

Regulatory Techniques in
Consumer Protection
Lecture 4:
Pro-Consumer Default Rules

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Regulatory Techniques in Consumer Protection

- Disclosure
- Mandated Protections & Mandated Access
- “Exit” Regulation
- Default Rules

Examples for Default Rules

1. Privacy Protection: what personal data of consumers can firms collect?
 - Default Rule #1: **ALL DATA** may be collected
 - But consumers can **OPT OUT**
 - Default Rule #2: **NO DATA** may be collected
 - But consumers can **OPT IN**

Examples for Default Rules

2. Overdraft Protection: can consumer overdraw checking accounts (and pay large fees)?
 - Default Rule #1: **OVERDRAFT AND FEES ALLOWED**
 - But consumers can **OPT OUT**
 - Default Rule #2: **NO OVERDRAFT AND NO FEES**
 - But consumers can **OPT IN**

Default versus Mandatory Rules

Why use default rules instead of mandatory rules?

- Freedom of contract
- Protect consumers without excessive paternalism
- Efficient tailoring
- Easier to enact (less opposition)

The Ubiquity of Default Rules

Default rules are a common regulatory technique

- Remedies
- Warranties
- Risk allocations
- Duration of contract
- Choice of law and forum
- Intellectual property rights in licenses
- Privacy rights
- Shareholder rights
- Inheritance rules

How should default rules be designed?

Theories of optimal default rules:

1. Mimic the joint will of the parties

- Is there a common will? What is it
- Terms that maximize the total surplus → the most efficient terms
 - Parties can divide the surplus through price adjustment
 - Example: warranty by seller, unless the consumer is the LEAST COST AVOIDER
- If parties are heterogeneous: mimic will of majority
 - Or: use “tailored” default
 - Strahilevitz: Use BIG DATA to tailor the default

Mimic the joint will of the parties (cont.)

The Value of a majoritarian “mimicking” default rule:

- Save transactions costs, drafting costs
- “pre-clicked” option
- Example: Wills
 - Costly to write
 - But most people have similar preferences
 - A minority have different preferences → opt out

How should default rules be designed?

2. “Penalty” default rules: force the parties to reveal information

- Set a default rule unfavorable to the informed party
- By opting out, information is revealed to other party
- Example: limited compensation for breach
 - Shipping contract
 - Customer can purchase added insurance
 - Self-selection is efficient
 - Private information is being “revealed”
- Example: interpret contract against drafter
 - Insurance contracts
 - Force insurance companies to write clearer language

Pro-Consumer Default Rules

Should default rules favor consumers?

Rationale:

- Favor the consumers
- But allow freedom to opt out
- The process of opt out would inform and alert consumers to the right being taken from them
 - A type of penalty default rule arrangement
- Pro-consumer default rules shape expectations

Pro-Consumer Default Rules

Pro-consumer default arrangements – the new
“One-size-fits-all” solution

- “Automatic enrollment” in retirement savings
 - Employees do not save enough for retirement
 - People say that they want to save more
 - But a very small minority changes their behavior
 - Solution: change the default to automatic enrollment
 - Result:

401(k) Participation by

AE = “Automatic Enrollment”

Pro-Consumer Default Rules

Pro-consumer default arrangements – the new “One-size-fits-all” solution

- “Automatic enrollment” in retirement savings
 - Employees do not save enough for retirement
 - People say that they want to save more
 - But a very small minority changes their behavior
 - Solution: change the default to automatic enrollment
 - Result: Very little opt-out from new default; most people save more

Thaler & Sunstein: Libertarian Paternalism

Pro-Consumer Default Rules

Proposals to use pro-consumer default rules:

- Mortgages: a “plain-vanilla” 30-year fixed rate
- Homeowners Insurance: include flood coverage
- Employment: termination only for good cause
- Privacy: no data collection by websites; disable tracking by web browsers
- Consumer banking: no overdraft

Pro-Consumer Default Rules

The problem:

- “wholesale” opt-out
- Example: implied warranties – generous to buyers

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Pro-Consumer Default Rules

The problem:

- “wholesale” opt-out
 - Example: implied warranties – generous to buyers
 - Example: remedies – give consumers generous redress

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Pro-Consumer Default Rules

- Default rules are too weak!
- All it takes for an opt-out is just another . . .
DISCLOSURE
- The retirement savings “success” is unique, because the other party did not have a conflicting interest to lure the consumer to opt out
- The reason they fail: they do NOT mimic the will of the party who drafts the contract, and who can easily lure consumers to agree

(Ben-Shahar, *A Bargaining Power Theory Of Default Rules*, Columbia Law Review (2009))

Sticky Default Rules

- Pro-consumer default rules may work when they are “sticky”
 - Example: web-browser privacy setting (DO NOT TRACK)
 - It is difficult to opt-out
- The law can affect the cost of opt-out
 - Ian Ayres, *Altering Rules* (Yale Law Journal 2012)
 - If opt-out is made artificially difficult, only a sub-group of consumers will opt out

Less libertarian, more paternalism

The End