



Payment Innovations in the Wake of the Financial Crisis

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asking the right questions



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What is Behavioral Economics?

Traditional view

We're rational agents, well informed with stable preferences, controlled, self-interested, calculating

Behavioral perspective

Sometimes fallible judgment, malleable preferences, can make mistakes calculating risks, can be impulsive or myopic at times, driven by social desires and identities...Behavioral agents are not irrational or stupid.
They're just people.



Payments Through A Behavioral Lens

- **Traditional view:** Payments are the “plumbing” that *facilitate* consumers’ choices to purchase
- **Behavioral view:** Payment instruments also *influence* consumers’ choices
 - Make it easier to buy
 - Credit cards, in particular, enable instant gratification, but delay pain
 - Could anchor the consumer to something different like the total balance rather than the amount of cash in the wallet

Example: Prelec & Simester (2001)

- Auctioned tickets to sold-out Celtics game to MBA students
- Second price sealed bid auction
- Payment due later that day – some told cash was required, others told credit cards would be accepted
- ‘Credit card’ subjects bid twice as much



Why do consumers tolerate high penalty fees? Answer: Overconfidence about future self-control

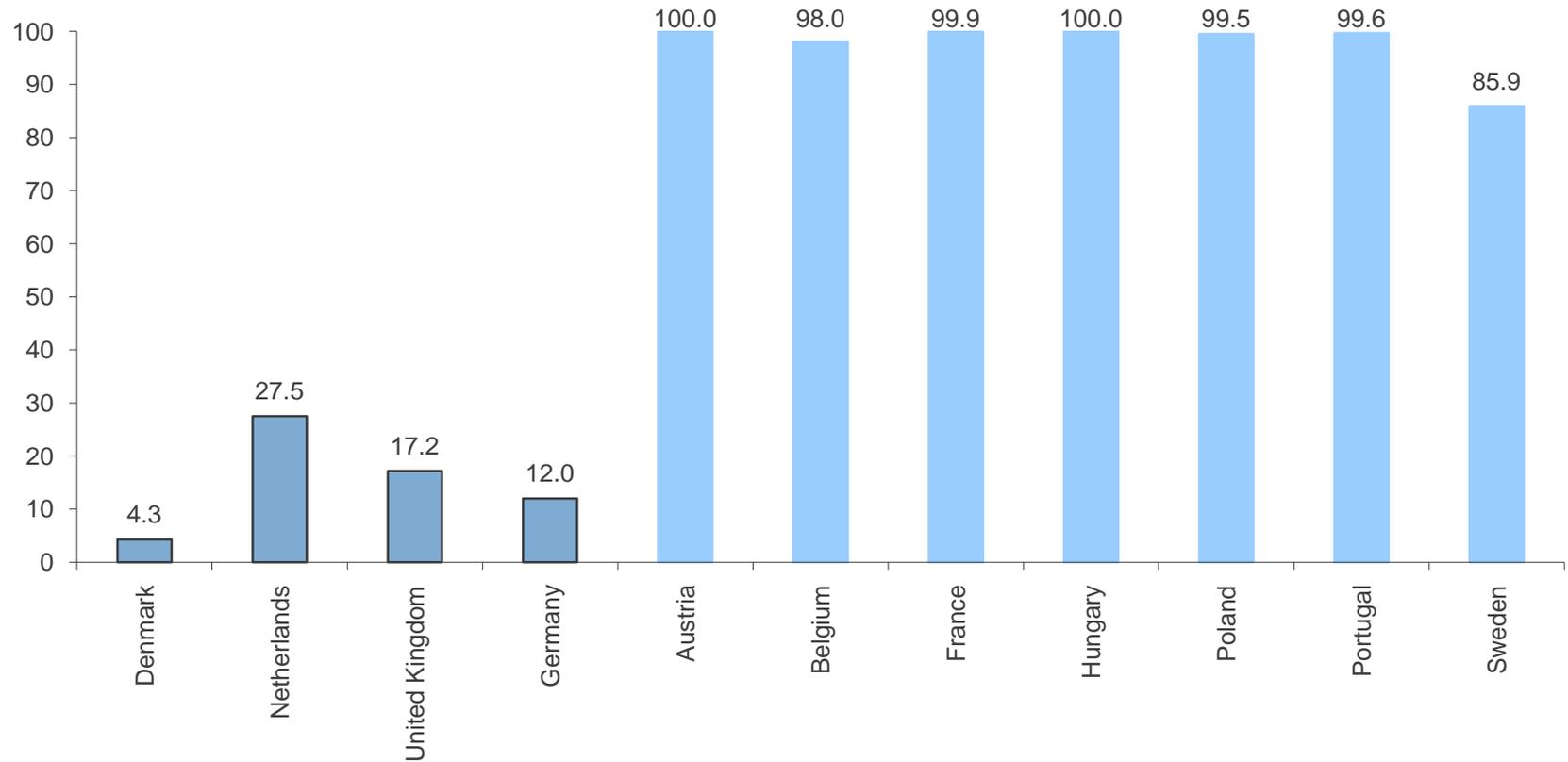
- Data from 3 US Health Clubs (DellaVigna and Malmendier, 2006)
- Choice between:
 - Monthly contract at \$80/month
 - Pay-per-use contract at \$10/visit
- Vast majority of sample choose monthly contract, but only attend 4.4 times per month on average
 - They end up paying \$17/visit
 - Survey data confirms that these people overestimate how many times they will go to the gym



The Power of Defaults – low minimum payment, overdraft fees

Effective organ donation consent rates, by country.

(Johnson & Goldstein, 2003)



Payments Regulation Through A Behavioral Lens

- Regulations largely rely on disclosure or on restricting product features
 - Disclosure assumes that people will use all available information to make well thought-through decisions, but we know this is not the case from behavioral research
 - Restrictions have many negative effects, e.g. choking innovation, reducing access to credit, taking away legitimate tools like penalty fees that deter unwanted behavior
- Barr, Mullainathan and Shafir (2008) propose a behavioral approach to regulation

	Definition	Examples
Rules	Changing the rules of the game.	<ul style="list-style-type: none">• Opt-in for overdrafts• “Opt-out” payment plan for credit cards: Set higher default payment, but allow consumer to choose the minimum
Scoring	Changing the pay-offs for providers.	<ul style="list-style-type: none">• Require all penalty fee revenue above reasonable processing cost to be donated to some public good

Payment Innovation Through a Behavioral Lens - products that can help consumers and be profitable, e.g.

- Turn saving into an impulse purchase: Savings Card
 - Sell J-hook savings cards of fixed denominations at retailers
 - Purchase transaction causes funds to be deposited into savings account



- Enable easier budgeting while capturing more of the consumer's wallet: Mental Accounting Credit Card
 - Issue a package of cards rather than a single credit card, but with same total credit limit
 - Each one is designated for a particular use, e.g. day-to-day, emergency, large purchases
 - Customer can set limits and re-payment plan

Is this really an opportunity?

- Designing a product that's good for the consumer and profitable seems hard
 - Can reduce balances, spending and penalty fees
 - Could have high transaction costs
- We believe other benefits compensate
 - Loyalty can be worth a lot, especially in a consolidated market
 - Credit risk can be lower
 - New sources of revenue, e.g. savings
 - People often willing to pay for a helpful service