

Behaviorally Informed Consumer Financial Services Regulation

Cleveland Federal Reserve Bank

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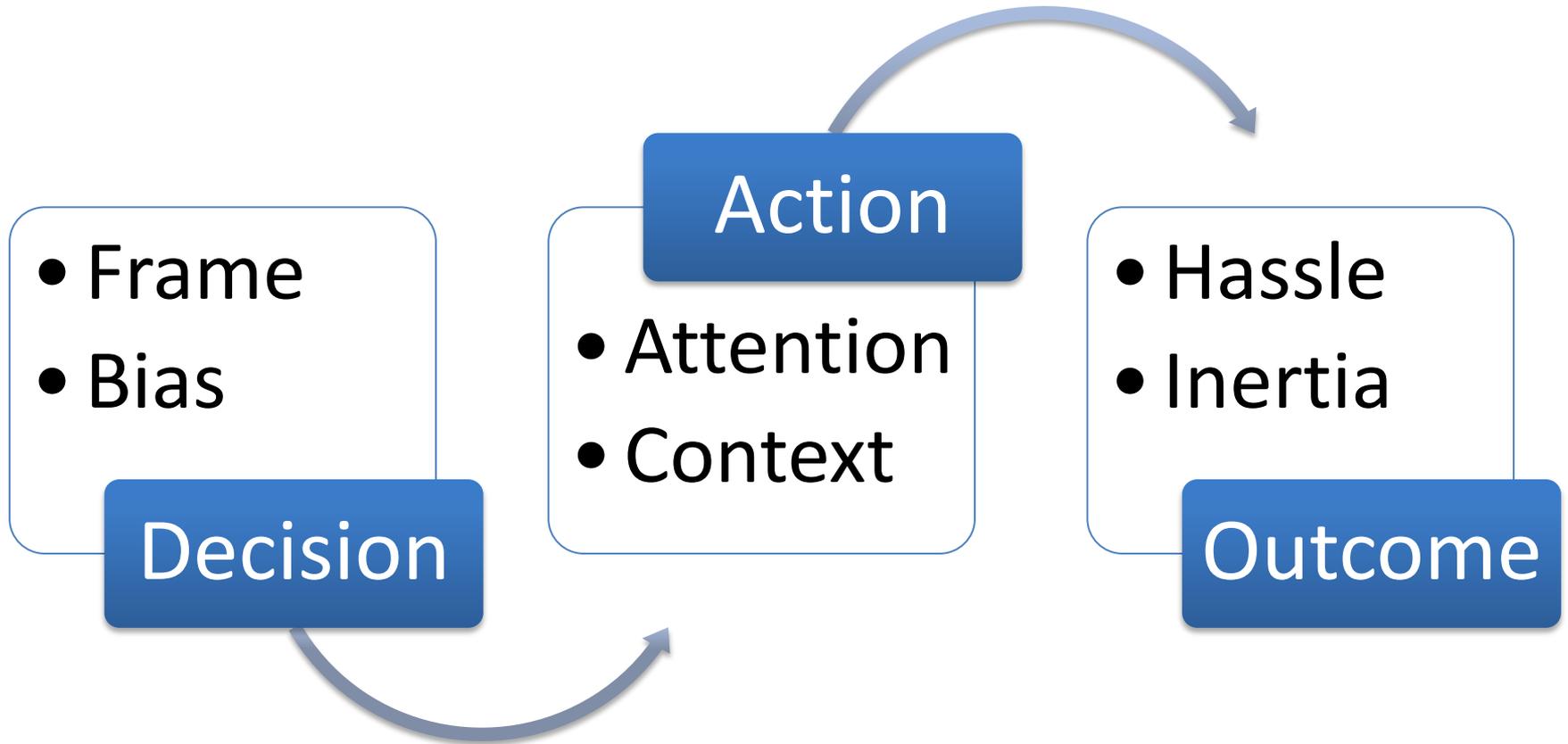
Classical model



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



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)

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TABLE 1
The Firm and the Individual

Behavioral fallibility	Market neutral, or wants to overcome consumer fallibility	Market exploits consumer fallibility
Consumers misunderstand compounding	Consumers misunderstand compounding in savings. → Banks would like to reduce this to increase savings base.	Consumers misunderstand compounding in borrowing. → Banks would like to exploit this to increase borrowing.
Consumers procrastinate	Consumers procrastinate in signing up for EITC. → Tax filing companies would like to reduce this to increase customer base.	Consumers procrastinate in sending in requests for rebates. → Retailers would like to exploit this to increase revenues.

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TABLE 2
Changing the Game

Rules	<ul style="list-style-type: none">• Set the defaults in 401(k) savings• Set the default for organ donation
Scoring	<ul style="list-style-type: none">• Penalties for 401(k) enrollment that is top heavy with high-salary employees• Grants to states that enroll organ donors

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TABLE 3

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	Market neutral or wants to overcome consumer fallibility	Market exploits consumer fallibility
Rules	<ul style="list-style-type: none">• Public education on saving• Direct deposit or auto-save• Licensing of brokers	<ul style="list-style-type: none">• Opt-out mortgage system• Information debiasing on debt through framing, salience
Scoring	<ul style="list-style-type: none">• Tax incentives for savings vehicles for the poor	<ul style="list-style-type: none">• Penalties to make the opt-out system sticky• Ex post liability standard for truth in lending• Broker fiduciary duty, or changing compensation (banning yield spread premiums)

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)

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NO SLACK

The Financial Lives of
Low-Income Americans

