Preface

Economics has a history of drawing on other sciences that are helpful for understanding markets, most obviously mathematics and statistics, and arguably physics. Drawing on cognitive sciences to improve analysis of demand and supply, namely, behavioural finance, is a natural supplementary step. The behavioural approach is not limited to psychology. Increasingly, scholars promote the use of cognitive anthropology, neuroscience and Artificial Intelligence in socioeconomic sciences.

The regulators' mandate involves improving financial markets' efficiency and functionality, while protecting people from exploitation by financial institutions. To this end, the regulator needs to understand the drivers of the observed equilibria, which arise from the processes that generate decisions of firms, consumers and of course, of regulators themselves. Behavioural economics can help this pursuit by shedding light on how people make choices and why they might make choices that are not in their best interest or in line with their goals. Such insights allow both firms and regulators to detect behaviourally rooted problems in the markets and to design and test ways to deal with them. In particular, financial consumers are vulnerable in the face of many financial products that are credence or experience services. Sophisticated suppliers can and do observe consumers' decision biases by observing decisions under different conditions, then use these biases to design exploitative marketing strategies. A behavioural approach to the design of regulations enables the government to employ psychology and other sciences to sort out relevant from irrelevant elements towards increasing the efficiency of both market and non-market mechanisms, while reducing the possibility of exploitative practices.

The behavioural approach that we advocate does not retire the existing body of knowledge but seeks to expand and enrich it. We believe that behavioural and traditional analysis can complement each other to generate more comprehensive insights that adequately acknowledge and meaningfully combine the roles played by specific market structures, competitive dynamics, information access, culture, values, emotions, beliefs, regulators' licence to operate, compliance vs. non-compliance conditions, contract design, law of contract, law of tort, consumers' general rights, consumer advocacy bodies, marketing by firms, institutional structures such as courts and so forth. Many of these aspects of behavioural finance are discussed in different chapters of the current book. Focusing on improving regulations, a variety of topics are examined from multiple aspects: What are the right criteria for intervention in the markets? Do we mean to improve total welfare or the welfare of specific groups? Or is welfare altogether the wrong metric? Which remedies work best for which problems? What is the optimal combination of regulatory tools? And how does this differ by regulatory goals? What is the right unit of account for designing interventions? Are regulators to interfere with property rights?

A multidisciplinary behavioural-based approach to economics is not limited to the development of more comprehensive financial market regulations. All macroeconomic actions – monetary, fiscal or regulatory – are ultimately intended to influence behaviour. For instance, monetary policy changes interest rates in order to affect people's preference to hold or spend money. Fiscal stimulus increases aggregate demand, giving people more income in the short term, which is hoped they will spend, and thus directly brings unemployed resources back into use by paying them to work. Regulatory changes restrict or encourage some behaviour more directly than others, but generally aim to channel the behaviour of consumers by directly restricting the actions of financial institutions (or more properly, their staff). Although aiming at changing behaviour, almost all approaches to managing the economy share a common but fallacious assumption: that people, on the whole, respond rationally to price incentives. By adopting a behavioural view, regulators can thus benefit from going beyond the dominant but unrealistic hypothesis of full rationality in their search for the roots of the observed behaviour and for designing rules to tame the unwanted. There is much to be done in this area. While many tools have been experimentally tested at the micro level the extensions to macroeconomics are severely limited. Price anchoring, framing, endowment effects, confirmation bias and various social and peer effects all demonstrably allow us to influence behaviour in market transactions; however, their direct and significant applications to what we might call "macro-rationality" are much less explored. Macroeconomics needs to significantly engage other disciplines both to define analytical metrics and to generate decision aids. The current book offers some recommendations towards this goal.

This book is part of a larger project that commenced on 6 December 2017 as an initiative by Herbert Simon Society in collaboration with the Bank of Italy and the Max Planck Institute for Human Development. Behavioural Financial Regulation and Policy Initiative (BEFAIRLY)'s mission is to employ, interpret and translate the behavioural finance and economic discourse to improve financial regulatory decision-making and outcomes. This mission is fulfilled by creating a forum for direct exchange between members of academia, industry and government presenting and discussing academic papers, policy proposals and industry case studies followed by multichannel propagation of the generated knowledge. The initiative is a non-profit project, whose venues and operations are funded by sponsorships. The initiative operates under a steering committee composed of the chairman Riccardo Viale of the University of Milano-Bicocca and the Herbert Simon Society, and members Barbara Alemanni of the University of Genoa, Umberto Filotto of the University of Rome "Tor Vergata", and Shabnam Mousavi of Johns Hopkins University and the Max Planck Institute. All administrative and operational tasks, including those related to the publication of the current volume, are overseen by Giovanni De Rosa of the Herbert Simon Society.

The steering committee is advised by an international scientific committee (being currently shaped) envisioned to be European oriented with a balanced mix of 10 to 14 members from central bankers, regulators, practitioners and academics. The scientific committee convenes annually to provide guidelines and suggestions for speakers, to evaluate and approve themes and topics proposed by the steering committee, and thereafter to disseminate the topic and invitations among its community and network to attract contributions and papers of the highest possible quality. Furthermore, to promote the cause of this initiative, an annual award will be granted to a young researcher for a publication in behavioural sciences with application to financial regulations and policies.

Our ultimate goal is making meaningful and sustainable contributions to the well-being of society. By upholding a behavioural and cognitive approach to financial regulations and policy, we employ a wholesome view of people that acknowledges human beings simply as they are. By bringing together academics and practitioners, we build a platform for combining wisdom from both sources. The BEFAIRLY initiative translates this rich combination into recommendations and recipes for financial regulators towards increasing stability and security of the people. This volume is our first delivery in print, which we hope to be found useful by the reader. We welcome and encourage inputs and contributions from you, the reader, and invite you to join our cause for making the financial world a safer place for everyone.

This book is part of the programme BEFAIRLY (Behavioural Financial Regulation and Policy) promoted by the Herbert Simon Society in collaboration with the Bank of Italy and the Max Planck Institute for

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