

Remarks before The Banking Committee hearing: "Creating a Consumer Financial Protection Agency: A Cornerstone of America's New Economic Foundation"
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Chairman Dodd, Ranking Member Shelby and members of the Committee, thank you for providing me with an opportunity to testify. By way of background, I am a Professor of Economics at Harvard who specializes in behavioral economics, a topic that combines two areas—economics and psychology. Any discussion of financial regulation must incorporate both areas—economists have a healthy respect for market forces while psychologists have a healthy respect for both people's immense capacities and limitations; they recognize that people are not financial engines churning out optimal choices in all environments. Understanding the current crisis—with its combination of competing lenders and sometimes-confused borrowers—requires behavioral economics.

In my comments I will make four points:

- First, some decision environments allow consumers to choose well while others result in poor choices.
- Second, when customers choose well there is healthy competition: firms clamor to provide better products at lower prices. When customers choose badly, there can be a race to the bottom. Even a few unprincipled firms offering products that exploit human fallibility can put pressure on the entire market.
- Third, a two-part approach to financial regulation can promote consumers capacity to choose well. Safe products would be lightly regulated while less safe ones—where low road firms could potentially exploit customers—would be more heavily regulated. A fence around the safer products creates a more level playing field between safe and less safe but superficially attractive products. It provides an additional tool that is less intrusive than bans, mandates or selective bans for some customers. It allows all customers to access products but simply ensures that those who access less safe ones would be doing so with greater safeguards.

Though the scope of the proposed regulation is broad, I will use the choice between mortgages—at the heart of the current financial crisis—to illustrate my points.

Choosing Well and Badly

First, let me describe the psychology of choice. Over the decades much research has helped us understand how people choose. I will illustrate the insights from this research using two familiar examples.

Most of you have painted a room in your house. You probably remember choosing from thousands of colors; Benjamin Moore alone proudly offers 140 shades of white. How do you tackle this ocean of choice? You pick a general color—blue, yellow, whatever. You pick

a few shades within that color. You try them out in small swatches on one wall, see if you like them and repeat until you have a color you like. The bottom line: despite the explosion of choice people are largely happy with the end outcome. And certainly we don't think the government could step in and improve this market through regulation.

I am also sure most of you have bought a digital camera. Going into the electronics store, you have some sense of what you want—do you need a small camera or a big one, do you prefer one brand over another? But once there the problem gets tougher. One camera has 8 megapixels and is smaller and cheaper; another has 12 megapixels and is bigger and more expensive. How do you choose? What is a megapixel? How many is enough? Are 8 megapixels 50% better than 12? You can ask the camera salesman but are his incentives to give you the best advice? If the bigger camera is the cheaper per megapixel it may draw you to buy that one even without knowing fully understanding what megapixels are. Though there are far fewer cameras than paint colors the choice is far more difficult. At the end of the process, you hope you have bought the best camera but you're never really sure.

Part of choosing a mortgage is like choosing a paint color. Choosing a 30-year fixed rate mortgage means deciding on what is an affordable monthly payment. How much do you earn? What are your other expenses? The consumer can intuit much of this—in fact they may know it better than any outsider.

But sometimes when choosing a mortgage you encounter features all too similar to megapixels. Suppose one mortgage costs 1000 dollars a month for the first two years and then the payment is 3 points above one month LIBOR, while another says it is 900 dollars a month and then the payment is 4 points about the 1 year constant Treasury bills rate. How do you make this choice? What is the difference between the LIBOR and the T-Bill rate? How much do they vary? Are 3 and 4 points about the right number? If the provider says you can refinance in 2 years, should you worry about being able to get another loan? Notice that in this morass, the 900 dollar mortgage has some appeal; whatever else, it is cheaper now and allows you afford a bigger house. Few know the answers to these questions and those who do are the kind of people you avoid at a dinner party. This is worse than megapixels.

Choices such as these are at the heart of why choosing mortgages and other financial products pose so many difficulties for customers. With paint, you can try different colors; you can't really try on many mortgages. With paint, you get feedback; with mortgages feedback comes rarely and far too late—when the payments explode. With paint, a mistake is, well, easily painted over; with mortgages mistakes have lifetime consequences. And most importantly, we understand the colors we like whereas few of us understand the financial technicalities that can have large consequences.

Under such conditions, errors abound. For example, as Bucks and Pence show in their recent study “40 percent of borrowers with income less than \$50,000—corresponding roughly to the bottom half of the income distribution of ARM borrowers—do not know the

per-period caps on their interest rate changes.”¹ To cite another example, nearly fifty percent of ARM borrowers think their mortgages can be converted to fixed rate ones whereas only 9% actually appear to be convertible.

Put simply, confusing choices do not represent real choices. Rather than empowering consumers it can frustrate them. To promote effective free choice one must ensure the choices can be made sense of.

Competition

This leads to my second point: how markets operate depends on how people choose. It is useful to separate the world between high road and low road lenders. High road lenders are in the game for the long run and trying to do what is best for their customers. They recognize that a bad mortgage is bad for business in the long run. Low road lenders have shorter time horizons; their management is focusing on the bottom line now. These firms would give out a bad mortgage—one that hurts consumers—if it makes them money today, even if it costs them in the long term.

The fortunes of high and low road firms depend on how people choose. When people choose well, low road firms can do no better than offer better products or lower prices. Here markets work well and innovation helps consumers.

Things change when consumers are choosing badly. High road firms now suffer from the actions of low road ones. Suppose a consumer is offered a reasonable 30 year fixed rate mortgage by one firm and offered a balloon ARM with an appealing teaser rate. Unless they understand the arcane financial details of the adjustable rate jump and amortization clauses, the balloon ARM will look deceptively attractive. The better product can look like the worse product. One lender offers a reasonable debt-to-income; another a much less safe debt-to-income. One lender offers standard principal payments while another offers a payment option ARM and advertises the minimum payments that do not even cover interest and lead to negative amortization. In all these cases, customers could easily be misled as to which is the good safe product and which is the bad unsafe one. Good firms suffer again when they start losing staff to bad firms who can pay more. And so on. This can lead all firms to begrudgingly adopt low road strategies.

John Bogle, founder of Vanguard, has personal insight into this process. Vanguard faced it directly in marketing a no-load minimum-fee index fund. He points out that competition from (what I refer to as) low-road funds has shifted the “industry’s focus from management to marketing.” He further notes, “Small wonder that in all the rush to salesmanship in the fund industry, stewardship seems to have been left in the dust.”²

¹ Brian Bucks and Karen Pence (2006) "Do Homeowners Know Their House Values and Mortgage Terms?" Federal Reserve Board of Governors. FEDS Working Paper No. 2006-03. Available at SSRN: <http://ssrn.com/abstract=899152>.

² <http://johncbogle.com/wordpress/wp-content/uploads/2009/03/iacompliance2.pdf>.

The experience of credit unions provides another interesting window in to the race to the bottom. Because of their structure—they are not for profit cooperatives—they may be better equipped to resist low road approaches. According to a recent Experian-Oliver Wyman study, credit unions are experiencing as little as one-fifth the delinquency rate on mortgages and half the delinquency rate on credit cards as banks, even within the same credit score band.³ This does not mean credit unions are necessarily a panacea to the mortgage problem; it merely illustrates the possibility of a high-road strategy.

When consumers choose badly innovation—one of the greatest benefits of markets—is also perverted. What did mortgage markets innovate in the beginning of this decade? Teaser rates, negatively amortizing loans, exploding subprime interest rates, prepayment penalties and low- or no-doc lending are hardly shining examples of how financial innovation helps consumers. Instead these products, while surely useful for a few customers, have been abused because they have a superficial appeal to confused customers. They likely contributed heavily to the defaults we must now deal with. In short, when borrowers choose badly innovation can be geared towards exploiting mistakes rather than producing products that help customers.

The challenge of regulation.

I believe the financial crisis we have faced illustrates the importance of how market forces combine with how people choose. When the worst of these collide—bad banks introducing mortgages that exploit confused customers—the result is a toxic combination that leaves not just consumers but the entire financial system at risk. Successful financial regulation must pay attention to both of these.

The challenge of regulation is to ensure a system where customers can choose well according to their needs. In such a system, high road lenders will face a level playing field; competition and innovation will benefit customers. This is much like the need for a referee in any sport. If there are no referees, dirty players cheat and good players lose or must follow suit. It's not a foul unless a referee calls it. A good referee applying sensible rules can ensure that all players—honest and dishonest—play by the same rules. At the same time, the referee must let players play the game and not interfere too often. I believe appropriately implemented the Consumer Financial Products Agency (CFPA) can be like a good referee for the financial sector. It can ensure that firms compete on a level playing field. It can allow players to play the game as long as they are within the bounds of the rules.

As Michael Barr, Eldar Shafir and I have proposed, a two-part approach to regulation is particularly important to accomplishing this goal.⁴ Some financial products—call them first

³ See <http://www.marketintelligencereports.com>.

⁴ Michael Barr, Sendhil Mullainathan and Eldar Shafir, "Behaviorally Informed Home Mortgage Regulation In *Borrowing to Live: Consumer and Mortgage Credit Revisited*, edited by N. Retsinas and E. Belsky, 170-202. Washington, D.C.: Brookings Institution Press, 2008.

choice products—are easily understood and easy to choose between. First choice products are regulated minimally: ensure disclosure, prevent fraud; we know how to do this, do much of it already and know how to do more of it. But notice this is not enough.

This is because other products—option ARMs, subprime ARMs with interest rates set to increase substantially—can pose significant risks for the typical consumer. They allow bad choices and for low road lenders to enter. These exotic products may make sense for some sophisticated consumers of course. But unchecked they are dangerous because their superficial appeal—with hidden risks—makes them unfair competition for the first choice products. These products would need to be regulated far more stringently. The Federal Reserve, for example, has put forward fact sheets that might serve as disclosure for more exotic mortgages.⁵ While a good start to what can be done this is not enough. New products appear all the time, and marketing can be endlessly inventive in sidestepping disclosure. As a result, an agency like the CFPB would need to constantly update as the product mix changes. Done correctly, it would assure that customers could access exotic products. But they would do so with a greater understanding that their superficial attractiveness comes laden with hidden risks.

This is analogous to how we regulate drugs. Those with minimal risks that consumers understand—ibuprofen, cold medicine—are regulated only to prevent fraud and malfeasance. More complicated drugs—powerful antibiotics—are more stringently regulated. Testing mechanisms ensure efficacy. Independent advisors—a prescriber—ensure those who receive them understand their purposes and risks. In short, we create a fence around a set of products within which firms can compete freely. Outside of this fence, for the more exotic products, there is greater regulation. Individuals taking a door through the fence would know they are moving to a less safe suite of products.

A few points are worth noting about this two-part approach.

- The vast majority of the market is already inside the fence. For example, Freddie Mac reports that fixed rate mortgages made up 67% - 75% of applications in 2006.⁶ First choice products of course would include more than just fixed rate mortgages and not all fixed rates (because we do not know the LTV or DTI of these mortgages) would be first choice. Still this number gives us the sense that most products offered would likely fall into the first rate category. So such regulation would in fact help most lenders; it would insulate them from competition by low road products, which would now sit outside the fence facing higher scrutiny.
- It is not necessary to mandate the offer of first choice or vanilla products. Done correctly, the ring-fenced area will be made attractive enough that firms will—as

Also see “Behaviorally Informed Financial Services Regulation.” New America Foundation, 2008.

⁵ See <http://www.federalreserve.gov/newsevents/press/bcreg/20070531b.htm>.

⁶ See http://www.freddiemac.com/news/finance/refi-arm_archives.htm.

they do now—want to offer products there. The challenge here is to ensure sufficient safeguards for the non-first choice products. Otherwise high road firms wanting to offer good products will once again face unfair competition from bad products.

- There are several precedents for this type of two-part approach. Individuals wishing to trade options or other sophisticated products must initially complete more paperwork and are given greater warnings of their dangers. In July 2008, the Federal Reserve placed higher-priced mortgages (which include all loans in the subprime market but excludes nearly all prime market loans) under far greater scrutiny such as a greater requirement for income verification, an explicit affordability requirement, and higher-than-normal penalties for violation of these requirements. I understand that the authority for this regulation would permit the Federal Reserve, or the CFPB, to place other mortgages, such as option ARMs, in this category of mortgages that receive greater scrutiny and higher penalties.⁷
- For credit cards, Rep. Hensarling (R-Texas) has proposed a close cousin in the form of an amendment to the bill that eventually became the Credit Card Act in 2009. For potentially harmful features, as long as all of a lender's customers are offered a card without the feature, allow customers to opt-in to one with the feature. By ensuring the opt-in includes sufficient warnings, the CFPB could allow exactly this type of door in the fence between first choice and more exotic products. In this particular case, Congress' judgment was that the "first choice" approach would not work to protect consumers, and that a ban of these features was necessary. I believe, however, that it is important for the CFPB to have the first choice tool as an alternative to outright bans even if in some cases the ban is used.
- Private firms already realize the value of clarifying and simplifying choice. Charles Schwab for example has created a category of "Select Funds" which are pre-screened for loads, fees and other qualitative criteria.⁸ Of course, no firm can control the choice set offered by the entire market; however well structured one firm's choice set is, it sits and competes with other firms' offerings.

For such an approach to be successful there must be a transparent, predictable process by which products become first choice. First choice is not a one-size fits all solution. Since it aims to facilitate choice by customers, first choice products must include a suite of products. Who decides what is in this suite? On what basis? This is especially important as we look forward to the financial innovations that are surely on the horizon. A transparent, predictable will give lenders who create a good product comfort that they can reap rewards

⁷ See <http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm>.

⁸ "Schwab's Income Select List was developed and is managed by the Schwab Center for Financial Research (SCFR) experts and includes mutual funds that have met their rigorous criteria, including both quantitative and qualitative factors. All are no-load and no-transaction fee and are selected based on their ability to generate income in their respective asset classes. The list is designed to help you achieve income and growth." <http://www.schwab.wallst.com/retail/public/research/mutualfunds/oneSource.asp>.

from it. I believe such a process can be put in place. At the very least this ought to be one of the injunctions to the CFPB to develop and codify this process.

Conclusion

The financial crisis has laid bare the dangers of bad financial products and generated a strong and understandable impetus for consumer protection. I believe that the research on behavioral economics gives guidance on how best to express this urge. The challenge is to provide protection while promoting healthy market competition. The two-part approach in the proposed legislation accomplishes this by providing an attractive tool that is an alternative to bans and mandates.

On the one hand, the proposed CFPB would regulate strongly the most exotic products. On the other hand, vanilla or first choice products—the ones consumers really can choose well between—would be given far greater freedom. This promotes competition and helps high-road firms who operate in the part of the market that the typical consumer operates in. The result I feel will be a financial sector that benefits consumers by allowing them to choose better; that benefits firms by allowing good firms to not be undercut by bad firms offering bad products and that benefits sophisticated consumers by still letting them access more exotic products on the other side of the fence.