Towards a democratization of finance: can BE help manage small and large financial risks?

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Take aways

Homer

Frequency: *could be better understood before firm conclusions for regulation (shopping models)*

Competition – transparency – role of the internet

Timing of disclosure – important interaction with frequency and competition: *the latter should ensure that people have effective choice (switching options) no matter how infrequent the moment of choice*

Add ons

How important are these effects in relation to overall financial risks facing the household?

Put otherwise: Where are the biggest gains to be made from increasing individuals‘ awareness of financial risk and how they can be managed? (financial education of the intermediaries, e.g. MCD requirements; what about local bank branches, what to expect from internet-based finance?)

How can we democratize financial innovation? *(a hands-off approach producing re-distribution from poor to rich with residual risk accumulating on the balance sheet of the government/society)*

„homer" sapiens vs. homo oeconomicus?

Homo oeconomicus = optimizing behaviour subject to constraints

➔ *Does not imply maximization of financial wealth*

➔ *What is optimized depends on arguments in the (ordinal) utility function*

In my view it is difficult to think of a more rational man than Homer Simpson

=> Mr. Burns seems to have relatively more difficulties to understand the relevant constraints to his optimization problem...

Assets		Liabilities	
Educational status	(12-18k)	Student loans	
Health status	(50-150k)	Net present value of private health spending	
Real estate assets	**(200k; 64.4%)**	Mortgages	(68.4k; 23.1%)
Other non-financial assets Financial assets	11.4k	Financial liabilities other than mortgages	(5k; 29.3%)
Financial and non-financial guarantees and entitlements (pension, healthcare and long-term care)		Tax and social security liabilities **Residual longevity risk**	
		Household net worth	

Explanations of values in parenthesis: the indicated range for educational status is a ballpark figure for per capita expenditure for tertiary education; health status: ballpark figure for median real capital stock per worker; real estate assets: EUR 200 000 is the conditional median value of real estate assets where 64.4 % of all households have real estate assets; other non-financial assets includes, for example, motor vehicles; financial assets: EUR 11 400 is the conditional median of financial assets in the form of any of the following: deposits (sight and saving accounts), mutual funds, bonds, shares, money owed to the household, value of voluntary pension plans and whole life insurance policies of household members and other financial assets items, including private non-self-employment businesses, assets in managed accounts and other types of financial assets; mortgages: EUR 68 400 is the conditional median value of outstanding mortgage debt, where 23.1 % of households have mortgage debt; financial liabilities other than mortgages: 29.3 % of all households have non-mortgage debt with a conditional median value of EUR 5 000 (student loans shown as a separate category here are included in this figure); Source: First wave of the Eurosystem's Household Finance and Consumption Survey, authors' calculations.

Behavioural finance & the balance sheet of HHs

Empirically proven BE effects, but how relevant?

➔ *Framing effects*

➔ *Difficulties around zero, around certain payoffs (Savage vs. von Neumann-Morgenstern)*

But more problematic in my view:

➔ *Accumulation of losses in the region of (heavy) losses: (ir)rational?*

➔ *Massive difficulties to deal with exponential growth (and interest) more generally*

Behavioural finance & the balance sheet of HHs

BE effects relevant for product design

➔ *Financial wealth (management); should we not allow activist managers? How much inefficiency should be tolerated?*

➔ *Private pensions: real issue due to boomerang effect on public fin.*

Financial literacy and risks, or underestimation of „discomfort"?

➔ *How would HHs change their behaviour if they had a better view of RoIs? Or if they could insure against risks?*

➔ *Cultural bias: we choose to ignore many risks not because they are small but because thinking about them is too costly (financial wealth is pretty safe in that respect)*

Housing Finance

central role of housing finance, increasing with income per capita

home acquisition remains biggest single financial undertaking for most private households in their lifetime, and (frequency!) …

… credit financed or not, owner occupied home tends to be the biggest asset (size of risks)

what is the best possible design for mortgages to ensure

choice and consumer protection

MCD: flexible and reliable markets; behavioural regulation of the entire mortage supply chain

A possible hierarchy of market structure, product design, and policies

1 housing with incomplete markets and poor mortgage design: loose monetary policy found to strengthen risk taking esp. in the non-prime segment

➔ 2 rental markets: competition for lending to non-prime borrowers, DE&AT even competition for lending to prime borrowers (HFCS)

3 housing finance with more intelligent mortgage design and good micro&macro prudential policies (leverage channel under control "frees up" interest rate channel)

4 housing with more complete markets (but remaining behavioural issues on the side of borrowers, hence continued need for strong consumer protection policies)