Cognitive Thimblerig:
Behavioral Economics and the CFPB
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Behavioral Economics

• Three fundamental insights
• Implications for b2c relationships
• Implications for regulation
First Fundamental Insight

• Human beings process information imperfectly.
• Many reasons:
  – Imperfect cognitive faculties
  – Cost of processing information (e.g., reading disclosure form takes time)
Second Fundamental Insight

• The manner in which information is presented affects how it is understood.
  – Format of information
  – Timing of information
  – Contents of information
  – Source of information
What’s the Length to Width Ratio?
What’s the Length to Width Ratio?
Third Fundamental Insight

• Human beings often make mistakes in predictable, systematic ways.
  – Estimation of likelihood of future events
    • Overestimation biases
    • Underestimation biases
  – Hyperbolic discounting
  – Anchoring effects
  – Bird in hand vs. Bird in bush
  – Bottle half-full vs. Bottle half-empty

• But not everyone suffers from same cognitive biases equally.
From Information to Behavior

• Informational asymmetry problems are not behavioral economics issues per se.
• But the costs of information gathering and processing are high.
• Therefore consumers often rely on “rules of thumb” (heuristics).
• And that’s where cognitive biases come into play.
Implications for B2C Dealings

• Businesses are aware that consumers don’t process information perfectly and that they make predictable mistakes.
• Profit-maximizing business will exploit this.
• Cognitive thimblerig
Cognitive Thimblerig

- Consumers don’t process information perfectly.
- Often make mistakes in predictable, systematic ways
- Profit-maximizing business will exploit this.
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• Thimblerig—hide the pea under the thimble, shift around, try to distract watcher.

• What if I know that you are more likely to pay attention to certain types of fees than others?
  – You do not value $1 of fee type X the same as $1 of fee type Y.
  – I’ll put as much of the cost as I can into whichever fee you value less.
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• Example 1: credit card annual fees
  – Low or no annual fee
  – High contingent fees (late fees, overlimit)
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• Example 2: credit card rewards
  – Very limited value
  – But consumers choose cards based on them
  – Recent Chicago Fed study—consumers will switch cards for $25 in rewards
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• Example 3: credit card minimum payments
  – Minimum payment requirements as anchoring
    • Only 3-5% make minimum payments.
    • But plurality will pay 2x minimum or 3x minimum.
  – Font use for minimum payment vs. balance
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• Example 4: mortgages
  – Emphasize teaser rate, not amortized rate
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• Example 5: subprime auto sales
  – Emphasize monthly payments, not total cost
    • “How much can you afford?”
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- Example 6: payday loan
  - Play down rollover risk and fees
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• Is there anything wrong with this?
  – No:
    • Information was all available for consumer. Not business’s fault if consumer misjudged.
  – Yes:
    • Consumer isn’t getting the deal he thought he was getting.
    • And business knew that consumer doesn’t understand the deal.
    • And business chose to design deal in way that made it less likely consumer would understand.
    • Consumer might not enter into deal if consumer properly understood risks, cost, etc.
Legal Hook?

• Good faith & fair dealing?
• Unconscionable?
• UDAP?
• UDAAP?
• Fraud?
Applications of Behavioral Economics to CFPB

- Disclosure
- UDAAP
- ADR
Disclosure

• CFPB charged with disclosure overhaul and consumer testing
  – Format of disclosures (font, layout)
  – Contents of disclosures (what’s included, what’s not)
  – Timing of disclosures, contents, timing)
  – Cost of processing information (e.g., reading disclosure form takes time)
UDAAP

• Unfair, Deceptive, and *Abusive* Acts and Practices. § 1031 of Dodd-Frank.

• Abusive?
  – “materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service”
  – “takes unreasonable advantage of a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service.”
Alternative Dispute Resolution

• § 1028 of Dodd-Frank permits CFPB to restrict ADR, including Binding Mandatory Arbitration.

• Consider possible behavioral argument for restriction:
  – Consumer is one-shot player
    • Consumer thinks dispute is highly unlikely (otherwise wouldn’t deal).
    • Consumer doesn’t know exact likelihood of dispute
  – Financial institution is repeat player
    • Financial institution knows that it has disputes in 5% of cases.
  – Financial institution therefore values BMA properly; consumer does not.
  – Informational asymmetry from consumer underestimation of likelihood of dispute results in consumers getting bad deal.
  – Implication—limit BMA?