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Behavioral Economics In Banking: Insights Into Retail And Corporate Financial Decision-Making

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Abstract
This paper examines how principles of behavioral economics influence financial decision-making in both retail and corporate banking. While classical economics assumes rational behavior, behavioral economics demonstrates that cognitive biases, heuristics, and emotional factors shape individual and group decisions. In retail banking, biases such as present bias, loss aversion, and overconfidence affect savings, investment, and interactions with FinTech platforms. Banks and FinTech companies leverage these insights through mechanisms like automated savings, goal-based nudges, personalized alerts, and smart budgeting to guide consumers toward better financial outcomes. In corporate banking, group-based biases, including groupthink, authority bias, and confirmation bias, can affect collective decision-making, increasing organizational risk. Strategies such as promoting diversity, structured decision-making, and independent oversight help mitigate these biases. Case studies, including the 2008 financial crisis, illustrate the consequences of neglecting behavioral insights. Overall, understanding and applying behavioral economics enables financial institutions to enhance decision quality, reduce cognitive errors, and promote more stable and efficient banking practices.

Keywords: *Behavioral economics, retail banking, corporate banking, financial decision-making, cognitive biases, nudges, FinTech*

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I. Introduction

Why do people truly end up making financial decisions that are out of character or even against their own interests at times?

Rationality refers to behaviour that suggests people make decisions that maximise their utility or benefit (Hayes, 2019). Classical economics assumes that economic agents (individuals and firms) are perfectly rational, operating as homo economicus to maximize utility or profit based on available information (Pilat and Krastev, 2021c). However, behavioral economics emerged as a challenge to this idea. Behavioral economics reveals how social factors, emotions, and other psychological factors significantly influence people's decisions (The Chicago School, 2021). A few important concepts underpin explanations in this field: bounded rationality, self-interest, and willpower, as well as several heuristics and biases (Witynski, 2024). This field was further explored and supported by economists such as Daniel Kahneman, Amos Tversky, and Richard Thaler.

The assumption of rationality and the reality that behaviors are influenced by biases and emotional factors have significant implications for financial institutions, such as banks, whereby a proper understanding of human behavior can enable the institutions to design and offer better products and services related to savings, investment, etc. This is even more important given that, despite technological advancements and access to a great deal of information, people continue to make irrational financial decisions. Furthermore, while behavioral economics is more focused on individual decision-making, it may also be applied in group settings, such as corporate banking, where decisions are made by multiple people. The research question this paper, therefore, aims to answer is: **How do the principles of behavioural economics influence financial decision-making in retail banking, and what implications can be drawn for corporate banking?**

This paper argues that behavioural economics offers valuable insights into consumer and professional decision-making in the banking industry, illustrating how psychological biases and heuristics shape savings, investments, and product-related decisions, and how understanding these trends can help banks design much more effective and inclusive financial services.

Theoretical Foundations of Behavioral Economics

The term 'behavioral economics' was first used in the 1940s, though it never had a precise definition at the time. The view that psychological factors play a crucial role in economics can be traced back to Adam Smith and other early economists, who recognized that human behaviour does not always follow rationality. The work of Daniel Kahneman and Amos Tversky has contributed greatly to the development of behavioral economics

(Beatty, Moffitt, and Buttenheim, 2023). Tversky and Kahneman identified several consistent biases in the way people make judgments. Other economists and psychologists have also played an important role. Some of these key ideas have been analyzed below.

Bounded rationality, a concept developed by Herbert Simon in 1955, is a human decision-making process in which people tend to choose the option that's "good enough" rather than the best or perfect one - a process referred to as satisficing. The tendency for people to be bound by their rationality usually results from limited information, limited cognitive ability, and limited time (Pilat and Krastev, 2021a). For example, when making a purchase decision, an individual may rely on a 'popular' or well-established brand rather than conducting extensive research into whether the product's specifications truly meet their needs. In this case, choosing a brand like Apple may be perceived as "good enough" due to its reputation, even though it may not be the optimal choice for the individual's specific requirements.

Heuristics are the mechanisms people use to cope with bounded rationality, introduced by Kahneman and Tversky, and defined as mental shortcuts that simplify problem-solving and probability judgments. They are effective at making decisions more quickly but often lead to inaccurate or irrational judgments (Pilat and Krastev, 2021b), i.e., **biases** (Vaidya, 2021).

Loss aversion and prospect theory are concepts also developed by Kahneman and Tversky. Loss aversion is a cognitive bias in which the emotional impact of a loss is felt more intensely than the joy of an equivalent gain (Pilat and Krastev, 2019a). For example, marketing often uses loss aversion by utilising phrases like "last chance on this offer" or "limited time" in our daily lives. Prospect theory is a model describing how individuals evaluate gains and losses asymmetrically. For example, a store might advertise a sale as "don't miss out on saving 20%!" rather than "save 20%".

Mental accounting is a concept developed by Thaler that describes our tendency to assign subjective value to money in ways that usually violate basic economic principles. Although money has a consistent objective value, the way we spend it is often governed by different rules depending on how we earn it, how we intend to use it, and how it makes us feel. Although mental accounting is commonly associated with money, people often create mental categories in other aspects of their lives, such as time, effort, and emotional investments, that influence their decision-making (Pilat and Krastev, 2019b). An example is people's willingness to pay more for goods when using credit cards than when paying with cash.

Overconfidence bias is a cognitive bias in which individuals overestimate the accuracy of their beliefs, knowledge, or judgments and underestimate potential risks or errors. Overconfidence bias often leads individuals to make overly optimistic decisions or take on tasks beyond their actual capabilities (Drew, 2023). An example is when a stock trader believes they can consistently beat the market and make profitable trades without conducting thorough research or analysis.

Nudge theory is an application of behavioural economics, i.e., it applies prior concepts to show how policymakers or businesses can design environments to influence decisions without restricting choice (Steele, 2023). The concept was developed by Thaler and Sunstein. An example of this is when a department store places fruit stalls at eye level; it is a nudge to promote healthy eating.

Altogether, when these concepts are applied, they highlight that financial decisions are not always made rationally. Specifically, banking decisions are often influenced by cognitive shortcuts, emotional responses, social influences, and the decision context, as will be explored in the following sections.

Application of Behavioral Economics to Retail Banking

The study of behavioral economics has greatly impacted the financial world by enhancing the understanding of consumer behavior in investment, purchasing, and personal finance and wealth management decisions. As a result, the influence of behavioral economics is most evident in retail banking, which serves individual consumers, rather than large institutions, seeking everyday financial services.

Savings behavior

Savings are the portion of income set aside for the future and not spent on current expenses. Consumers often don't save as much as they intend because of multiple behavioral biases. These include present bias, mental accounting, limited self-control, and default option. For instance, present bias is the tendency to focus more on the present situation than the future when making decisions. This leads people to prioritize immediate rewards over future payoffs, even when the latter would benefit them more. When applied to savings behavior in the banking world, this bias explains why people spend more in the present and reduce their likelihood of saving in the future (Hitchcock, 2022).

Banks leverage insights into present bias to design savings programs that "nudge" customers toward better financial habits and higher savings. As established, present bias leads individuals to undersave and overspend, prioritising immediate gratification over future benefits. To counter this, banks offer automated savings mechanisms, such as default enrolment into savings plans, often incorporating goal-setting and predictive

tools to guide users toward more consistent, future-oriented financial decisions. This approach is effective because it reduces the cognitive load otherwise required to save.

When designing policies, decision-makers must consider how default settings create a path of least resistance, which can strongly influence people's choices. Opting out of defaults requires individuals to overcome inertia and deviate from what may be perceived as a societal norm. Defaults should therefore be chosen carefully to promote the best societal outcomes, while ensuring that opting out remains easy and seamless. The result is a more efficient system that helps society achieve collective goals while preserving individuals' freedom to make their own decisions. Banks apply this principle through automatic enrollment and preset contribution rates, reducing delays and increasing participation in savings plans (Yeganeh, 2020).

These behavioural interventions help individuals build savings without manually depositing funds each month. They also support better budgeting and spending habits (Kagan, 2022) and increase participation in retirement savings. However, there are drawbacks: such interventions rely heavily on constant authority decisions made on behalf of users, which can discourage independent long-term investment planning and wealth-building (Dhoke, 2024).

Investment behaviors

Investment can be defined as the act of allocating money or resources to an endeavour with the expectation of generating income or profit in the future (HDFC, 2026). Investments are important for a variety of reasons, including financial security, wealth creation, a passive income stream, tax benefits, and retirement planning.

Investment decisions are heavily affected by biases such as herding, loss aversion, anchoring, and overconfidence, which often cause investors to deviate from rationality. For instance, herd instinct in finance occurs when investors follow others' lead. By doing so, investors are influenced by emotions and instincts rather than by independent analysis of the situation (Paulus, 2024). Loss aversion also applies here, as it causes investors to hold on to losing investments to avoid feeling the emotional impact of loss (Liberto, 2024). Additionally, anchoring bias, the tendency to rely too heavily on the first piece of information offered when making decisions, can lead to poor financial investments and consequently suboptimal returns and missed opportunities (Conde and White, 2024). Lastly, overconfidence bias is also relevant, as it explains investors' tendency to overestimate their abilities or knowledge, leading them to engage in irrational behaviours such as trading too frequently or ignoring relevant information (Hayes, 2023).

A strong example of the effect of behavioral biases on investment decision-making is evident in the 2008 financial crisis. During this period, overconfidence bias led many investors, financial institutions, and regulators to underestimate risks associated with mortgage-backed securities and complex financial products, believing that markets would continue to rise indefinitely. At the same time, herding behavior reinforced these risky decisions, as investors followed peers' actions rather than independently assessing potential pitfalls. These biases inflated asset prices and contributed to the formation of financial bubbles that eventually collapsed, triggering widespread economic turmoil. For instance, it causes a large 30% drop in US housing prices, which had been increasing at a strong rate of 80-95% from the late 1990s to 2006 (ECB, 2009). Furthermore, GDP during this period shrank by 4.3% from peak to trough, and the unemployment rate increased to about 9.5-10% by mid-October of 2009 (Rich, 2013). Even market anomalies can often be traced back to behavioral biases. For example, calendar effects, patterns in stock market prices linked to specific times of the year (Canady, 2019), and momentum effects, where investors follow recent winners, creating short-term price trends that are disconnected from fundamental values, both illustrate how collective behavioral tendencies can influence market outcomes.

Financial advisors and institutions have countered these tendencies through education, risk profiling, and personalized advice. To assist customers in setting better financial goals for the future and adhering to them more successfully, behavioral finance enables advisors to consider both the rational and irrational components of investment (Goulart, 2023). Professionals who receive behavioral finance education are better able to recognize these biases and implement countermeasures, which ultimately improve financial results. One key tool in this process is risk profiling, which involves evaluating an investor's financial situation, goals, and psychological tolerance for market fluctuations before making investment decisions. By systematically assessing both capacity and willingness to take risks, risk profiling helps ensure that investment recommendations align with an individual's true risk tolerance. This approach not only reduces the likelihood of impulsive or emotionally driven decisions but also mitigates the impact of biases such as overconfidence or loss aversion, supporting more consistent and rational investment behavior.

Digital/FinTech behaviors

Fintech banking platforms leverage behavioral nudges to support better financial decision-making among users. For instance, smart budgeting tools monitor spending trends and alert consumers before they exceed category limits, helping curb overspending. Goal visualisation dashboards make progress toward financial

objectives visible, reinforcing positive behavior. Similarly, goal-based savings jars encourage individuals to save with specific objectives in mind, enabling actionable planning and informed allocation of funds. These features are reinforced by personalized, behavior-driven notifications that analyze user data, transaction patterns, and goals to deliver timely prompts. Unlike generic alerts, these nudges guide users toward smarter financial choices without being intrusive.

The benefits of fintech banking are significant. Such platforms improve financial awareness by making spending patterns and progress toward goals visible, and increase accessibility and inclusion by offering services to underserved populations, including those in rural areas. Many apps also support automated savings and investing through features such as goal setting, automated transfers, and transaction rounding, which help users build consistent savings habits.

However, fintech platforms are not without risks. The convenience of digital payments and services like "buy now, pay later" can lower mental barriers to spending, increasing impulsive purchases. Overreliance on automation may reduce user engagement in financial decision-making, leading them to miss important details such as subscription charges or declining balances. Additionally, digital platforms introduce security and privacy vulnerabilities, increasing exposure to cyber-attacks, data breaches, and identity theft.

In summary, behavioral economics has reshaped retail banking by recognizing that consumers do not always act as rational decision-makers. By understanding behavioral biases, fintech and banking institutions can design tools that help consumers make better financial choices. Yet, these tools are most effective when applied ethically and when users possess sufficient digital and financial literacy to engage with them responsibly.

Application of Behavioral Biases to Corporate Banking

As mentioned, retail banking provides financial services to individual consumers rather than businesses. Corporate banking, on the other hand, is a banking service offered to corporate clients. While retail banking entails decisions made at the individual level, such as saving and spending, corporate banking involves collective decision-making by teams or committees.

Behavioral economics plays a strong role in corporate banking as well, but since decisions are made as a team or a committee, it manifests as organizational behavior or group psychology. To further explain, organizational behavior is the study of how people interact in groups, and it's frequently used in the business world to improve individual and group performance. Additionally, its role in corporate banking includes improving decision-making, enhancing team performance, aligning individuals and organizational goals, and leading to better profitability and client satisfaction (Thomas, 2024). Group psychology provides essential insights into decision-making, risk management, leadership, team dynamics, and client relationships.

There are certain concepts that can help explain how group decision-making can lead to decisions that stray from rationality. For instance, groupthink is a theory that describes a situation in which individuals, as a team, make decisions without critical reasoning or evaluation of consequences or possible alternatives. It is a result of a common desire not to upset the balance of a group of people (Kenton, 2024). Furthermore, confirmation and overconfidence biases can also occur in risk committees, with risk assessment teams overestimating their expertise or selectively seeking confirming evidence when approving loans or setting credit limits. Finally, social norms and authority bias may also persist, as senior executives' views unduly influence group financial decisions.

Once again, many of these group-based behavioral biases can be traced back to the causes of the 2008 financial crisis. Research indicates that the crisis was largely avoidable and primarily resulted from excessive risk-taking, corporate mismanagement, and inadequate regulation (Rushe, 2011). In other words, behavioral misjudgments led investment banks to assume disproportionately high risks, despite repeated warnings from risk managers, senior management, and the broader financial system.

Behavioral intentions, such as promoting diversity in teams or intentionally structuring meetings, can help prevent groupthink by providing opportunities for diverse perspectives, improving risk assessment, and supporting better decision-making (Gau, 2023). For example, during the 2008 financial crisis, involving a broader range of team members rather than relying solely on senior management could have reduced the influence of dominant voices and potentially mitigated risky decisions across financial institutions, including investment banks. Similarly, organizational biases can be addressed through behavioral interventions, such as independent oversight or external audits, which can carefully evaluate decision-making processes and help identify cognitive biases within organizations. Overall, these behavioral strategies demonstrate that understanding group dynamics and deliberately designing decision-making structures can improve corporate banking decisions and enhance risk management.

II. Conclusion

Behavioral economics plays a significant role in professional and consumer decision-making in the financial and banking world, and it helps combat multiple psychological biases to achieve the best possible decisions.

The use of behavioural economics started in the 1940s through the work of Daniel Kahneman and Amos Tversky, but early ideas can also be traced back to Adam Smith in the 1700s. Behavioral economics challenges the very foundations of traditional economics and explains the possible irrationality behind certain decisions. Over time, multiple concepts such as bounded rationality, heuristics and biases, loss aversion, mental accounting, and nudge theory have been developed to explain irrational decision-making. These key concepts show that the model of rational decision-making doesn't always fit the bill, and that mental shortcuts often drive several financial decisions.

The findings of this paper highlight how the principles of behavioral economics influence financial decision-making in both retail and corporate banking. In retail banking, banks apply these principles to shape savings behavior, guide investment choices, and design fintech platforms that nudge consumers toward better financial habits. In corporate banking, behavioral strategies such as promoting diversity, independent oversight, and structured decision-making help mitigate organizational biases and improve risk management. The 2008 financial crisis serves as a stark example of the consequences of neglecting human irrationality in financial decision-making. Overall, behavioral economics provides critical insights that enable more informed decisions, reduce the impact of cognitive biases, and promote a more stable and efficient financial system, underscoring its essential role in modern banking practices.

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