Behavioral Economics Tutorial 11

Behavior of Bankers

Questions to Consider

- What methods do you predict bankers will use in evaluating loan application and deciding whether or not to approve them?
- How do banks price their products (e.g. interest charges) and decide to change their prices?
- What does behavioral economics imply about the design of remuneration systems for bankers if policymakers wish to reduce the possibility of financial instability and reduce inequality?

Loan Evaluation Methods

- The banks face uncertainty and may not have expertise to understand complex projects that loans are being requested to finance, or (with sovereign debt) political complexity
- Simple checklist proxies for capacity to service debt: acceptable ratios of debt to income – and for scale of default risk (size of deposit being offered, or types of security)
- Proxies for likelihood of actually using capacity to service debt – track record with previous debts (so it pays to have a record of paying back loans if you want to borrow), stability of career, residential standing
- So, unusual proposals that don't fit the lending norms will have a hard time winning funds if lending systems involve routines being run by computers or inexperienced loan officers, rather than benefiting from complex pattern recognition skills of experienced bankers who can 'intuitively' make judgments
- Significance of heuristics in face-to-face dealings with clients (inferences from signs of nervousness, etc.)

Pricing by Banks (1)

- There are often significant switching costs for customers (loan set-up fees, penalties for premature repayment or withdrawal of term deposits, cancellation and set-up hassles for direct debits – consider relevance of hyperbolic discounting), so this might seem to imply banks have scope for using MC=MR ‘charging what the traffic will bear’ approaches to setting interest rates, etc.: letting one’s interest rates get a bit out of line with rivals won’t have spectacular immediate effects on market share but could have significant impacts on profits
- Greedy pricing that does increase profits will provide a bigger reserve cushion, enabling the bank to take bigger risks with loans
- But if customers do switch to rivals, the latter may keep them for many years: this is potentially a case where ‘goodwill’ considerations will deter short-term pursuit of profits and lead banks to follow a mark-up approach to pricing, not departing from their industry’s norms – cf. Marshall, PWS Andrews
- If the latter happens, competition will then focus more on the quality of service (e.g. relationship management) and provision of innovative products – though this is a sector in which innovations may be very readily copied by rivals.

Pricing by Banks (2)

- Do differences in banks' profit margins and prices imply that the Marshall/Andrews view is wrong, with competitive pressure being insufficient to force banks to match each other?
- Not necessarily: banks may differ in the kinds of risks they are taking, and are multi-product suppliers; we would only expect competition to equalize profit margins where banks are taking on the same sets of risks and have similar operating costs
- Although switching may be costly for customers, banks need to win customers in the first place, and potential customers may be making market-assisted choices (e.g., using mortgage brokers)
- Don't forget the role of potential competition in the Andrews analysis: do banks have to worry about this, given that the business is one with goodwill challenges on both lending and deposit-taking, and trust is a key issue
- Entry by established foreign banks (e.g. HSBC, ING) shouldn't happen on a large scale if banks aren't being too greedy with their profit margins. The big banks also have to worry about rising local banks that may not have economies of scale but may be better at competing on service.

Changing Banks’ Prices

- Normal cost theory of price (Andrews) predicts prices will get changed when firms have had a change in their ‘normal’ costs, not when demand for their product changes; otherwise they will adjust quantities (credit-rationing would be the equivalent of having waiting lists if there are supply constraints)
- Reserve Bank’s discount rate is a key reference cost for banks, so should be a key driver of banks’ interest charges
- Overseas rates matter too, as banks have to ensure their charges don’t get out of line with what is available offshore (or risk losing deposits or being flooded with more deposits than they can service from lending)
- These key cost reference points will affect the big banks at the same time, so we would expect similar responses at the same time or, if there is uncertainty about the duration of the change, some kind of price-leadership convention to be followed (e.g. Bank X normally acts first and the others follow) to avoid coordination problems such as unintended price wars.

Bankers’ Remuneration Packages

- Current situation is morally questionable if bonus recipients are not especially outstanding at what they do (many bright, numerate graduates could be trained to do it) and are not penalized for expensive mistakes: perhaps bankers need to take morality tests!)
- Publishing a league table of bankers’ remuneration isn’t a good idea: status matters and attempts to restore status may result in reckless behaviour
- Since loans can take a long time to be repaid successfully, linking bonuses to long-term performance of banks may be wise and limit ‘present bias’
- Case for rules that address inequality by limiting top-level pay to a multiple of low-level pay (but beware: lowly jobs might get outsourced or turned into private contractor arrangements)
- Are bonuses/commissions really needed to ensure people give their best performances: self-identity (pride in how one does one’s job) versus satisficing – but the latter depends on the aspirations of the employee, so it is these that the remuneration system might better focus on – are bank employees looking for rewards in terms of, say, more leisure or early retirement to escape work pressure/engage in self-actualization, promotion to positions with more power/control, rather than huge sums of money?