Seeking Financial Stability

Remarks by
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Good afternoon, it is great to be here with all of you and to see so many familiar faces. Thank you to Katy Jacob and the Federal Reserve Bank of Chicago for inviting me to speak here today.

When President Obama came into office a little more than two years ago, our financial markets were frozen, our economy was shrinking, and we were facing the worst economic crisis our country has endured since Franklin Roosevelt came into office. Our nation was losing nearly 800,000 jobs a month. Small businesses were closing their doors. And home prices were in free fall. Although the economy is now showing signs of improvement, and many employers have begun to hire again, considerable challenges remain.

When I was in government, we were focused not only on repairing the economy but also on the urgent obligation to fix the failures in our financial system that helped trigger the economic crisis that has cost American families and small businesses so dearly.

The failures that lead to the 2008 crisis had many causes. Regulators did not protect consumers or investors—and households and firms took on risks they did not fully understand. Legal loopholes and regulatory gaps allowed large parts of the financial industry to operate without oversight, transparency, or restraint.

The passage of the Dodd-Frank Act[1] provides a strong foundation on which we must now carefully build a more stable and resilient financial system--a system that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial markets.

Meanwhile, for the 1 in 7 Americans who live in poverty, or the millions of Americans who live in fear of falling out of the middle class, these times have been particularly devastating. These families were the least prepared to handle the shock of the recession. They had little or no savings to fall back on; and stood one medical emergency, or one major unexpected car malfunction, away from a personal economic crisis. When the crisis hit in 2008, families found themselves overleveraged and underresourced. What these families are seeking is some measure of financial stability.

Going forward American families will need to try to save a larger share of income and to borrow more responsibly. Today, many Americans are rediscovering the importance of living within their means. They're building assets by saving more and paying down debt. And they're growing more careful about how they borrow and how they invest. These changes are necessary and healthy. And, ultimately, they will build economic security for American families and make our economy stronger and more resilient.

One of the critical ways we can help promote economic security is by making consumer financial markets work better for America families. We need to continue to learn more about the dynamics of these markets, including about individual psychology and behavior, and the role of financial firms as they react to individual capabilities and psychologies.

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Using a Behavioral Framework

The evidence on consumer fallibility and on how firms behave in light of this fallibility suggests a framework for understanding which types of mechanisms will work best in particular markets.[2] It is helpful to divide consumer financial markets into two buckets: those where firms are neutral towards or have incentives for overcoming consumer fallibility; and those where firms have incentives to exacerbate consumer biases.

For example, providers of bank accounts have incentives to help individuals overcome the behavioral barriers to savings. Lenders, on the other hand, may have incentives to exploit biases that lead consumers to over-borrow. And providers of all kinds have incentives to charge fees that are less salient for consumers or that take advantage of consumers' errors in predicting their own future product usage—such as late fees, over-the-limit fees, and overdraft fees. The implications for policymaking in each of these two cases are different.

It is also helpful to think about potential market interventions as falling into two different categories: changing the "rules" of the game and changing the "scoring." Changing the rules means changing what market participates must do or are allowed to do; while change the scoring means changing the incentives--cost or benefits—of market participants to choice one practice over another.

Interventions that change the rules and change the scoring can be useful in both types of market contexts, the scenarios where firm incentives are to overcome or to exploit consumer fallibility.

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[2] Michael S. Barr, Sendhil Mullainathan & Eldar Shafir, *The Case for Behaviorally Informed Regulation*, *in* NEW PERSPECTIVES ON REGULATION 27-63 (David Moss & John Cisternino eds., 2009).

However, the two scenarios may require different approaches. In the scenario where firms are neutral to or have incentives to overcome consumer biases, rule-changing may be highly effective on its own. The success in promoting retirement savings through the use of smart defaults is obviously a well-known example. In this case, employers were at worst indifferent to and at best inclined to increase employee participation in defined-contribution plans.

In cases where firms have incentives to exacerbate biases, changing the rules may not be enough. In these cases firms will have incentives to work around the rules and render them less effective. For example, firms may comply with the letter of disclosure laws, but act to undermine them by discouraging consumers from focusing on and understanding the their content. In such cases, it may be necessary to change the way the game is scored to make a real difference for consumers.

This behavioral framework has profound implications as we think about how best to promote financial access. Defaults in the defined-contribution plan world serve as a prominent example of how behaviorally-informed innovation can have a significant impact on the lives of everyday Americans. But there is a need for a lot more innovation that is informed by the interplay of consumer psychologies and firm incentives in market-specific contexts.

A Three-Legged Stool

We can help families seeking financial stability in three primary ways: first, enhancing individuals' core competencies in financial capability; second promoting access to innovative financial products and services that meet consumer needs; and third, establishing and enforcing strong protections for consumers. Basic financial literacy

is the necessary foundation for informed consumer decision-making. But to be effective, financial literacy must be combined with improved access to suitable financial products and strong consumer protections. And, importantly, efforts in all three areas must be driven by well-considered evidence on how consumers and firms behave in the real world.

One area where more innovation is sorely needed is in expanding access to financial services that meet the needs of low-and-moderate-income Americans. A growing body of research has revealed that the financial access gap in our country is sizeable. The FDIC has estimated that 9 million American households are unbanked and another 21 million are underbanked, meaning they have a checking or savings account but are not well-served by these accounts and rely on costly alternatives financial services, such as check-cashing and money orders, to meet their financial needs. [3]

One challenge—and opportunity—we face in expanding financial access for low-and-moderate-income Americans is harnessing low-cost electronic payment mechanisms, such as debit cards. The private sector has been innovating in this area and low- and moderate-income (LMI) households can benefit a great deal from further efforts in this regard. In research I conducted in the Detroit area, for example, there was strong interest among LMI households in a payment card. While cost was an important determinant of preference, so too were non-pecuniary factors; households were especially concerned with whether the card had strong federal consumer protections, and whether it had national branding.

As to the government's role, there may be ways that the government could help to accelerate changes in the payments system that benefit

[3] FDIC National Survey of the Unbanked and Underbanked 2009.

LMI households and the market as a whole. Defaults—changing the "rules"—may help in this context because the providers of savings and transaction accounts have incentives to alleviate consumer biases, for example, with respect to procrastination, to gather deposits. However, defaults maybe less effective on their own than they are in the retirement context. The reason is that the cost to serve individuals with small balances can discourage firms from serving low-and-moderate income populations.

In this context, a combination approach is needed. It may be necessary to change the "scoring" as well as the rules, such as by designing creative solutions that help firms serve these populations with sustainable product economics.

Treasury is taking an innovative approach to direct federal benefits payments that relates to the insights I've been discussing. Treasury is responsible for making ongoing payments to 70 million individuals for direct federal benefits, including Social Security, Supplemental Security Income, and Veterans, Railroad Retirement, and Office of Personnel Management benefits. Fifteen percent of these individuals still receive their benefits by paper check.

Individuals who have accounts can use Direct Deposit. Individuals who are unbanked, or who prefer not to use Direct Deposit, receive payments on the "Direct Express" card. Direct Express is a debit-card account platform offered by a bank according to requirements established by Treasury. There are more than 1.4 million federal benefits recipients who have opted into receiving benefits on Direct Express, which was launched in 2008. Customers report 95% satisfaction with the card's features.

Direct Express is an example of how government can help make serving low-and-moderate income customers more sustainable for providers. In this case the government is bundling many customers' accounts together, allowing for a more favorable scale of operations for the provider. And the states have key programs too.

Treasury is simultaneously undertaking other efforts to improve the electronic delivery of federal benefits payments. For example, Treasury established rules that better protect federal benefits payments from bank account garnishment. And Treasury enhanced requirements on the types of payment cards that are eligible to receive benefits payments, including prohibiting benefits from being deposited into accounts set up for payday loan-type arrangements.

This tax season Treasury piloted an initiative to improve tax administration by offering selected low-and-moderate income households an opportunity to receive their tax refund on a debit card. We'll be able to learn what works and what doesn't.

Electronic benefits payments are part of a broader set of efforts by Treasury to promote financial access. Another major element of these efforts is an initiative called "Bank on USA," funded for the first time in the FY 2011 budget. These funds will build on the local "Bank On" movement, made up of local coalitions dedicated to promoting access to mainstream financial products.

Consumer Protection

So we need to educate consumers. And we need to improve access. Now we also need consumer protection. In an environment of weak and ineffective regulations, the tendency of some consumer financial markets to end up in "races to the bottom"—as we saw in the

housing market—are not likely to be overcome solely by consumer education and access.

The CARD Act[4], which President Obama championed and signed into law in May 2009, is an example of regulation written for a market and product in which the provider has a strong incentive to usher consumers to suboptimal choices—to rack-up lots of late fees and to make only the minimum payment each month. Nearly 80 percent of American families have a credit card, and over 40 percent of families carry a balance on their cards. Before the Act, Americans were paying $15 billion, annually, in penalty fees.

The CARD Act was well crafted legislation that combined a requirement of common sense disclosures with protections from practices designed to make use of consumer fallibility for the benefit of the credit card issuer and the detriment of the consumer.

For example, the Act banned unfair rate increases, including rate increases on existing balances due to "universal default" clauses and severely restricted retroactive rate increases due to late payment. It banned unfair fee traps, including weekend due dates, or due dates that change each month, or payment deadlines in the middle of the day. And it ended the confusing and unfair practice of so called "double cycle" billing.

The CARD Act also used a de-biasing approach, by requiring *minimum balance warnings* that help to inform consumers of the consequences of their actions by displaying how long it would take to pay off an existing balance, if the consumer paid only the minimum payment each period; and the amount the consumer would need to pay each period to pay off the balance in 36 months.

[4] Credit Card Accountability, Responsibility, and Disclosure Act of 2009.

Credit card companies know that the impact of compound interest on credit balances is not necessarily intuitive to most consumers. The consumer may even, incorrectly, assume that the credit card issuer has a primary interest in the consumer paying down the balance sooner rather than later and therefore has set the minimum payment to an amount in line with that objective.

So imagine the shock that a consumer has when he or she learns that paying a minimum payment of $150 each month on a $7,000 credit card balance would take 22 years to pay off in full. Or the relief of learning—on that same page—that an extra $60 payment each month would reduce the time it took to pay off that balance from 22 years to 3 years and save more than $5,000 in interest payments along the way. That's meaningful disclosure. That's disclosure that empowers families to make choices that are right for them.

Now undoubtedly we'll learn from this process. Many consumers will be helped by the minimum payment disclosures, but some may end up paying off more slowly. These disclosures will, of course, have to be improved and changed over time. That's what we need: evidence-based openness to change.

So the CARD Act was important. And the Dodd-Frank Act contains key changes in the mortgage market. For example, the Act bans yield spread premia and steering; it requires brokers to assess the borrower's ability to pay; it makes reforms to escrow practices; and it requires key changes to make disclosures easier to understand.

And now with the creation of the Consumer Financial Protection Bureau we have a chance to not always play catch up. The Bureau has provided a historic opportunity to build a successfully

regulatory structure for consumer protection; one that is designed to promote financial inclusion, preserve consumer choice, and provide for more efficient and innovative markets for consumer financial products—markets that operate on the competitive basis of price and quality, rather than hidden fees.

Before Dodd-Frank, our system was largely incapable of supporting a successful regulatory structure for consumer protection. Fragmentation of rule writing, supervision, and enforcement made it impossible to create a comprehensive and well calibrated consumer regulatory regime. Jurisdiction and authority for consumer protection was spread over many federal regulators, which had higher priorities than protecting consumers. Banks could choose the least restrictive supervisor among several different banking agencies. And a large number of non-bank providers escaped any meaningful supervision completely.

The CFPB will provide, for the first time, a consumer agency with necessary mission focus, market-wide coverage, and consolidated authority. It will be an agency that focuses not simply on more regulation, but smarter, more coherent and more effective regulation. Regulation that is designed and implemented with an understanding—and respect—of classical models, but is not blind to the compelling insights into consumer decisions derived from behavioral economics. Regulation that seeks to balance a consumer's ability to find the most suitable financial products from among many seemingly indistinguishable choices, on the one hand, and a product provider's incentives to hide that most suitable choice, on the other hand.

I have to admit, that what I find most curious about the voices of opposition CFPB—an agency, I remind you, whose primary

principles are accountability, transparency, fairness and access—is that their logic rests on the premise that empowering consumers is somehow antithetical to free markets. They appear to be stuck in a debate that presumes that regulation and efficient and innovative markets are at odds. In fact, the opposite is true. Markets rely on good faith and on trust and fair dealing. Markets require transparency that reflects economic reality rather than distortions caused by misleading sales pitches and hidden traps. And the discipline of the market requires clear rules.

Conclusion

Thank you again for the opportunity to speak with you today. I know that many people think the payments system is a dry, technical area, but I know, and you know, that it can have profound implications for households and for our financial system as a whole. The work you are doing will help to build a stronger America. An America where working hard and playing by the rules means greater financial stability for our families. Where firms compete based on price and quality, not tricks and traps. Where old fashioned values of thrift are rewarded. Thank you very much.