Risk Management for Households: The Democratization of Finance

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The Questions

- What are the barriers to household risksharing?
- Is the problem a lack of suitable financial instruments, or something deeper?
- How is the retail financial system evolving?

Barriers to Risksharing

- Adverse selection
- Moral hazard
- Credit problems of insurers
- Credit problems of households
- Consumer confusion
- Shrouded equilibrium
- Counterproductive regulation

Adverse Selection

- Examples:
  - Annuities
  - Health insurance
- Some familiar solutions:
  - Product bundling
  - Universal or group insurance

Moral Hazard

- Examples:
  - Sharing house price risks
  - Sharing income risks
- A familiar solution: insure only group risk, not idiosyncratic risk

Credit Problems of Insurers

- Example: annuities (DB pensions) insure longevity risk which is resolved over many years
- Can households trust that annuity (DB pension) payments will be made?
- Partial solutions:
  - Insurance/pension regulation and government guarantee
  - Reinsurance contracts and longevity bonds
  - Pool idiosyncratic longevity risk (tontine)
  - Trade aggregate risk with mark-to-market payments (futures contracts)

Credit Problems of Households

- The main asset for households is human capital which cannot be collateralized
- Thus households face borrowing constraints
- Example: a young household takes a long position in house price futures
- What happens if house prices fall?
  - Forward contract exposes the counterparty to household default
  - Futures contract leads to margin calls and the household's position is closed out
  - Macro security requires investment of liquid assets

Consumer Confusion

- Examples:
  - Inflation illusion leads to disinterest in inflation-indexed contracts
  - Many households fail to prepay FRMs when it appears advantageous to do so
  - Many households seem not to understand the terms of their ARMs
- Consumer confusion slows down household financial innovation because it is expensive to educate households and there is limited patent protection in retail finance

Shrouded Equilibrium

- Models of Ellison and Gabaix-Laibson
- Suppose naïve consumers are expensive to reach
- Sophisticated consumers benefit from cross-subsidy in existing products
- New financial products that eliminate the cross-subsidy cannot gain a foothold
- Examples:
  - Refinanceable FRMs in US
  - Refinanceable ARMs with teaser rates in UK

Counterproductive Regulation

- Examples:
  - Laws against negative mortgage amortization framed in nominal terms
  - Disclosure rules that require mortgage costs to be calculated assuming a constant term structure (rather than future spot rates equal to current forward rates)

The Big Picture

- Improved credit availability, better consumption smoothing
- But households must increasingly manage important risks
  - Longevity risk (DB to DC pensions)
  - Income risk (erosion of long-term job security)
- Household behavior itself creates some risks in the financial system
  - Prepayment risk in MBS
  - Inflation illusion and house prices