. They find it difficult to fathom the existence of bank accounts when they don't see a brick and mortar building which is labelled as a bank. Even though these accounts are entirely safe when covered under the government's deposit guarantee scheme, they nonetheless evoke a sense of mistrust which acts as a bound to their being rational.

The less than optimal outcomes from this situation are not for the customers alone. Deserving banks also have to lose out on customers and business because of this. For example, Rabo Bank and Arab Bank Australia have been less successful in attracting deposits in spite of offering competitive interest rates.

Rational ignorance & Path dependence

Bounded rationality puts limits on the ability for consumers to be truly rational. However, some consumers may well be aware of the fact that the choice they are making is not optimal but go ahead with it anyway. This is because the process of gathering information is costly. Time spent collating information on savings account has an opportunity cost and if the cost of gathering relevant information to make a decision is more than the benefit that the optimal outcome will provide, the consumer makes a less than optimal choice with full knowledge that not all information may have been considered. This is known as rational ignorance. So in our example if the person wanting to open a savings bank account is a lawyer who earns $500 per hour or a single mother of three small children with a very high opportunity cost of time, he or she would much rather spend their time practicing law or caring for dependents rather than gathering information on savings accounts which could probably save earn them an extra few dollars over a period of one month. They are both being rationally ignorant as the opportunity cost of time is very high for them. Relatedly, on many occasions banks deliberately introduce greater complexity to their savings accounts to induce rational ignorance among prospective savers as well as existing ones. It may so happen that an existing customer gets a better deal at some other bank but she refuses it. However, she has a strong reason for being rationally ignorant and continuing with the old bank. That reason can be explained by the idea of path dependency.

When the number of currently available choices is limited because of some choices that were made in past, there exists a path dependency. Decisions made by bank account holders are often path dependent. The degree of dependency depends on the length of the time period the account has been maintained and, crucially, also on their use of the ancillary services provided by the bank. Savings bank accounts are often used for more than the purpose of simply saving. The systems of BPAY, internet transfers and debits are used by people to pay their numerous bills and receive money from others too. People might have taken a variety of loans from the same bank where they have their savings account or have their paychecks deposited to it as well. All of this creates an increased reliance of customers on the bank. Changing banks under such circumstances can become very inconvenient for a consumer as she would have to face a new set of rules, fees, staff etc. This is known as the switching cost. The cost of switching banks, to make use of a better deal offered by another bank, could be much higher than the potential benefits. This causes the customer to be rationally ignorant and continue in a path dependent manner, with the same bank.

Banks are only too aware of these switching costs and do their best to make their existing customers more path dependent. They aggressively promote their new services and often offer discretionary discounts to existing customers to create increased dependence and greater switching costs. This customer retention allows them to price their services above their marginal costs. Recently, the Treasurer, Wayne Swan reprimanded ANZ bank for increasing its home mortgage interest rate more than what it should have. He even urged the customers of the bank to look for alternatives. (Gans, 2009)

In the real world where consumers are in the market for a savings account, neoclassical rationality is arguably a scarce commodity. However, this also does not mean that consumers make irrational or even suboptimal decisions. Bounded rationality and optimization under constraints is the truth that exists between the two fictional extremes of rational optimization and irrationality.

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