Federal Reserve Forum on Consumer Research & Testing: Tools for Evidence-based Policymaking in Financial Services
Panel Three: Exploring key consumer issues

Elizabeth Costle:
I am with AARP and so I guess I'm sort of focusing on the elderly but that's 50 plus and I don't think a lot of people who are 50 think of themselves as elderly. But it is the older cohort and those who may at least begin to be thinking like about retirement.  I must admit, when I got out of college, I couldn't imagine myself as I am now.  I think that's a big stretch, although I think it's very interesting to think of oneself as an older person being the other or the same person.

But I think part of what I wanna look at is how we make decisions over a lifetime that will give us a more or less secure retirement income when we get to that point of view--that point. Now, let me see.  Alright, next one, no, I don't wanna do that.  Oops!  How do I get out of this?  I better look at this.  Oh, I see.  Okay, this maybe--this just--this just says what the AARP Public Policy Institute is about.  I don't think it's going to take time there.  I think as we look at retirement income, Social Security was the foundation of retirement income, but it was certainly never expected to be the sole source of income, although it is now for many people.  We also have seen--we've been talking about consumer decision making in one way or another. Consumers didn't used to have to make a lot of decisions.  We look at the decline of the traditional defined benefit plan which provided a lifetime income, a fixed benefit, and it was automatic.  You didn't have--in most cases you were just part of the pension plan where you worked provided you had an employer that provided one.  And this just shows beginning in the 1990, the decline as a percentage of the work force of the defined benefit plans and the increase in the defined contribution plans. But of course, as we can see there are many working people who don't have either. Oops!  Come on.

We also had sort of another retirement income, our home savings account, not that we necessarily thought of it that way.  People had their mortgage more or less paid off by retirement. It could be annuitized, to say, a reverse mortgage or it could be sold to support retirement needs, or just be a rent-free place to live.  In many cases, that's no longer the case.  Many mortgages are not typically repaid by retirement.  The home has been used as an ATM for all kinds of things. And in some cases now it's a liability and not an asset.  So that as a foundation of retirement security is much less available today.

So basically, we have do-it-yourself retirement.  I don't think I skipped a thing.  Just to make sure of that--but anyway.  So it begins with the youth in one sense.  Where do you bank or borrow? This goes to the underserved, the unbanked which I think is also a concern of AARP's but I'm not gonna go into it in depth this time.  How you use your credit cards.  College expenses, this is both for yourself and your children.  I mean some people amortize their college expenses over a 30-year period 'cause that's all they can afford and then for their children, so they make those decisions.  Housing expenses, how much are you gonna spend on your housing, on your mortgage? You have to make a decision to save in a 401k or perhaps outside of the employment context. You have to make--and when you save something, you have to make investment choices while you're working. How are you gonna get what you saved to grow? And then spending and investing once you're retired. So suddenly, when we talk about financial literacy, we talk about choice architecture, this kind of thing, it is really important because in all these cases, people are really making choices. And I'm gonna talk a little bit about maybe there are some ways that we can nudge them into what I guess I would say are more prudent choices and through regulation, and in other ways.

We've had financial products. I think we all know that there have been a real obstacle. We've had unpredictable and unsuitable mortgage products, hidden fee credit cards, bank overdraft programs, the alternative of financial services industry with very short repayment periods and very high multiple rollovers. We have very complex investment annuities. These are things that make it very hard for people to make prudent decisions. And as we look at this and decide on what subjects we're gonna research, I think a lot of it, particularly, on disclosure has been--well, let's look at what's effective disclosure for the product and have a financially literate consumer. As if, you know, that's--that part of the triangle is all you're worrying about. As I think we brought up today, not only getting a financially literate consumer but a consumer that can set long term goals. How is this gonna affect me in the future? I think in terms of--I'll now use this great word which I now like, choice architecture, how do we get a suitable product or at least a product that's suitable for most people? That doesn't mean you couldn't possibly go outside of it so that it's easier for a consumer to understand the choices they're making and perhaps encourages them to make a more prudent choice, which eventually also supports the overall financial system in the economy because I think some of the unsuitable choices, the victimization of the people, ended up being the sources of instability in our economy. And no hidden traps.

But we also have – in many cases, not all cases – a third person in there, and this is either your investment advisor or the sales person. And no matter what we do about literacy and disclosure, we have to wonder how this person is going to be part of the equation. A sales person, they need to have expertise through licensing. They should be acting in the best interest of the customer, and they should disclose any conflicts because they have relationship often with the product producer. So as we look at these things, it's not--and I'm not disparaging all the work that everybody's doing on disclosure 'cause I think it's terribly important, but as we look at research, I think we have to look at this sort of triangle and recognize that, you know, you can have the best disclosure in the world and even the financially literate consumer, if you have a really good personable sales person who just wants to make a sale, it's a little bit like, and I know there is some FDA guy here, like the Lunesta moth while – going across while they're talking about all the side effects of the drug. Or Sally Field, you know, patting her dog, you know, while all of the side effects are described. You know, it's--how do you deal with that? And part of it may be through regulation of that particular person and what they can do, but that's a human being too.

So as we look--and I--you know, I am not a person that designs these studies and these things which I think are really great and will help to inform our debate, but hopefully they'll look at this fairly complicated product, and also look at various policy and regulatory responses which I think has been done with the Dodd-Frank bill. But we will see as it is implemented.

And I thought I would look--just look at mortgage products briefly 'cause I'm not gonna have a chance to go into all the typesof products. And we know how bad they were on lifetime income so I won't spend long on this, but we did do a study at AARP and it showed that borrowers 50 plus made up 28 percent of all foreclosures in 2007. We haven't had the money to update that, but it is a significant problem for people over 50 as it is for people under 50.

With mortgage products--I mean they really tried to set it up so there would be no hidden traps or fewer hidden traps maybe I should say. It has specific limitations on certain provisions -- balloon payments, negative amortization, prepayment penalties. So they basically said you can't do this or if you do this, there are other hoops you have to go through. They also have the skin in the game securitization which basically says that if you sell, say, a mortgage into--as a security or securitize it, you have to keep five percent of the risk. But there is an exception to that, which is a qualified residential mortgage. My feeling, and maybe I'm wrong, is that the definition of the qualified residential mortgage will act as a mortgage template. I know we're not supposed to say plain vanilla, but maybe we'll have some kind of template of plain vanilla mortgages which really will make it easier, will make fewer choices for the consumer and the consumer can, you know, have the choices and it will be--make it easier for the disclosure and for the consumer to make the decisions. And hopefully, we will nudge consumers a little bit in terms of being prudent by requiring documentation of ability to repay and maybe even return to debt-to-income ratios. I'm not predicting that, but they seemed sensible to me when I was a lot younger. And future GSE reforms. So the mortgage products--I think there will be changes, not that there won't be, you know, unusual ones, but they'll be sort of the outliers in the market.

The mortgage sales persons -- there is increased regulation of them, licensure, state, and federal. And there's a prohibition on these wonderful things we discussed earlier -- these yield spread premiums. And they're – basically you have to offer a fair loan that the borrower understands and is reasonably likely to be able to repay. And I'm sure there are gonna be regulations around that, but that relationship is so important in most transactions that I think, you know, in all probability, disclosure will not be enough. I think there will have to be regulations.

And also the consumer decisions, the Consumer Financial Protection Board, a sort of uniform fact box, which I think is Jeanne's term, maybe something like total annual loan cost. I'm not sure exactly how you wanna do it so that people really understand the cost of these mortgages. I think there's a challenge for financial education because of the consumer's understanding. They lack knowledge, but also, I found consumers lack confidence. Often they have this nagging question, they think, “People will think I'm stupid if I ask it” or “it's really that I don't know what I'm talking about so, therefore, I better not ask the question which occurs to me.” So I think in terms of financial education, one is to empower the consumer to ask questions, any question that they think is relevant to them and, of course--what are the consumer goals? How is this mortgage decision gonna affect their lifetime income?

With credit cards again, there's a lot--it's the same. I don't think it's gonna keep people from overusing credit cards. In that case, it's really the consumer and the product. You don't have somebody in the middle such as an advisor or a sales person. You really have the consumer and the product. I think the CARD Act has made a lot of steps forward, but in effect, I think financial education is gonna be very powerful and maybe the most powerful tool that we'll have to try and educate the consumers so they don't get this--get themselves in the cycle of debt. I heard that seventy percent have maxed out their credit cards. I mean that's still pretty scary, and hopefully, as more people get jobs, we can begin to get back to some kind of sanity.

In the do-it-yourself retirement, now the individual must decide to save and how much. They have to--not only do they have to overcome with "I wanna buy this now or I need to save," they have to overcome inertia and procrastination. They're much more likely to save at work through payroll deduction than on their own. So you see that there are lots of people that don't have easy access. They'd have to make the effort to go in and open an IRA, and unfortunately, most of them don't.

They have to make investment choices. Most people need some kind of advice to frame these choices. Lawyers can provide written materials and offer expert advice. They've also found--again, this is how you can frame decisions -- but automatic enrollment boosts the rate of planned participation substantially in 401ks. In other words, a worker is automatically opted in unless they decide to opt out. And they found over time, at least in the studies, that those who are automatically enrolled are no more likely to disenroll than those who actually signed up for it, and also that this automatic enrollment boosts the participation of the people who are least likely to participate.

There is an Auto IRA proposal which would expand saving to more businesses and their employees by setting up a system requiring businesses to offer an Auto IRA and a relatively cheap way to do it. It hasn't gotten too far in the Congress, but given how close to 60 percent of people don't work in businesses that offer any kind of pension plan, that would be quite helpful.

Then as we go into the investment decisions that you have to make, and you have the same triangle to worry about, and particularly often, the investment adviser who may not be a sales person or may if they're with a brokerage, is very important in helping the consumer to one, make a decision at all, and two, to make a decision that may comport with their long term goals.

Employers provide a range of choices and information. They provide a default investment. Now, it's often a target date fund based on the person's age, but individuals should review their investment choices regularly. And they often need personalized investment advisers to make choices for them. So one of the things is how do people choose an adviser? That may be something for a consumer research. And the duty and expertise of an adviser, the SEC is gonna be looking at expanding the concept of a fiduciary duty to people that were--to brokers as opposed to just investment advisers. That's a regulatory response, but I think there's also ways to look at how should an individual choose an adviser.

At retirement, you're choosing two things. You're choosing how to keep investing because most likely, you're gonna live for a while longer and that's--you have a bewildering choice of other options and you have a need a trusted expert advice. Again, defined benefit plans would just pay you a fixed stream of income. In other words, it's automatically annuitized.

Defined contribution plans usually pay out a lump sum at the point of retirement and rarely a choice at that moment of an annuity or even to annuitize a portion of the amount due which the employer sets up for you. I think there have been issues about fiduciary duty, you know, what happens if the insurance company goes belly up? And other things that employers have not been doing that, they would be in a better position to maybe make good choices for an employee, but they no longer--in most cases, they no longer offer that. So suddenly, you get to retirement and you're offered this big pot of money and what do you do with it? Annuitize it or not? Pay outs can be structured to last a lifetime or lifetimes, which is great as a protection for running out of money. It disciplines spending, but it's not for everyone. You need a certain amount of liquidity. You need money for emergencies. Maybe you have enough Social Security and defined benefit plans from another job. Or maybe you wanna really try and leave as much money as you can for your heirs or to whoever you wanna leave it to.

Other issues as we look at do-it-yourself retirement obviously involve diminished capacity. People--more and more people as they get older--you'll have people--they may not be incompetent, but they begin to show diminished capacity whether from Alzheimer's or other aspects. And of course, fraud which is a particular concern, I think, for seniors since they seem to be most often the targets and seem to be more susceptible to it.

So I've tried very briefly to outline many issues for research and I think some of this has already been going on. I guess this shows something of a bias that I don't think that disclosure and financial literacy are gonna go all the way there as important as they are. I think we need to frame the choices, what products are routinely available in the market so that we will enable consumers to make better decisions in their own best interest. Anyway, thank you.