The Effects of Regulating Penalty Fees for Consumer Financial Products

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Motivation

- US consumers have incurred high costs associated with household debt possibly in part because of lack of understanding of these costs.
- Prior to 2009 regulation, Americans paid $15 billion per year in credit card penalty fees (WH estimate) and $516 per household in bank and credit card fees (Stango and Zinman, 2009).
- Foreclosure rates have presisted at high levels post-financial crisis particularly with alternative mortgage products (Amromin, et al., 2012).

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- Foreclosure rates have presisted at high levels post-financial crisis particularly with alternative mortgage products (Amromin, et al., 2012).
- The *Credit Card Reform Act of 2009* and *Dodd-Frank Act of 2010* imposed new controls on credit card and mortgage markets.

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- Low cost initial terms to “lure” consumers, e.g., teaser introductory rates.
- High cost subsequent terms that are often obscured from consumers, e.g., penalty interest rates, late payment and overlimit fees, disadvantageous allocation of payments (“stealth pricing”).
- Consumers may make suboptimal decisions if they are unaware of costs that are shrouded.
- There may be implicit transfers between different consumers, i.e., "naive" consumers who pay interest and fees on credit-card balances subsidize "sophisticated" consumers who do not.

Regulation

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- Disclosure requirements for consumer lending established by the Truth in Lending Act (TILA) of 1968.
- The Dodd-Frank Act enhances disclosure requirements for mortgages.

Research Questions

- Do price and disclosure regulations generally improve welfare, or can they ever introduce distortions in a market with add-on fees that may be shrouded?
- We examine an idealized setting favorable to regulation:
  - Disclosure has zero direct cost.
  - Price caps are always greater than production costs, i.e., price controls cannot lead to underprovision of the good.

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- We examine an idealized setting favorable to regulation:
  - Disclosure has zero direct cost.
  - Price caps are always greater than production costs, i.e., price controls cannot lead to underprovision of the good.
- However, disclosure is imperfect in our model as in Gabaix and Laibson (2006), i.e., they cause some but not all naïve consumers to understand fees and act rationally.

Setup

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- Firms offer a base good (credit card) and add-on (penalty fees)
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Base good (credit card):

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Add-on good (penalty fees):

- Consumers' valuation is greater than cost
- Price may be shrouded (hidden) by firms
- There exists a maximum add-on price (fee cap)

Assumptions

Two classes of consumers

- **Sophisticated Consumers**:
  - Rationally anticipate the add-on price
- **Naïve Consumers**:
  - Assume the add-on price is zero if shrouded
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Additional Assumptions:

- Bertrand competition
- Disclosure is costless

Equilibrium

- As in Gabaix and Laibson (2006), firms price the add-on in one of two ways in equilibrium:
  - disclosed and set equal consumers' valuation for the add-on if it is profitable to capture sophisticate demand (**fair**)
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  - shrouded (if feasible) or disclosed (if mandatory) and set equal to the maximum feasible price (**unfair**)
- Therefore, the base good (credit card) is priced below cost (e.g., no annual fee, cash back bonuses, free miles, etc.) while the add-on fee is priced above production cost, e.g., credit card penalty fees.
- Firms maximize add-on prices (for a fixed level of sophisticate demand) since naïf demand is insensitive to add-on costs.

Welfare Functions

We employ two measures of consumer welfare:

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- **Total surplus**: net monetized utility consumers from the product across *all consumers*
- **Unsophisticated Welfare**: the expected net monetized utility of a priori unsophisticated consumers
  - If firms disclose, there's a non-zero probability unsophisticated consumers become sophisticated
  - If firms shroud, all unsophisticated consumers act naïvely, i.e., they buy the add-on regardless of its price

Welfare Losses

Source of welfare loss:

- Sophisticated consumers do not consume the add-on even though utility exceeds cost
- Unsophisticated consumers overpay for the add-on if its price exceeds their valuation

Welfare losses arise when the add-on is priced above consumers' valuations in the "unfair" equilibria, which exist when:

- The maximum add-on price (fee cap) is high
- There are few sophisticated consumers in the market
- Consumers' valuation for the add-on is low

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The "unfair" equilibria *cannot* exist if the fee cap is low, there are many rational consumers, and consumers' valuation for the add-on is high

Disclosure Mandates

It is well-known that disclosure mandates can harm consumers when they are costly to implement

- We assume there are no direct costs to disclosure

Disclosure mandates can harm consumers if price controls are lax

- Firms maximize profits by charging the maximum add-on price if it is sufficiently high
- Disclosure can reduce welfare because it increases the number of sophisticates who inefficiently avoid the add-on
- Firms earn less from the add-on, so they must charge more for the base good
- This increase in the price of the base good can dominate the benefits unsophisticated consumers receive from the disclosure

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Price controls can harm consumers when imposed while firms voluntarily disclose add-on prices

- For broad ranges of parameter values, both shrouding and voluntary disclosure equilibria exist simultaneously
- Price controls can move the market to an equilibrium where firms overcharge for the add-on

Complementarities

In isolation, either form of regulation can harm consumers

When applied jointly, the unintended consequences described earlier can be averted:

- Conditional on disclosure being mandated, price controls always (weakly) improve welfare
- Conditional on add-on prices (penalty fees) being sufficiently constrained, disclosure mandates always (weakly) improve welfare

Summary

- We show that price controls and disclosure mandates can harm consumers, including unsophisticated ones, even if disclosure is costless and the price caps remain above production costs

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- We show that price controls and disclosure mandates can harm consumers, including unsophisticated ones, even if disclosure is costless and the price caps remain above production costs
- By judiciously applying price controls and disclosure mandates (together), regulators can avoid the unintended consequences we document