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Daniel Kahneman, Matthew Syed, the theory of marginal gains, and, their relevance for Irish credit unions

By Brian Hayes

"Economists think about what people ought to do. Psychologists watch what they actually do." So says Daniel Kahneman, the internationally renowned Israeli-American psychologist who was awarded the Nobel Memorial Prize in Economic Sciences 2002 for his contribution to the world of economics. Much of Daniel Kahneman's work focused on behavioural economics; the way people behave in an economic context. Kahneman's central thesis as set out in his best-selling book (*Thinking Fast and Slow*), is about the biases of our intuition. That is, we assume certain things automatically without having thought through them carefully. Our brains are comprised of two systems, one that thinks fast (which he refers to as "System 1") and one that thinks slow (referred to as "System 2"). System 1 operates automatically, intuitively, involuntarily and effortlessly. System 2 requires slowing down, deliberating, solving problems, reasoning, computing, focusing, concentrating, considering other data, and not jumping to quick conclusions. These two systems often conflict with one another. System 1 operates on heuristics (learning from experience, trial and error) that may not be accurate. System 2 requires effort evaluating heuristics that can lead to error. Kahneman refers to a number of cognitive biases that drive System 1 and are error prone. People can tend to search for and find confirming evidence for a belief while overlooking counter examples (*"confirmation bias"*). Things that are easier to compute, more familiar, and easier to read seem more true than things that require hard thought, are novel, or are hard to see (*"cognitive ease"*). To make sense of the world we tell ourselves stories about what is going on; we make associations between events, circumstances, and regular occurrences. The more these events fit into our stories the more normal they seem (*"associative coherence"*). The premise of his book is how to *"recognize situations in which mistakes are likely and try harder to avoid significant mistakes when stakes are high"*.

Matthew Syed, British journalist, author and former table tennis Olympian, develops Kahneman's behavioural economics in his recent book, *Black Box Thinking*. The book, as the name suggests, focuses on learning from mistakes. Syed argues that the cognitive biases as set out by Kahneman, often prevent people from learning from mistakes. Syed argues that the greatest difficulty that many people face is in admitting their personal failures and learning from them, Syed notes that we often *"reframe, spin and even edit out our mistakes"*. He shines a light on the aviation industry, where due to the catastrophic impact of mistakes, learning from them is a key element of the culture of the industry. In March 2015 Andreas Lubitz locked himself into the cockpit of a Germanwings Airbus A320 and flew it into the French Alps killing everyone on board. That led to an immediate response from the aviation industry with new regulations on cockpit pilot presence and screening for mental health of pilots. The industry reacted to a mistake, adapted, and ensured its core objective of safe aviation could be better achieved. Syed argues that this culture of learning from mistakes, black box thinking, is at the heart of all successful organisations. It is at the centre of the *"psychological dynamic"*. Syed draws on a wide array of examples from popular culture to support this position. While many may think that James Dyson, creator of the revolutionary vacuum cleaner, had a moment of inventive genius, he actually had over 5,000 prototypes before his hoover worked. David Beckham, he argues, scored his spectacular injury time equalizing free kick against Greece in 2001, not due to sublime skill, but from relentless practice. And Steve Jobs attributed the success of Apple more to tenacity than genius. Building a business, he would say, was not for the mentally sane, it was for the passionate and maddeningly persistent. Syed notes that at times, progress is not driven by the accumulation of many steps, but by dramatic leaps, or moments of genius. Syed refers to these dramatic leaps of progress as "ballistic" strategies. Galileo Galilei, Albert Einstein and Marie Curie all made dramatic leaps of progress through individual brilliance. Given the current levels of interest in debit cards in the credit union movement, it may come of interest to some, that the ATM card was originally invented in a moment of brilliance by an Englishman, while having a bath (John Adrian Shepherd-Barron). But Syed's central proposition is that creativeness and progress comes from incremental steps of progress by learning from mistakes. It comes from *marginal gains*. Any organisations that have a culture of feedback generally perform better, and make enough marginal gains to make material progress.

So how is all of this relevant for credit unions? The loan to asset ratio of the Irish credit union movement has fallen from 51% to 26% between 2008 and 2015, an epic shift in economic fortunes for Irish credit unions. Now the average credit union has roughly 75% of its members' funds held on deposit and exposed to the exigencies of the low interest rate environment. All other challenges that the Irish credit union movement faces pale into insignificance alongside the loan to asset ratio issue. In early July 2016, the Credit Union Advisory Committee ("CUAC") issued its eagerly awaited report on the review of the implementation of the recommendations in the Commission on Credit Unions Report. The report noted that the loan to asset ratio *"is a cause of deep concern"*. The report went on to note that there has been *"significant shift away from larger value, longer duration loans to smaller value, shorter duration loans"*.

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The report concluded that *"both trends raise fundamental questions around the credit union business model(s)."* This is unquestionably the core challenge for Irish credit unions in modern times.

So faced with this strategic challenge, what is the response? The CUAC report, while pointing in certain directions, does not hold a magic wand response, or to use Syed's term, a "ballistic" solution. Nor should it, mindful of the statutory role of the Committee and its term of reference. But more importantly, nor would it be realistic to expect it to, mindful of the sheer

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complexity of the loan to asset ratio issue. And this is at the heart of the issue. The loan to asset ratio issue is multi-layered and complex. Confronting the loan to asset ratio has been at the centre of strategic plans of credit unions since the 2012 Act and has driven a plethora of common strategic responses:

- It is due to ICT shortcomings, let's develop an ICT strategy
- It is due to money transmission shortcomings, let's get debit cards
- It is due to marketing shortcomings, let's develop a marketing strategy
- It is due to product development shortcomings, let's develop a product development strategy
- It is due to the legal and regulatory environment, let's push the boundaries
- It is due to our size, let's merge
- It is due to post recession scar tissue, let's sit back and wait for the tide to come back in

It is this author's view that it is in reality all of the above, and many more. But the central issue is not which of the above, if any, is the ballistic strategy. The central issue is the process and culture by which the issue is confronted and tackled. And this is where Daniel Kahneman and Matthew Syed become relevant. The loan to asset ratio issue is a complex issue that is unlikely to be cured overnight, or unlikely to be cured by a unitary ballistic strategy. The loan to asset ratio issue requires Daniel Kahneman *System 2 Slow Thinking*; slowing down, deliberating, solving, reasoning, concentrating, considering other data, and not jumping to quick conclusions. It also requires Matthew Syed *Black Box Thinking* where progress may come in a series of marginal gains, through tenacity and perseverance and learning from mistakes along the way. It requires that proper systems and proper culture are in place to enable the credit union movement itself to cure the loan to asset ratio issue.

In this context, it is worthwhile to turn attention to Section 76A of the Credit Union Acts. Legislation is not a traditional breeding ground for innovation, but Section 76A provides all of the strategic architecture to confront the loan to asset ratio. Furthermore, Section 76A provides the means, if applied sensibly, to enable Daniel Kahneman *System 2 Style Thinking* and Matthew Syed *Black Box Thinking*. Section 76A is in fact the James Dyson element of the 2012 Act. The innovation piece.

Section 76A requires credit unions to have strategic plans. Very few institutions are legally compelled to be strategic. But Section 76A sets out a framework to ensure strategies are carefully thought out, monitored, assessed for appropriateness, and, revised and iterated. And this is critical. Managers have defined roles to propose strategies, Boards have defined roles to monitor and reassess strategies. Following Section 76A in a meaningful and effective way, should lead to *System 2 Thinking* and *Black Box Thinking*. And that is central in confronting the loan to asset ratio. Strategies should be calibrated to deal with the loan to asset ratio. Strategies should not be rushed or display cognitive biases. Strategies should be concise and focused. Strategy should be centre stage on the Board agenda. Management reporting should be designed to enable Boards to carefully monitor strategy through carefully structured financial and economic reporting platforms. Boards should review progress carefully, and adapt, iterate, modify and persevere. And this is what will confront the loan to asset ratio. This may come from incremental marginal gains (James Dyson Style) or it may come from the individual brilliance of a ballistic strategy (maybe even conceived in a bath). But for all of this to happen, strategic thinking must be at the centre of the *"psychological dynamic"*, to use Matthew Syed's term. And Section 76A is central to this.

It is likely that the credit union movement will successfully rebuild the loan to asset ratio in time. In the coming years, it is likely that debit cards will be offered by credit unions. It is likely that mergers will continue to reap reward. It is likely that long term lending will grow in credit unions. It is likely that ICT advances will be made. All of these things are likely to happen. And all of these things are likely to increase lending. But they will take time, and are likely to occur through incremental marginal gains with the right psychological dynamic.

Yes, Dyson did revolutionise the hoover, but the first hoover was first invented by a man called Daniel Hess in 1860. Yes, Steve Jobs did revolutionise the phone, but again the first phone was invented by Alexander Graham Bell in 1876. Good ideas withstand time. They just adapt and transform as they evolve. The Irish credit union movement is part of the worldwide credit union movement. The first credit union was opened in Germany by Friedrich Wilhelm Raiffeisen in 1864. The credit union movement has enjoyed phenomenal success since then, and now 57,000 credit unions serve the needs of 217 million people around the world. The credit union movement has enjoyed particular success in Ireland since the movement started in the 1950s. The current loan to asset ratio issue is a major challenge, but the credit union movement is well-capitalised and with the right strategic approach, imbued with Kahneman *System 2 Thinking* and Syed *Black Box Thinking*, it will correct the loan to asset ratio imbalance in time. After all, just like a phone and a hoover, a credit union is simply a good idea, and good ideas withstand time.

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