Behaviorally Informed Consumer Financial Services Regulation

Cleveland Federal Reserve Bank
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Classical model

Decision → Action → Outcome
Behavioral Economics

• Information vs understanding
• Intention vs. behavior
• Predictable biases
  – Misperception
  – Misforecasting
  – Myopia
  – Decisional conflict
  – Mental accounting
  – Attention constraints, local focus, information overload
  – Procrastination, inertia
• Context & Institutions
  – Defaults, framing, hassle factors
  – Behavior
  – Planning

• See Barr, Mullainathan & Shafir (2009)
Behavioral model

- Frame
- Bias

- Attention
- Context

- Hassle
- Inertia

Decision ➔ Action ➔ Outcome
Market Structure

• Competitive markets
• When does behavioral agent matter more? For example:
  – Shrouding
    • Mortgage contracts
  – Contingent payments
    • Credit card late fees, debit overdraft
    • Cell phone contracts with penalty rates over min.
  – Agency costs/side-payments/low-monitoring
    • Mortgage brokers
    • Securities brokers
  – Sometimes, bundling purchase & loan reduces debt discipline
    • Buy here, Pay here Used Car Dealers/Lenders
    • Rent to Own
  – High Switching Costs (e.g., from bill pay)
### TABLE 1
The Firm and the Individual

<table>
<thead>
<tr>
<th>Behavioral fallibility</th>
<th>Market neutral, or wants to overcome consumer fallibility</th>
<th>Market exploits consumer fallibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumers misunderstand compounding</td>
<td>Consumers misunderstand compounding in savings. → Banks would like to reduce this to increase savings base.</td>
<td>Consumers misunderstand compounding in borrowing. → Banks would like to exploit this to increase borrowing.</td>
</tr>
<tr>
<td>Consumers procrastinate</td>
<td>Consumers procrastinate in signing up for EITC. → Tax filing companies would like to reduce this to increase customer base.</td>
<td>Consumers procrastinate in sending in requests for rebates. → Retailers would like to exploit this to increase revenues.</td>
</tr>
</tbody>
</table>
**Behaviorally Informed Regulation**

**TABLE 2**

**Changing the Game**

<table>
<thead>
<tr>
<th>Rules</th>
<th>Scoring</th>
</tr>
</thead>
<tbody>
<tr>
<td>Set the defaults in 401(k) savings</td>
<td>Penalties for 401(k) enrollment that is top heavy with high-salary employees</td>
</tr>
<tr>
<td>Set the default for organ donation</td>
<td>Grants to states that enroll organ donors</td>
</tr>
</tbody>
</table>
Behaviorally Informed Regulation

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<td>Rules</td>
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<tr>
<td>• Public education on saving</td>
<td>• Opt-out mortgage system</td>
</tr>
<tr>
<td>• Direct deposit or auto-save</td>
<td>• Information debiasing on debt through framing, salience</td>
</tr>
<tr>
<td>• Licensing of brokers</td>
<td></td>
</tr>
<tr>
<td>Scoring</td>
<td>Scoring</td>
</tr>
<tr>
<td>• Tax incentives for savings vehicles for the poor</td>
<td>• Penalties to make the opt-out system sticky</td>
</tr>
<tr>
<td></td>
<td>• Ex post liability standard for truth in lending</td>
</tr>
<tr>
<td></td>
<td>• Broker fiduciary duty, or changing compensation (banning yield spread premiums)</td>
</tr>
</tbody>
</table>
Payment cards

- Private sector Innovation
- Scoring (bundling)
- Default (opt-out)
- Government payment cards
  - Direct Express
  - Pilots on tax refund accounts
CARD Act

• Disclosure enhancements
• Debiasing
  – Fees (misforecasting)
  – minimum payments (misperceiving)
• Opt-in for over-limit transactions
• Excess payments pay off highest rate first
• Reasonable time to pay/stable due dates
• Bans on double-cycle billing
• Bans on late fee traps, retroactive rate hikes
• Penalty fee “reasonable & proportional”
Dodd-Frank Act

• Mortgage regulation
  – Mortgage broker regulation
    • YSPs
    • Ability to pay
    • Ban on steering
    • Licensing, registration
  – Enhanced disclosures
  – Escrow requirements
  – “Plain vanilla” sticky default
    • QRM Risk Retention Rule
    • QM Ability to Pay Rule
    • GSE Credit Box
Dodd-Frank Act

• CFPB
  – Unfair, abusive, deceptive acts/practices
  – Consumer protection rules
  – Supervision
  – Enforcement
  – Information, Education, Counseling, Complaints
  – Empirical testing/safe harbors for pilots
  – Disclosure
Behaviorally Informed Regulation

• Financial regulation needs to take account of behavioral economic insights.

• Psychology & industrial organization.
  – Individual behavior
  – Market context
  – Regulatory response

• Behaviorally informed equilibrium model of intersection of firms and individuals

• Policies (regulation, access, technology)