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