

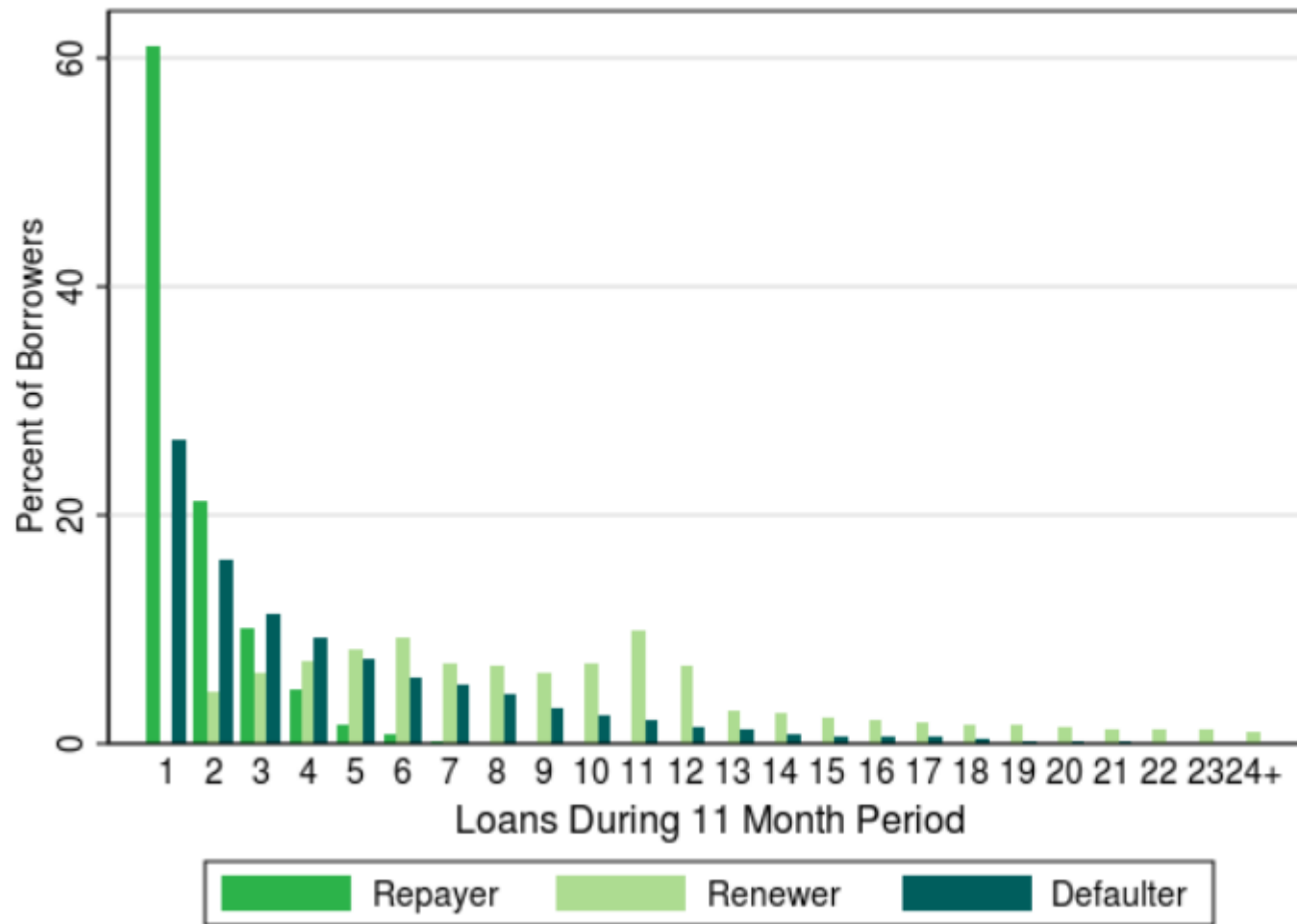
Behavioral Welfare Economics of Consumer Credit

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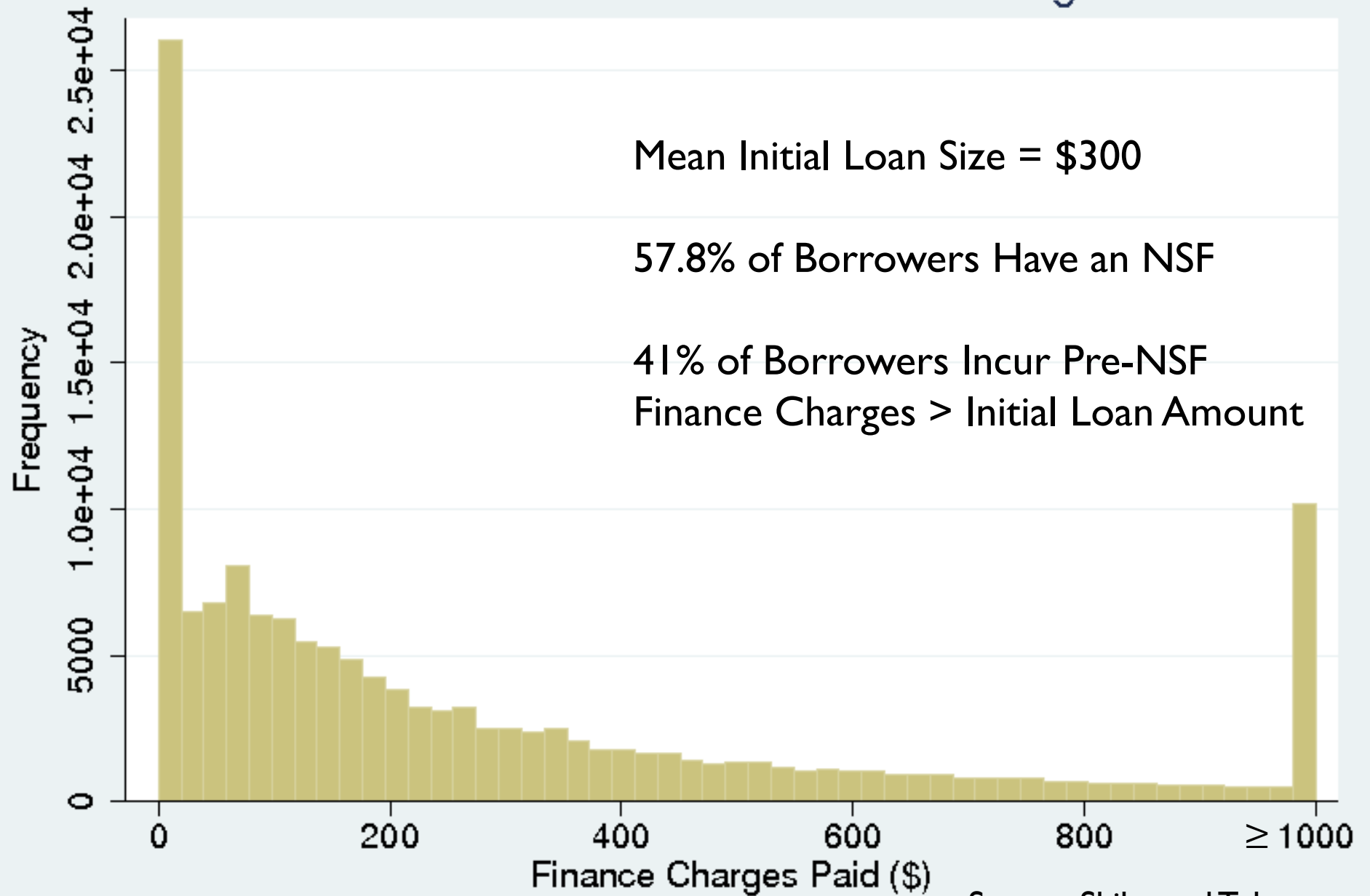
Jeremy Tobacman
April 24, 2014

CFPB Data Point: Payday Lending, 3/2014

FIGURE 14: NUMBER OF PAYDAY LOANS DURING 11 MONTH PERIOD FOR REPAYERS, RENEWERS, AND DEFAULTERS



Distribution of Pre-NSF Finance Charges Paid



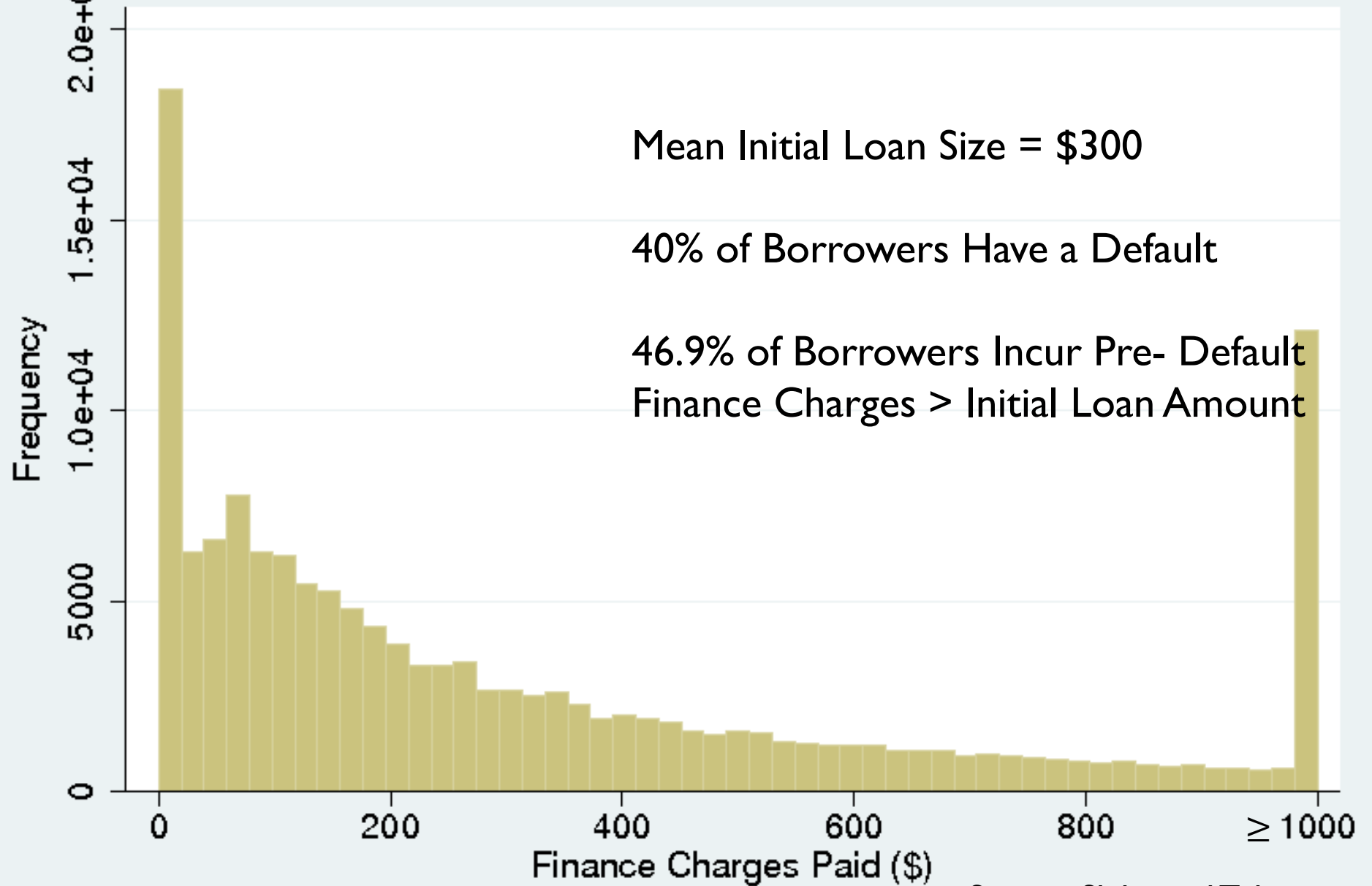
Mean Initial Loan Size = \$300

57.8% of Borrowers Have an NSF

41% of Borrowers Incur Pre-NSF
Finance Charges > Initial Loan Amount

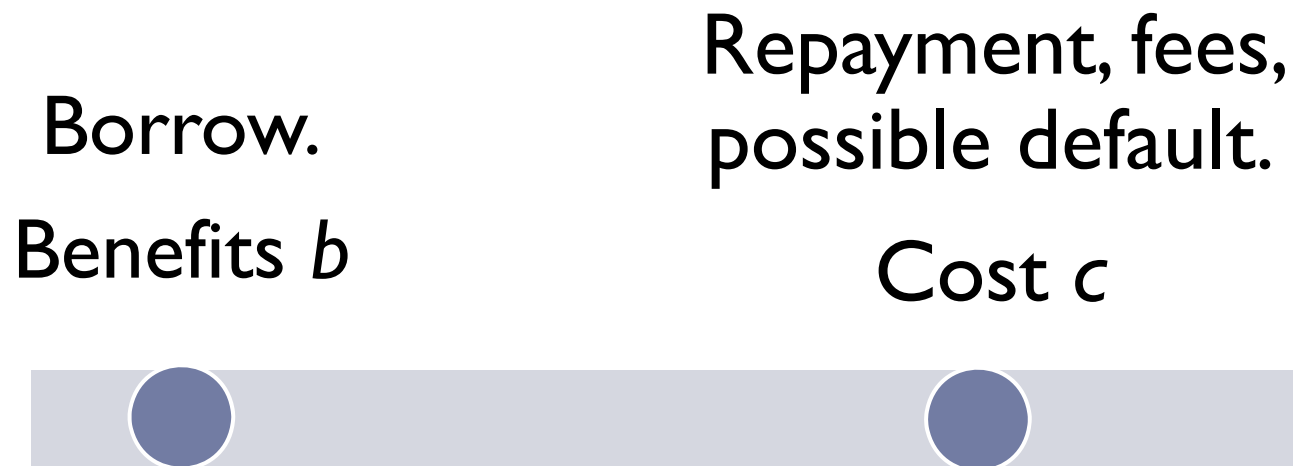
Source: Skiba and Tobacman

Distribution of Pre-Default Finance Charges Paid



Source: Skiba and Tobacman

Consumer Credit Transactions



Preference and Choice

“Decision utility is about wanting;
experienced utility is about enjoyment.”

-- Danny Kahneman

- ▶ Indispensable source: Congdon, Kling, and Mullainathan, *Policy and Choice: Public Finance Through the Lens of Behavioral Economics*

Consumer Credit Transactions



- ▶ Experienced utility: $u(\text{Borrow}) = b - c$

Consumer Credit Transactions



▶ Experienced utility: $u(\text{Borrow}) = b - c$

▶ Decision utility: $u(\text{Borrow}) = b - \gamma(c)$

Decision vs Experienced Utility

- ▶ **Markets react to Decision Utility**
 - ▶ Decision Utility governs voluntary choice
 - ▶ Choose to Borrow if $b > \gamma(c)$
 - ▶ Strongest possible complementary assertion:
- ▶ **Governments should make policy based on Experienced Utility**
 - ▶ Experienced Utility measures consumer welfare
- ▶ $\gamma(c) < c$ implies borrowing costs are underestimated

Many Questions

- ▶ What are b , c , and $\gamma(c)$? How can I use this framework?
 - ▶ Great questions! See the next slide
- ▶ Does this perspective criticize consumers who are trying their best in a complicated market and world?
 - ▶ No – Purely technocratic
 - ▶ Also, consistent with *Nudge* by Sunstein and Thaler
- ▶ When is my train out of here again?
 - ▶ Not yet!

Toward Practical Applications

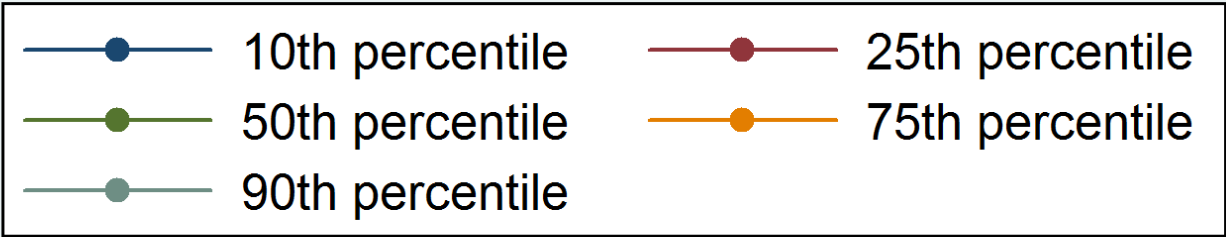
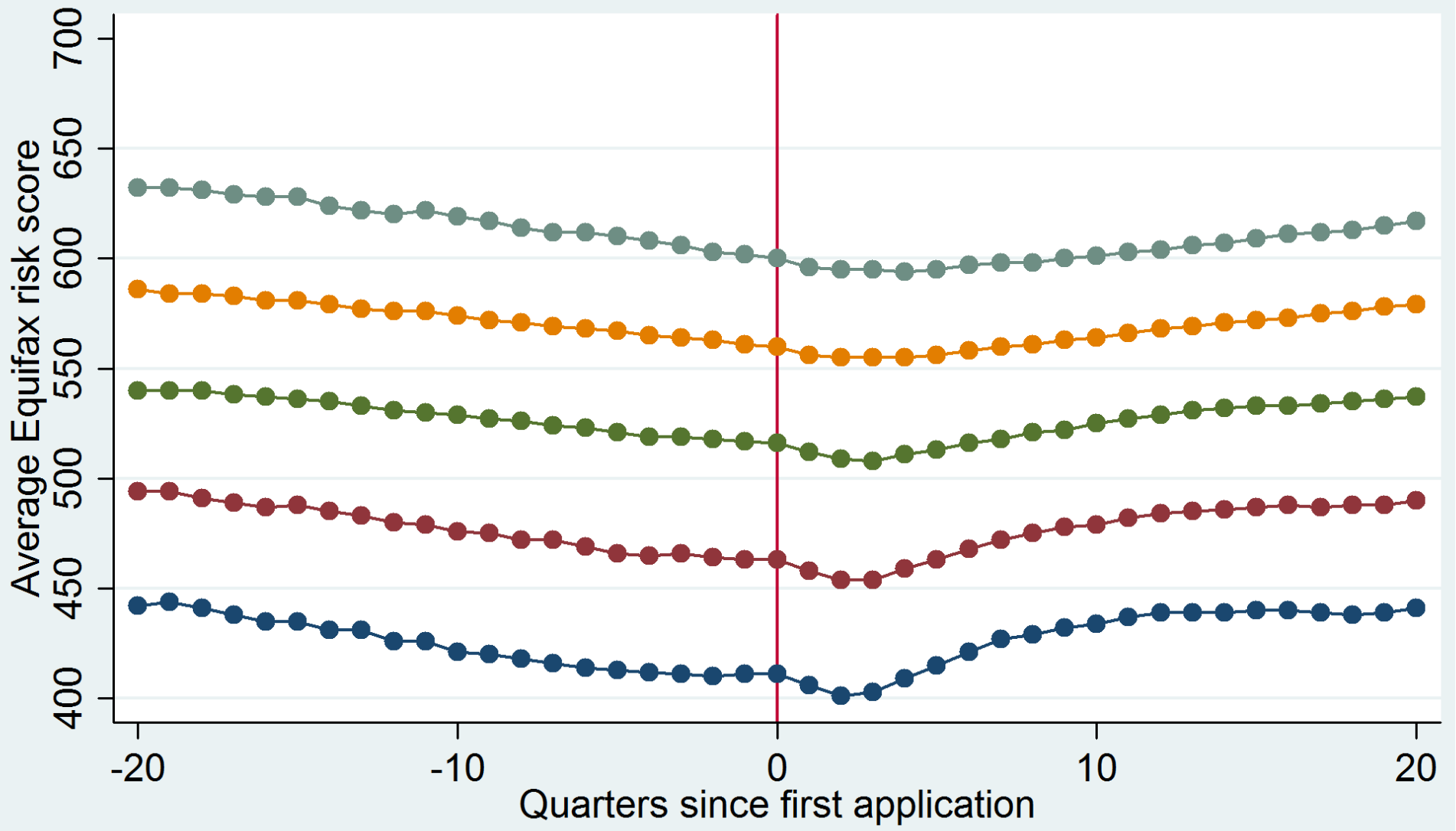
- ▶ What are b , c , and $\gamma(c)$?
- ▶ $b - \gamma(c)$: Infer from demand
- ▶ $c - \gamma(c)$: Difference between suffices
 - ▶ c often observed by policymakers in aggregate data
 - ▶ Average interest, fees, and default-related costs
 - ▶ Subjective costs ex ante: measured by reported intentions
 - ▶ Like Odysseus asking to be tied to the mast
 - ▶ Subjective forecasts ex ante: measured by reported expectations
- ▶ Generalize across contexts?

Small-Dollar Credit: Implications and Comments

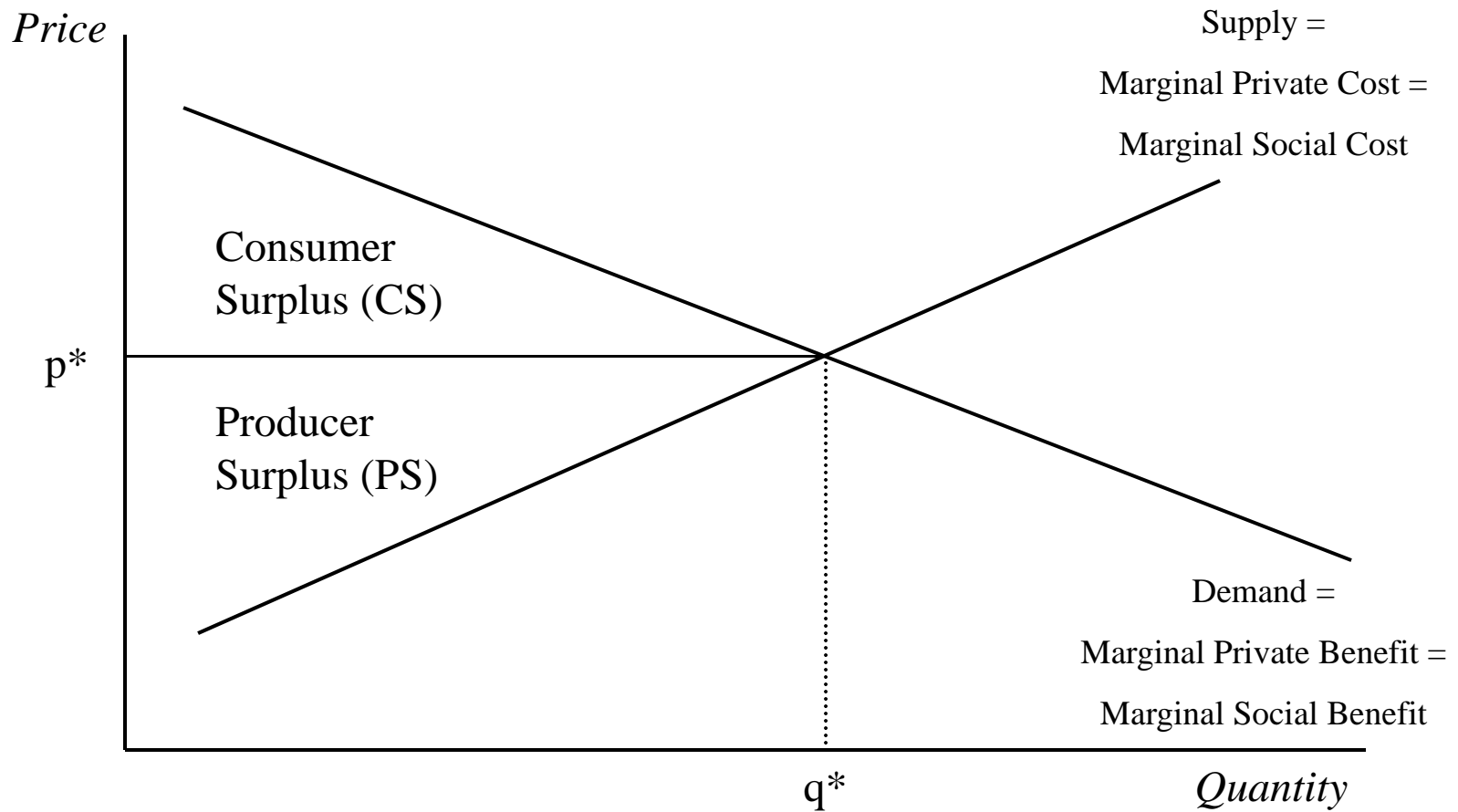
- ▶ Firm profitability is separable from these considerations
- ▶ Payday lending industry: low entry costs
- ▶ Demand-side prospects for possible competitors depend on cost advantages
- ▶ Installment credit vs payday loans and deposit advance
 - ▶ Installment payments reveal information
 - ▶ Installment loans have relatively higher appeal for people with limited self-control, who are aware of the limited self-control
 - ▶ But most literature supports unawareness
- ▶ Alternatives: promotion of saving and/or insurance

Small-Dollar Credit Implications and Comments

- ▶ Many payday loan defaults occur after lots of interest is paid, consistent with underestimation of borrowing costs
- ▶ Demand is not always a good guide to consumer welfare
- ▶ Additional data, on forecasts, intentions, and aggregate outcomes, can help



Econ 101 Efficient Equilibrium



Total Surplus (TS) = CS+PS

Internalities

