

Fixed:
Why Personal Finance Is Broken
and How to Make It Work for Everyone

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**Why
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The Purpose of the Book

- “Fixed” refers to both
 - The current state of the personal finance system, benefiting financially sophisticated people at the expense of the unsophisticated
 - The possibility that we can repair this situation
- The book is not written as a self-help guide
 - Although readers will get a lot of useful advice along the way
- The focus is on the financial system and how we can reform it.

Outline

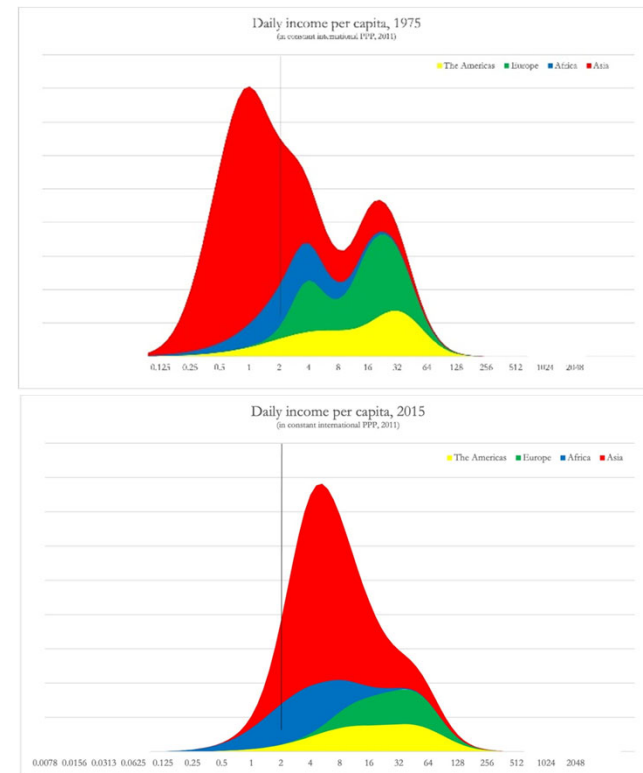
- Part I. The Problem: A Fixed Financial System
- Part II. The Specifics: What Goes Wrong in Personal Finance
- Part III. The Solution: Fixing Personal Finance

Part I. The Problem: A Fixed Financial System

- Chapter 1: The Scale of the Problem
- Chapter 2: Why People Find Financial Decisions So Difficult
- Chapter 3: The Corruption of Finance

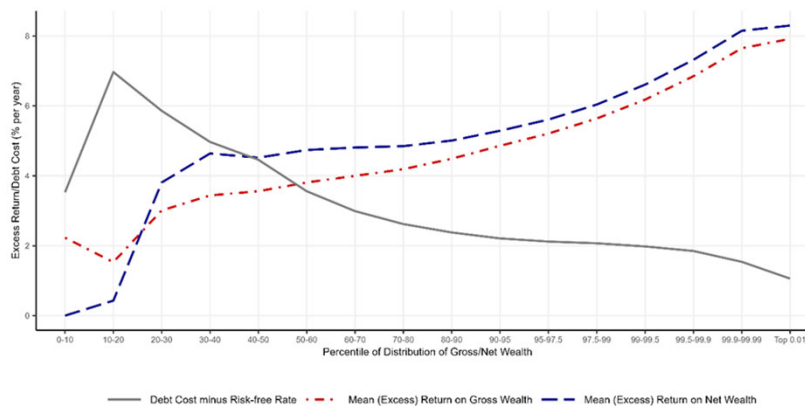
Chapter 1: The Scale of the Problem

- Greater demands on the personal finance system because of:
 - Longer lives and smaller families
 - Expensive higher education
 - Urbanization (expensive housing)
 - Growth of the global middle class



Chapter 1: The Scale of the Problem

- Personal finance contributes to wealth inequality because:
 - Richer people earn higher returns
 - Richer people borrow more cheaply
 - Richer people save more
- The reasons are both fundamental and behavioral:
 - Fixed costs of financial service provision
 - Rich people have collateral
 - Poorer people are more prone to make financial mistakes

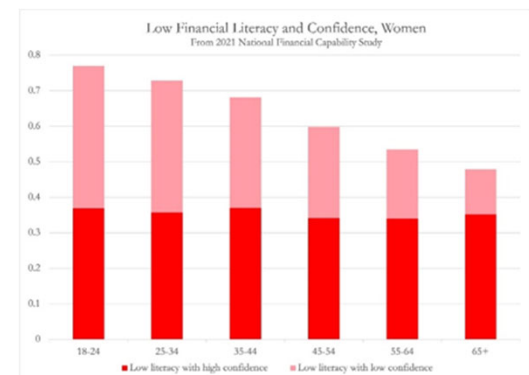
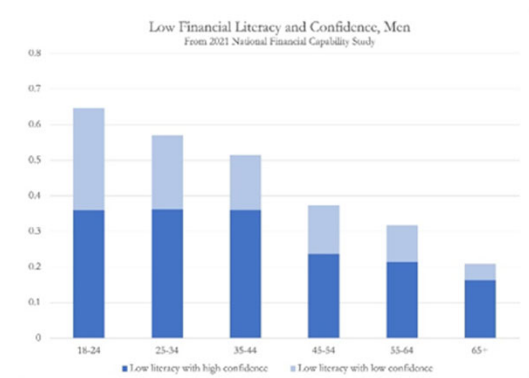


Using tables 1 and 2 on Swedish rates of return and debt costs from Bach, Calvet, and Sodini (2020)

Figure 1.4: Debt costs and returns on invested wealth in Sweden from 2000-2007, from Laurent Bach, Laurent Calvet, and Paolo Sodini, 2020, "Rich pickings? Risk, return, and skill in household wealth", *American Economic Review* 110, 2703-2747, Tables 1 and 2.

Chapter 2: Why People Find Financial Decisions So Difficult

- Financial illiteracy is widespread.
 - And many people with low financial literacy are overconfident about their abilities.
- Financial education is worthwhile but not an adequate solution:
 - High school: too early and demands scarce resource of math teachers
 - College: helps better off people
 - Rapid change in the financial system depreciates basic financial knowledge



Chapter 2: Why People Find Financial Decisions So Difficult

- In the financial context, **human intuition** fails:
 - Anchoring, exponential growth
 - Extrapolation from small samples, reliance on personal experience
 - Base rate neglect
- **Reinforcement learning** fails:
 - Outcomes are delayed and uncertain
 - People confuse luck and skill (biased self-attribution)
- **Social learning** fails:
 - Correlated shocks mean a large cross-section of experiences can still be misleading
 - People don't talk honestly about money
- **Present bias** makes it hard to do the right thing even if you know what it is
- People react by taking financial decisions **intermittently** and **emotionally**

Chapter 3: The Corruption of Finance

- Four types of financial mistakes:
 - Misperceiving benefits
 - Misperceiving costs
 - Failure to search
 - Mismanaging products once purchased
- Capitalists supply the products demanded, not those that objectively serve customers' interests
 - Analogy with unregulated medicine and tobacco advertising
- Financial firms have market power
 - Rent-seeking free entry raises costs (bank branches, realtors, etc.)
 - Complex and bundled products make comparison shopping harder

Chapter 3: The Corruption of Finance

- Product mismanagement leads to cross-subsidies:
 - Overdraft fees allow banks to offer free checking accounts
 - Credit card late payment fees subsidize card rewards
 - Black and Hispanic mortgage borrowers pay higher rates because they refinance slowly, lowering mortgage rates for White borrowers
 - Life insurance lapseders subsidize those who keep insurance in force
- People are often naïve about conflicts of interest
 - So it's easy for financial professionals to take advantage
- But when people figure it out, they become angry and mistrustful
 - Despite its importance, the financial industry is deeply unpopular

Chapter 3: The Corruption of Finance

- Some people seek alternatives to the formal financial system:
 - Money under the mattress
 - Credit and insurance provided by family and friends
 - Moneylenders and loan sharks
 - Crypto (Chapter 8)
- These alternatives are all worse: out of the frying pan, into the fire!
 - And society needs formal finance to allocate capital efficiently

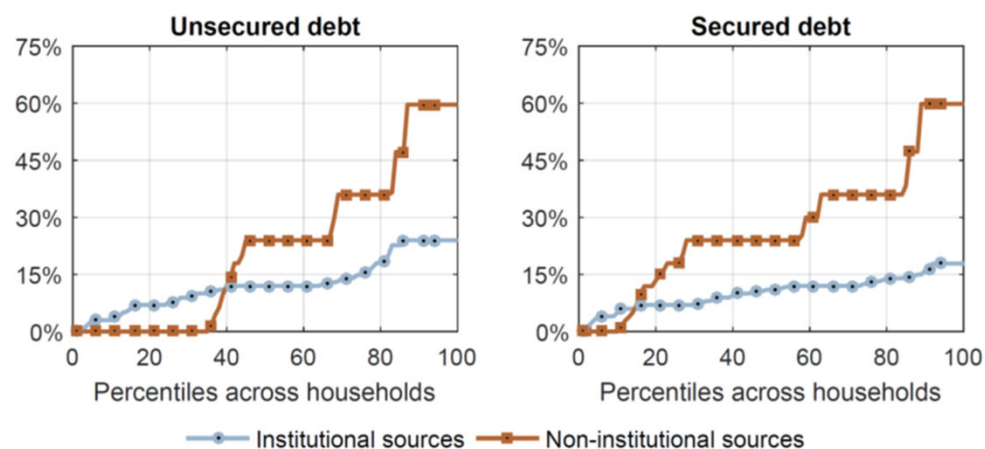


Figure 3.1: Interest rates on formal and informal debt.

The horizontal axis of the figure sorts household debt from the cheapest to the most expensive. The vertical axis shows interest rates on debt from the formal financial system (the blue line) and informal debt from social networks and moneylenders (the brown line). The left panel refers to unsecured personal debt, and the right panel refers to debt secured by assets.

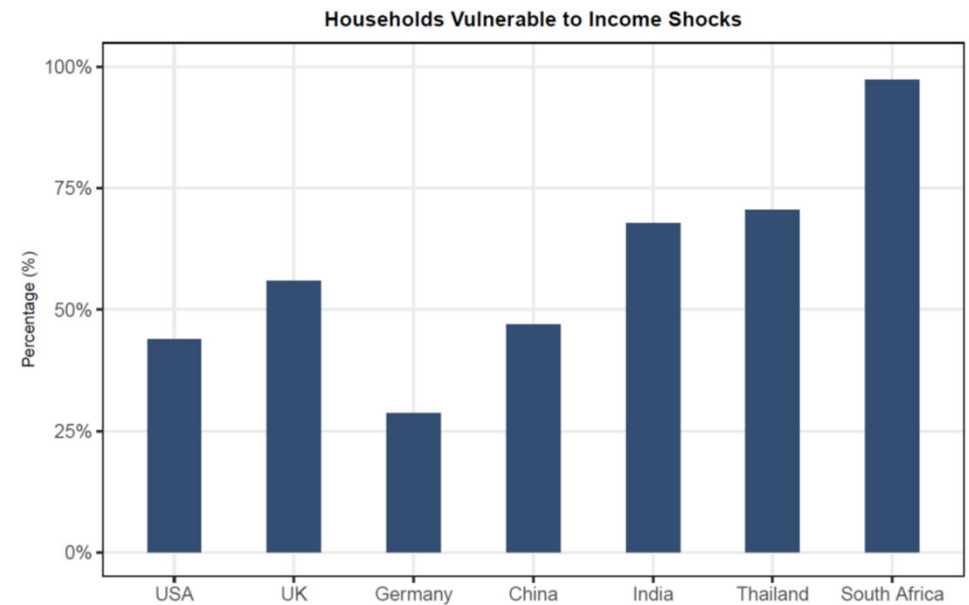
Source: Tarun Ramadorai and the Household Finance Committee, 2017, *Indian Household Finance*, Reserve Bank of India

Part II. The Specifics: What Goes Wrong in Personal Finance

- Chapter 4: Managing the Ups and Downs
- Chapter 5: Making Large Investments
- Chapter 6: Living with Risk
- Chapter 7: Securing Retirement

Chapter 4: Managing the Ups and Downs

- Volatile income and limited savings imply financial vulnerability
- Challenge of earning safe interest on emergency funds
- High costs for short-term borrowing arranged at the time of need
- Mistakes in paying off debt
 - Ignoring the problem
 - Balance matching
 - Debt consolidation vs payment plans vs bankruptcy



Data from various household finance surveys of developed and emerging economies. Percentage of vulnerable households computed using population weights. Vulnerability defined as not being able to sustain consumption using income and liquid assets for more than 3 months.

Figure 4.1: Fraction of households with liquid financial assets below three months of average consumption. Source: Authors' calculations.

Chapter 5: Making Large Investments

- This chapter treats two topics in parallel:
 - Higher education
 - Housing
- Both are large, lumpy investments with high returns although educational debt is unsecured while mortgages are secured
- Emphasis on the complexity of:
 - Understanding the cost and return of higher education
 - Choosing a student loan repayment plan
 - Choosing a mortgage (FRM, ARM, points, IO)
 - Refinancing a mortgage

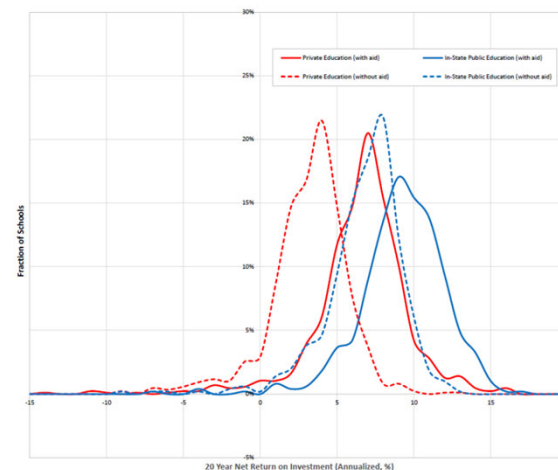


Figure 5.1: Distribution across private colleges (in red) and public colleges (in blue) of the annualized real return to education (computed over a 20-year period), based on paying full sticker prices (dashed lines) or average net prices (solid lines). Figure uses tuition for in-state students at public colleges. Rates of return are calculated by Payscale, a firm that sells data and consulting services on compensation. Source: authors' calculations using data from Payscale, <https://www.payscale.com/college-roi>.

Chapter 6: Living with Risk

- This chapter uses expected utility theory!
(Fools rush in where angels fear to tread....)
 - The principle of participation
 - The Merton share
 - Diversification raises the Sharpe ratio
 - Partial insurance demand given markups
- Other ideas in the chapter:
 - Efficient markets
 - Mean-reversion in stock returns
 - Adverse selection and moral hazard

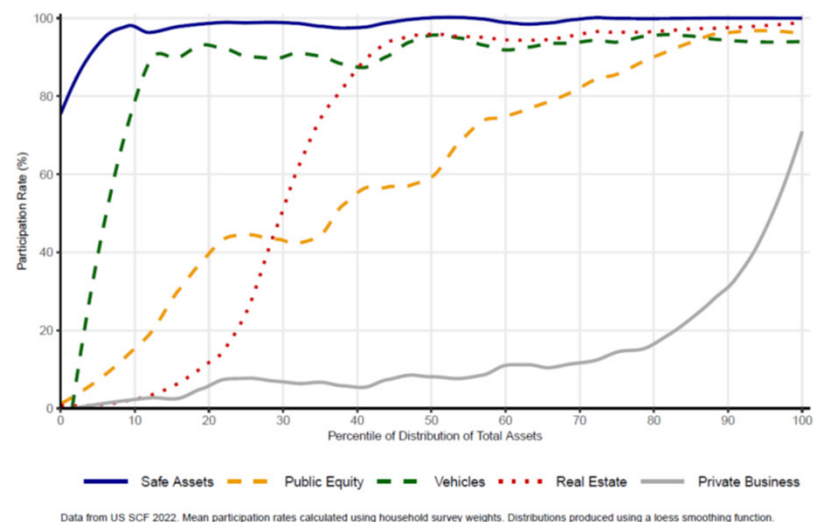
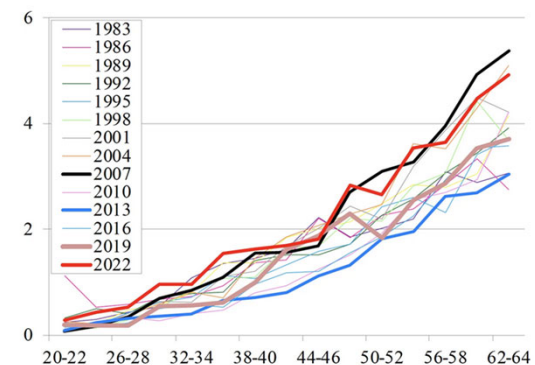
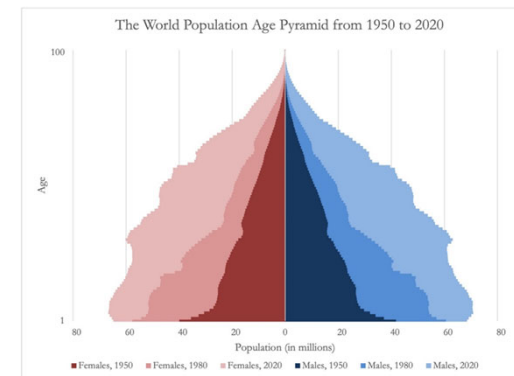


Figure 6.1: Participation rates (fraction of households that hold the given asset) by asset class (represented by the different lines) at each level of total assets (along the horizontal axis, the wealthiest households are at the extreme right, and the poorest households at the extreme left). Source: authors' calculations based on the 2022 US Survey of Consumer Finances.

Chapter 7: Securing Retirement

- The context:
 - An aging world population
 - Less family support for older people
 - Shift from DB to DC retirement plans
 - Low real interest rates
- The challenges:
 - Saving seems too low on average
 - People are often confused about their retirement prospects
 - Reluctance to annuitize
 - Trapped housing equity



Part III. The Solution: Fixing Personal Finance

- Chapter 8: The Promise and Peril of Technology
- Chapter 9: Shove!
- Chapter 10: We Can Do Better

Chapter 8: The Promise and Peril of Technology

- The promise:
 - Lower fixed costs
 - Customization
 - Lower search costs
- The peril:
 - Targeting weaknesses (e.g. gamified stock trading)
 - Price discrimination using personal data
 - End run around regulation (DeFi, deposit insurance)
 - Algorithmic discrimination in credit allocation

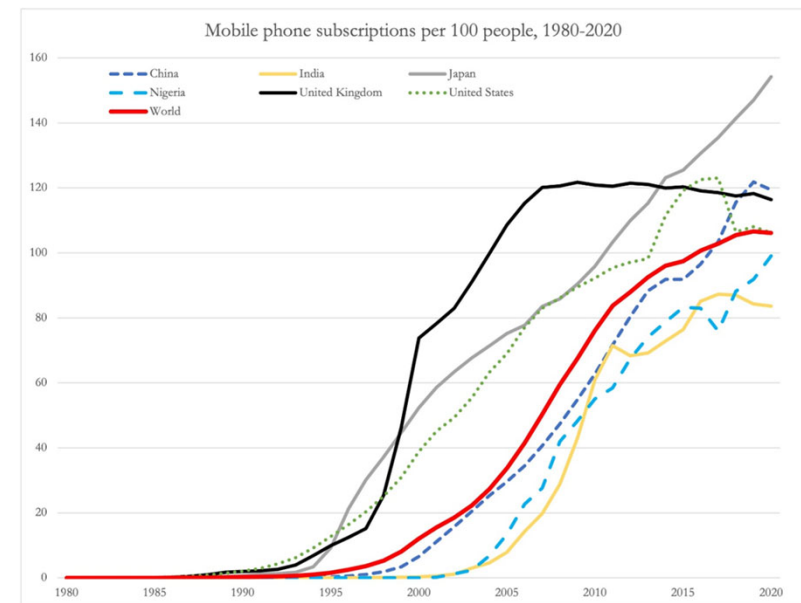


Figure 8.1: Mobile phone penetration.

Source: <https://data.worldbank.org/indicator/IT.CEL.SETS.P2>

Chapter 8: The Promise and Peril of Technology

- How to realize the promise while controlling the peril?
 - Regulatory sandboxes
 - Prioritize automation of simple processes over claims to solve complex optimization problems
 - Monitor manipulation of consumer psychology
 - Data privacy standards (beyond consent to statutory rights for data subjects)
 - Funding to help the late adopters
- This chapter also highlights the cryptocurrency peril
 - Direct ownership is inconvenient and intermediaries are unregulated (frequent frauds and failures)
 - Smart contract code is too difficult for people to understand
 - Cryptocurrencies are volatile, speculative investments
 - Social problems: criminal uses, electricity consumption

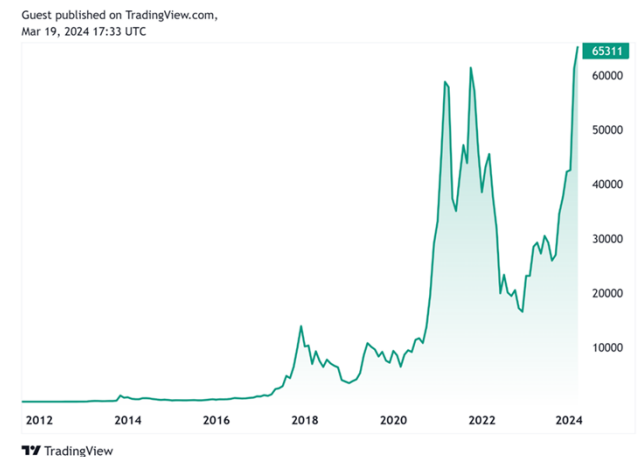


Figure 8.1: The price of Bitcoin since inception. Source: www.tradingview.com, accessed on 19 March, 2024.

Chapter 9: Shove!

- What role can government play?
- The basics: financial infrastructure and education
 - Digital IDs, payments system, ownership registries, etc.
 - Financial education: but this can only be a partial solution
- Channeling the flow of information
 - Disclosures: design is key (APR vs \$, college cost calculators)
 - Quality control: credit report concerns dominate consumer complaints to the CFPB

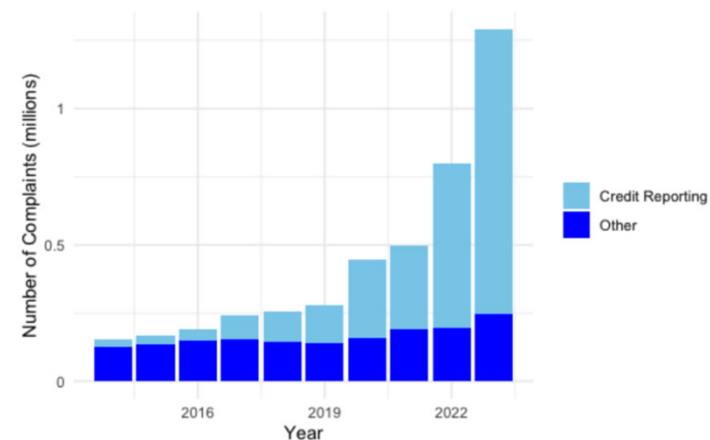


Figure 9.1: Complaints by US consumers to the Consumer Financial Protection Bureau, 2014-2023. Source: authors' calculations from <https://www.consumerfinance.gov/data-research/consumer-complaints/>.

Chapter 9: Shove!

- **Nudge?**

- Suggestions are often ineffective
 - CARD Act three-year payoff suggestion
- Defaults work better but
 - Weak defaults can have perverse effects while strong defaults trigger opt-outs
 - Default effects wear off over time
 - Counter-nudging is a frequent problem
- We conclude this medicine is too weak

- **No, shove!**

- Coordinated intervention (CFPB, FCA) with willingness to “name and shame”
- Tools to change prices (taxes, subsidies, price caps), costs to providers (litigation safe harbor), and product access

Chapter 9: Shove!

- What to shove?
 - Fight biases with biases (e.g. savings accounts aligned with mental accounts, prize-linked savings)
 - Curb market power (require standardized product offers and regulate the units in which prices are quoted)
 - Clamp down on conflicts of interest (fiduciary duty for financial advisers)
 - Automate financial decisions (self-refinancing mortgages, better target date funds)
- But be careful not to go too far
 - Fiduciary duty for the whole financial sector (FCA consumer duty?) is likely to choke off innovation and raise costs
 - Direct government provision of financial services is ill-advised in today's high-tech world (HealthCare.gov, FAFSA revision, TreasuryDirect, Post Office Horizon....)

Chapter 10: We Can Do Better

- This chapter offers a positive vision of a better personal finance system
- The design principles: Simple, Cheap, Safe, and Easy
- We argue that people need access to a personal finance **starter kit**
 - Analogy with sporting equipment (cleats, pads, helmets, bats, etc.)
 - In each financial product category, it is **mandatory to offer** starter kit products (although other products can also be offered)
 - Standardized designs with price structures that facilitate comparison shopping, and easy to manage after purchase
 - The most important starter-kit products should be **mandatory to choose**

Chapter 10: We Can Do Better

- Starter kit products for managing the ups and downs:
 - **Transaction accounts** paying money market interest with three explicit fees (fixed, proportional, and per transaction)
 - Dollar costs quoted for standardized usage scenarios
 - **Savings accounts** with the same fees but lower proportional fees and higher transaction fees
 - May be offered through employers
 - Possibility of government subsidies or matching contributions for small accounts, or a seed contribution at age 18 (“universal basic wealth”)
 - **Lines of credit**
 - Fixed fees and interest rates but no per-transaction charges or late fees
 - Amortizing loans
 - Can be linked to employment (paycheck advance) but not spending (BNPL)

Chapter 10: We Can Do Better

- Starter kit products for making large investments:
 - **Educational loans** with income-contingent repayment
 - Fixed % of income above a threshold, forgiveness after 20-25 years
 - Borrower choice of loan servicers
 - **Mortgages** should be ARM without teaser rates or FRM without points
 - “Ratchet” mortgages refinance automatically at fixed thresholds and can charge fees at these times to avoid driving up ex ante mortgage rates
 - Assumability and portability avoid lock-in when rates rise
 - IO mortgages can be advantageous for younger and older borrowers

Chapter 10: We Can Do Better

- Starter kit products for living with risk:
 - **Index funds** with fee caps
 - **Simple structured products**
 - Maturity 1-3 years, floor on % return of an index, fixed % fee per year or paying a fixed % of the index return above the floor
 - Can increase participation in risky markets
 - **Short-term insurance** with transparency about claims and payouts
 - High-deductible policies should be emphasized
 - Mandatory catastrophe insurance in high-risk areas, without subsidies
 - **Long-term insurance**
 - With increasing premium paths to mitigate cross-subsidies from lapsers
 - Possibility of linking credit provision to insurance to increase takeup

Chapter 10: We Can Do Better

- Starter kit products for securing retirement:
 - **Single retirement account** with automatic enrollment at date of first employment
 - Roth structure preferable to traditional
 - Government match for contributors with low balances
 - Possibility of tax benefits to employers based on enrollment (John Friedman)
 - Withdrawals for emergencies structured as amortizing loans
 - **Target date funds** with fee caps
 - Asset class components should be index funds
 - Possibility of adjusting asset allocation to balances, consistent with theory
 - Products for retirement consumption
 - **Deferred payout annuities**
 - Standardized **reverse mortgages** and property tax deferral options

Chapter 10: We Can Do Better

- Beyond the starter kit:
 - We are not trying to nationalize the financial system or choke off financial innovation
 - People should be allowed to move beyond the starter kit on the basis of modest starter-kit wealth accumulation and demonstrated financial knowledge
 - Lower barriers based on income and wealth than the current “accredited investor” standard
 - But higher requirements for financial education before granting access to products such as options and private equity.

Conclusion

- What is realistic?
 - Elections matter!
 - Different countries are different:
 - Economic fundamentals (tax systems, DB pension provision)
 - Financial system structure (banks vs markets)
 - Cultural attitudes to personal finance (stock market participation, options in financial contracts) and the role of government (financial regulation)
- We do not believe that “one system fits all”
 - But problems in personal finance are serious enough to undermine support for capitalism itself. It is dangerous to neglect them.
 - We aim to raise awareness of common problems around the world, and the benefits of carrying best practices across borders.