Banco De Mexico-CEMLA
Joint Seminar on Financial Inclusion
& Modernization in Latin America
Mexico City
April 24, 2008

Michael S. Barr
University of Michigan Law School
msbarr@umich.edu

Financial Access: Key Themes

- Financial access is not an on/off switch, but a path to meaningful inclusion.
- Financial access can increase growth & incomes of poor & reduce income inequality, but financial markets do not necessarily produce such outcomes on their own and the mechanisms for improving outcomes are not well specified.
- Financial access can be fostered by range of institutions using different designs to reach different market segments
- Government policy can help foster or hinder access
  - Paradigm shift away from direct lending & heavy subsidies towards better enabling environment & targeted programs.

Defining the Problem?

- Legal Infrastructure
  - Creditor rights & bankruptcy
  - Property rights
  - System of Justice
- Financial Infrastructure
  - Prudential supervision & competition
  - Financial depth & lack of crony capitalism
- Incomplete markets (scale, liquidity)
- Information asymmetries & externalities
- Collective action
- Network externalities
- Social externalities

Across which dimensions of access?

- Transactions
- Credit
- Saving
- Insurance

Tradeoffs Among Regulatory Regimes

- Legal & Financial Infrastructure
  - Prudential supervision, competition, etc.
  - Creditor rights, property, bankruptcy, etc.
- Access-related laws
  - Negative Prohibition
  - Disclosure
  - Affirmative Obligation
  - Product Regulation
  - Subsidy
  - Voluntary Regimes
  - Default Rules

Financial, Legal & Civic Infrastructure

- Institutions matter, not just laws
- What is the capacity of governmental regulatory institutions? Courts? Enforcement agencies? Non-governmental institutions? Media? Consumer & community organizations?
- Key legal/institutional areas
  - Prudential supervision
  - Capital requirements
  - Competition
  - Creditor rights
  - Property rights
  - Bankruptcy
  - Contract law

Negative Prohibition

- Anti-discrimination laws
  - Animus
  - Statistic discrimination
- Helps to reduce non-economic barriers to provision of financial services where rooted in stereotypes or bias.
- Problems: difficult to get at hierarchical, socio-economic problems; focused on racial, ethnic, or gender discrimination.

Disclosure

- Consumer
  - Negotiate to more efficient market
  - Problems
    - Behavioral economics literature
    - Complicated transactions & rules
- Market
  - Enforce other laws
  - Communicate social norms
  - Rely on market, media, consumer groups
  - Problems: effectiveness depends on other laws, norms, and groups

Affirmative Obligation

- Basic banking accounts
- Measures of lending activity
- Increases incentives, monitoring, and enforcement in improved access.
- Problems: may stifle market innovation; may increase regulatory burden or bureaucratic power; may lead to directed lending/credit allocation; inefficiency

Product Regulation

- Usury Laws
- Anti "Predatory Lending" Laws
- Enhance disclosure by limiting terms
- Regulate "unreasonable" terms & practices
- Problems:
  - may diminish access
  - may harm product competition & innovation
  - may be easily evaded
  - compliance may increase consumer confusion

Subsidy

- Theory
  - Make marginal social benefit equal marginal private benefit
- Types
  - Programmatic
    - E.g., U.S. Federal Housing Administration (risk-sharing)
    - CDFI Fund, Microfinance Apex Fund (grant-making)
  - Tax
    - Low-income housing tax credit, UK children's accounts
  - Sponsorship
    - E.g., U.S. Fannie Mae
    - Electronic payments systems, FRB, Banco de Mexico
  - Problems: targeting, windfall, incentives (adverse selection/moral hazard), taxpayer liability, level playing field for competition

Voluntary Regimes

- Industry organized or legislatively mandated
- Pure “voluntarism” not enough.
- Requires 5 elements:
  - Transparency
  - Goals
  - Incentives
  - Monitoring
  - Enforcement

Default Rules, Framing & Institutions

- Theory: Change behavior through institutional, contextual structures, cues.
- Examples:
  - Automatic retirement contributions (opt-out plans)
  - Direct deposit with savings plan
  - Bank account when apply for government benefits or file for tax refunds
  - Tax credits for savings behavior (cue + incentive)
- Problems:
  - May be too weak in particular market contexts
  - May need public subsidy to be meaningful for poor

The firm & the individual

Market neutral/wants to overcome consumer fallibility	Market exploit consumer fallibility
Consumers misunderstand compounding in *savings* → Banks would like to *reduce* this so as to increase savings base	Consumers misunderstand compounding in *borrowing* → Banks would like to *exploit* this to increase borrowing
Consumers procrastinate in signing up for EITC → Tax filing companies would like to *reduce* this so as to increase number of customers	Consumers procrastinate in returning rebates → Retailers would like to *exploit* this so as to increase revenues

Changing the Game

RULES	Set the defaults in 401(k) savings Organ Donation
SCORING	401(k) top heavy requirements for tax

Behaviorally informed regulation

	Market neutral/wants to overcome consumer fallibility	Market exploit consumer fallibility
RULES	Public education on saving Direct deposit/auto-save Licensing (if reputation cannot be proved)	Sticky defaults (opt-out mortgage product) Information debiasing on debt (where incentives not well aligned)
SCORING	Tax incentives for savings vehicles for the poor	Ex post liability standard for truth in lending Broker fiduciary duty and/or changing compensation (YSP)

Conclusion

- Tradeoffs Among Regulatory Regimes
- Different policies for different problems in different countries at different stages of legal and financial development.
- Areas for further research.