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The Age of Reason: Financial Decisions over the Life Cycle and Implications for Regulation

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Abstract

Many consumers make poor financial choices, and older adults are particularly vulnerable to such errors. About half of the population between ages 80 and 89 have a medical diagnosis of substantial cognitive impairment. We study life-cycle patterns in financial mistakes using a proprietary database with information on 10 types of credit transactions. Financial mistakes include suboptimal use of credit card balance transfer offers and excess interest rate and fee payments. In a cross section of prime borrowers, middle-aged adults made fewer financial mistakes than either younger or older adults. We conclude that financial mistakes follow a U-shaped pattern, with the cost-minimizing performance occurring around age 53. We analyze nine regulatory strategies that may help individuals avoid financial mistakes. We discuss laissez-faire, disclosure, nudges, financial "driver's licenses," advance directives, fiduciaries, asset safe harbors, and ex post and ex ante regulatory oversight. Finally, we pose seven questions for future research on cognitive limitations and associated policy responses.

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The Age of Reason: Financial Decisions over the Life Cycle and Implications for Regulation

ABSTRACT Many consumers make poor financial choices, and older adults are particularly vulnerable to such errors. About half of the population between ages 80 and 89 have a medical diagnosis of substantial cognitive impairment. We study life-cycle patterns in financial mistakes using a proprietary database with information on 10 types of credit transactions. Financial mistakes include suboptimal use of credit card balance transfer offers and excess interest rate and fee payments. In a cross section of prime borrowers, middle-aged adults made fewer financial mistakes than either younger or older adults. We conclude that financial mistakes follow a U-shaped pattern, with the cost-minimizing performance occurring around age 53. We analyze nine regulatory strategies that may help individuals avoid financial mistakes. We discuss laissez-faire, disclosure, nudges, financial "driver's licenses," advance directives, fiduciaries, asset safe harbors, and ex post and ex ante regulatory oversight. Finally, we pose seven questions for future research on cognitive limitations and associated policy responses.

Most households in the United States have accumulated a substantial pool of wealth by the time they retire. Among households with a head aged 65–74, median net worth—including net home equity but excluding public and private defined-benefit claims—was $239,400 in 2007, according to the 2007 Survey of Consumer Finances (SCF).[1] Moreover, household

1. For this group of households, mean net worth, again excluding defined-benefit accounts, was $1,015,700 in 2007. However, the mean is dominated by the right tail of the distribution, and saving for these households is motivated by many considerations other than retirement (particularly the desire to make bequests and the need for capital in ongoing privately held businesses).

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