

Behaviorally Informed Home Mortgage & Financial Services Regulation



New America

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The firm & the individual

Market neutral/wants to overcome consumer fallibility

Market exploit consumer fallibility

Consumers misunderstand compounding in *savings*
→ Banks would like to *reduce* this so as to increase savings base

Consumers procrastinate in signing up for EITC
→ Tax filing companies would like to *reduce* this so as to increase number of customers

Consumers misunderstand compounding in *borrowing*
→ Banks would like to *exploit* this to increase borrowing

Consumers procrastinate in returning rebates
→ Retailers would like to *exploit* this so as to increase revenues

Changing the Game

R
U
L
E
S

Set the defaults as participation in 401(k) savings
Opt-out for Organ Donation

S
C
O
R
I
N
G

Tax penalties if 401(k) plans are top heavy.
Grants to states for increasing organ donation

Behaviorally informed regulation

Market neutral/wants to overcome consumer fallibility

Market exploit consumer fallibility

R
U
L
E
S

Public education on saving
Direct deposit/auto-save
Licensing

Opt-out credit product
Information debiasing
on debt

S
C
O
R
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Tax incentives for
savings plans for poor

Sticky opt-out
Ex post liability
standard for truth in
lending
Broker fiduciary duty
Banning YSP

Individual psychology: home mortgages

- Information ≠ understanding. Intention ≠ action.
- Lenders can compete on non-rational push factors (e.g., “getting to yes”).
 - Fear of rejection, discrimination, poor negotiating ability
- Bad decision-making regarding complex products
 - Misperception
 - Information overload
 - Misforecasting
 - Inertia, procrastination, self-control, myopia
- Situational factors strong: defaults, framing, heuristics, channel factors. Outcomes do not reflect deep preferences.
- Subprime borrowers less likely to search, less likely to be offered alternatives, less knowledgeable than prime (Courchane, Surette & Zorn (2003))
- The role of institutions & law in shaping demand
 - Misplaced trust that mortgage broker works for customer
 - Misplaced belief that government regulation ensures safety

Industrial Organization: home mortgages

- Incentives theoretically aligned because costly to repossess collateral, and credit exposures large, so credit losses real.
- Reality: incentives too weakly aligned, given attenuated chain--borrower, broker, originator, MBS, CDO, investor; lack of transparency; financial innovation > agency cost wedge grew unnoticed.
- Markets “self-correct”, but cause real harm & unclear whether learn the right lessons.
- Brokers/firms use behavioral insights to make bad loans (e.g. teaser rates with prepayment penalties)
- Incentives reward brokers/loan officers to get highest interest rate
- Competition fosters bad, shrouded product features
 - prepayment penalties, balloon payments, teaser rates
- Specialized, bifurcated credit credit channels can be efficient, but only if borrower gets into “right” channel

A “Sticky” Opt-Out Mortgage Plan

- All applicants would be offered standard product(s) as a default
 - e.g. 30 year, fixed rate, self-amortizing mortgage, with standard minimum LTVs & loan-to-income ratios.
 - Could develop “basket” of standard products.
- To opt-out, alternative offers require heightened disclosures, suitability protections, liability exposure (to be specified)
- Benefits
 - Increases likelihood of understanding of products & comparison-shopping
 - Anchoring/expectations re: consumer decision-making
 - Reduces likelihood of mistakes
 - Permits financial innovation
- Risks
 - Too weak to matter given market incentives
 - Too expensive to implement so reduces loans
 - Too many cases in which alternative products are optimal
 - Uncertainty reduces financial innovation
- Modifications
 - Potential to develop “smart default” based on key borrower characteristics (income, age, education level).
 - Reduces error cost
 - Increases confusion
 - Potential to build in periodic review/adjustment of defaults

Ex post determination of unreasonable disclosure

- Shift from ex ante rules under TILA to ex post standard
 - determination of whether disclosure was one a reasonable person would have understood.
- Benefits
 - Permits innovation in mortgage products & disclosure approaches
 - Reduces “evasion through compliance”
 - Puts incentives on lenders to disclose appropriately
- Risks
 - Uncertainty raises costs of lending for complex products that might benefit borrowers
 - Lack of standardization in disclosure may increase borrower confusion and reduce ability to compare
 - Could mitigate with combined TILA rule + reasonableness as a defense in foreclosure action.
- Enforcement: Could be defense to foreclosure or bankruptcy, or cause of action for rescission, or tort liability, or agency supervision & enforcement only.

Information Debiasing: Require disclosure of all information favorable to borrower

- Borrower possible background assumption of full information disclosure
 - Lender validation
 - Government regulation validation
- Reality of asymmetric information
 - Lender has information about borrower that borrower does not (necessarily) know
 - Credit score
 - Qualification for (better) loan
 - Wholesale rate sheets
- Require disclosure of credit score, qualification & wholesale rate sheets at time of offer
 - Benefits: improve comparison shopping & outcomes
 - Costs: reduced profits for lenders & brokers

Scoring: barring YSP or imposing duty

- Problem: Brokers cannot be monitored sufficiently by borrowers & evidence suggests lenders do not monitor brokers
- Ban YSP & replace with flat fees
 - Evidence suggests YSP disclosure alone doesn't help
- Impose fiduciary duties
 - Compare to financial advisors under securities laws
- Benefits: reduce agency costs
- Costs: New regulatory structures
- Alternatives:
 - Improve disclosures to borrower
 - May help, but may reinforce mis-placed trust
 - Licensing & public disclosure of performance
 - May be too weak to change conduct

Debiasing Consumers or Opt-Out Payment Plan for actual credit card balance

- Problem
 - Making minimum payments is costly over long-term
 - New revisions to TILA rules will help by requiring cumulative cost + warning on paying minimums
 - But notice on paying off actual balance is option, not required.
- Require Actual Pay-down time frame & Cost
 - Benefits: Saliency & framing stronger than current regulatory requirement of time to pay off hypothetical balance plus phone number to call
 - Risks/Costs
 - May be too weak to change behavior by attempting to change intention; & may be “too late” since borrowing occurred.
 - Credit card companies need to revise programs/statements
- Require Opt-out payment plan to pay off actual balance
 - Require minimum payment high enough to pay off balance over set, reasonable time, say 6 months (unless opt out)
 - Change behavior with default, rather than framing.

Opt-out Credit Card

- Can a high-road firm offer a clean credit card (Warren) and remain profitable?
 - If shrouding works and consumers split between naifs and sophisticates, it is hard for high road firms to win (Laibson et al.)
- Can regulation be designed to reward high-road credit card firms and penalize low-road firms?
- Opt-out Clean Credit Card
 - Specify terms & conditions that are “safe”

Scoring: Regulate late & over-limit fees

- Problem: Credit card firms can charge late and over-limit fees with relative impunity because consumers never believe ex ante that they will pay such fees.
- Let firms deter paying late or going over the limit with whatever fees they want, but require that such fees be placed in a public trust fund to be used for financial education/troubled borrowers.
 - Benefits: “bad” conduct deferred but no “unjust enrichment” or incentives to overcharge
 - Costs:
 - Reduced revenue stream to lenders means other rates and fees may be adjusted to compensate.
 - Interference with contractual relationships.

Scoring: Savings in Safe & Affordable Bank Accounts

- Encourage low-cost, electronically-based bank accounts to foster savings, with tax credit for financial institutions
 - Pay for performance, fixed cost per account
 - Administered by IRS & FMS using adjustments to quarterly withholding payments
 - Direct deposit, auto-save plans
 - No overdraft, no check-writing, no chexsystem screen
- IRS deposit tax refund to default, privately offered bank accounts for the unbanked

Conclusion

- 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
- Preliminary ideas to foster discussion