

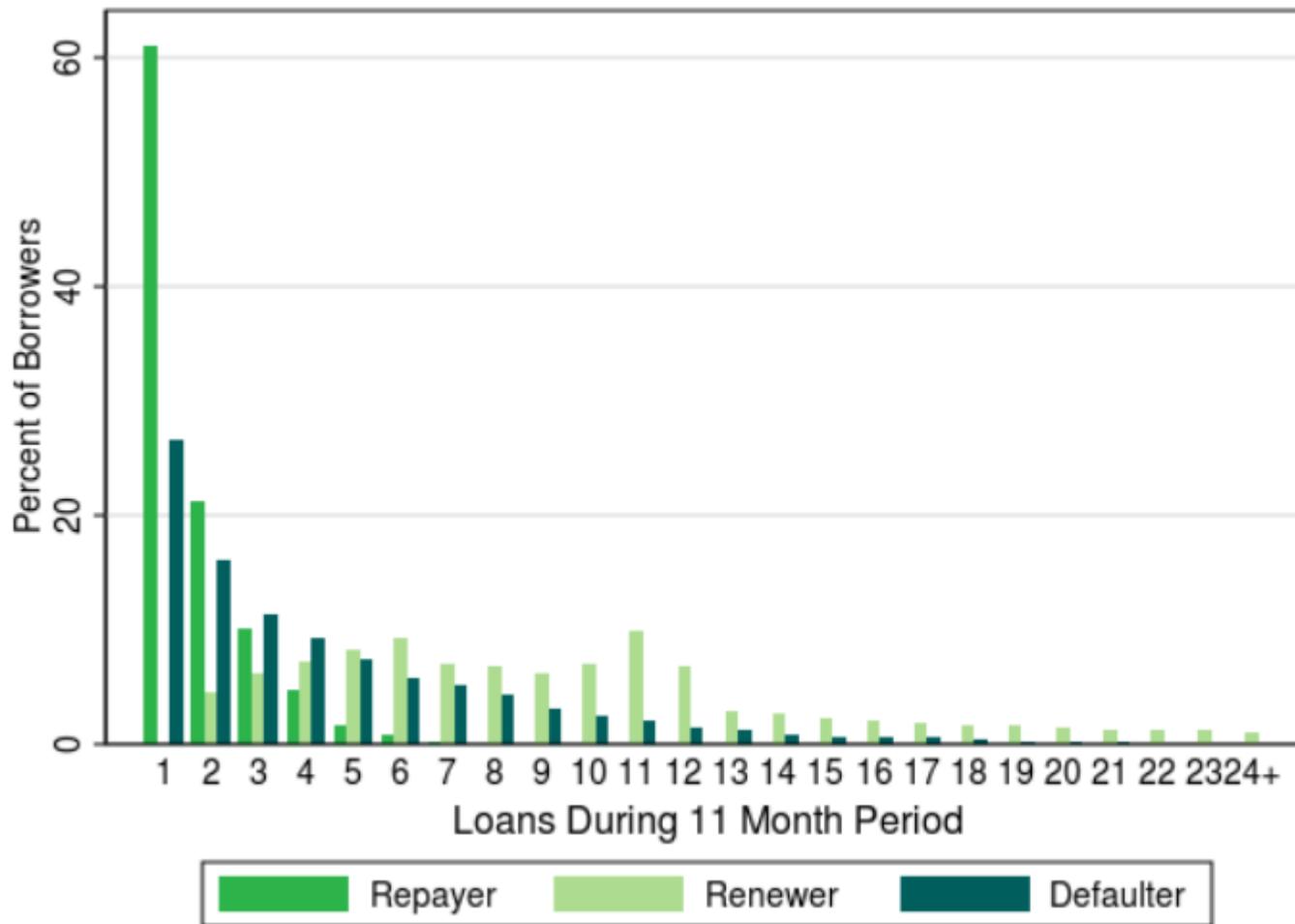
# Behavioral Welfare Economics of Consumer Credit

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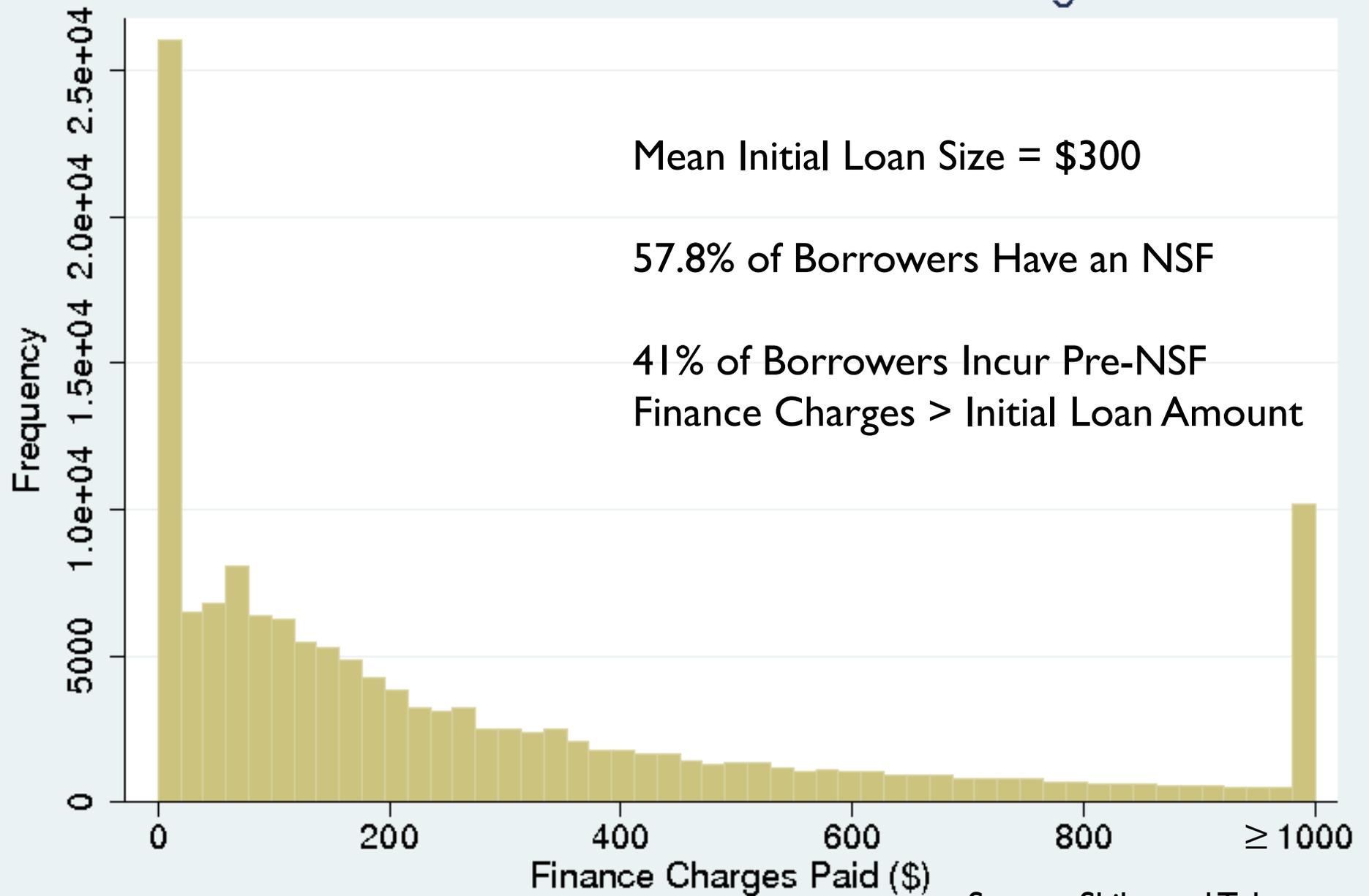
Jeremy Tobacman  
April 24, 2014

# CFPB Data Point: Payday Lending, 3/2014

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

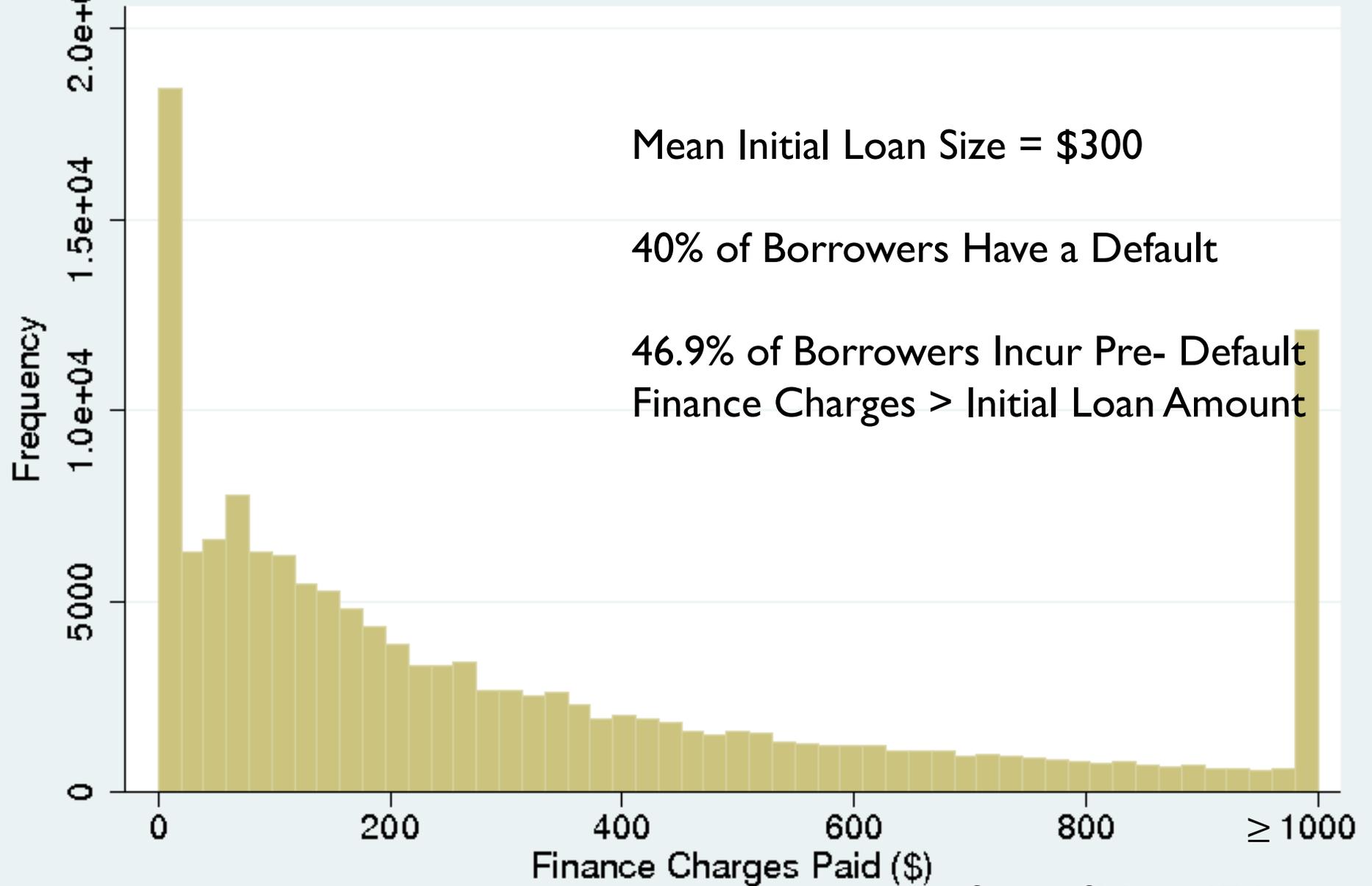


## Distribution of Pre-NSF Finance Charges Paid



Source: Skiba and Tobacman

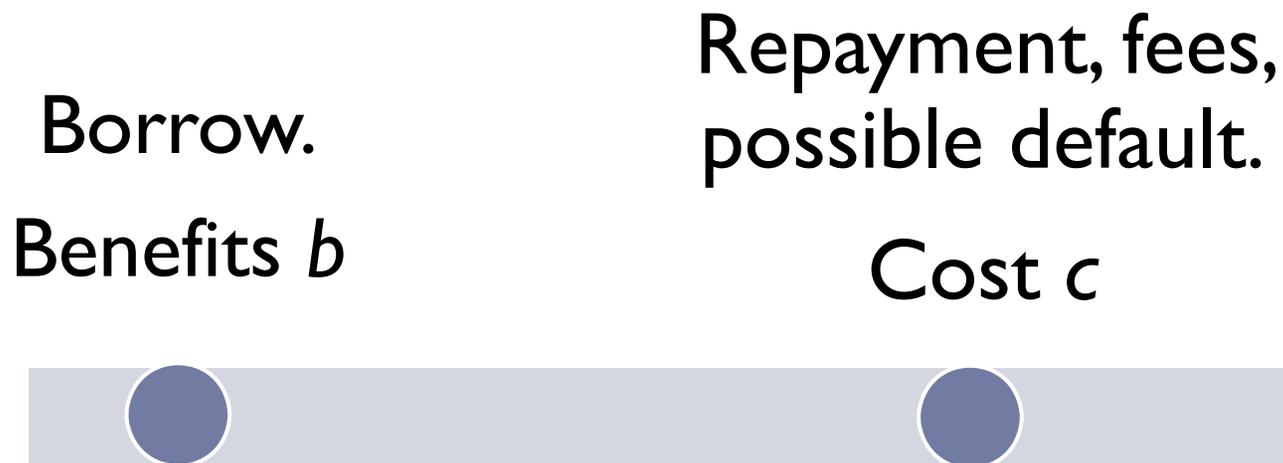
## Distribution of Pre-Default Finance Charges Paid



Source: Skiba and Tobacman

# Consumer Credit Transactions

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# Preference and Choice

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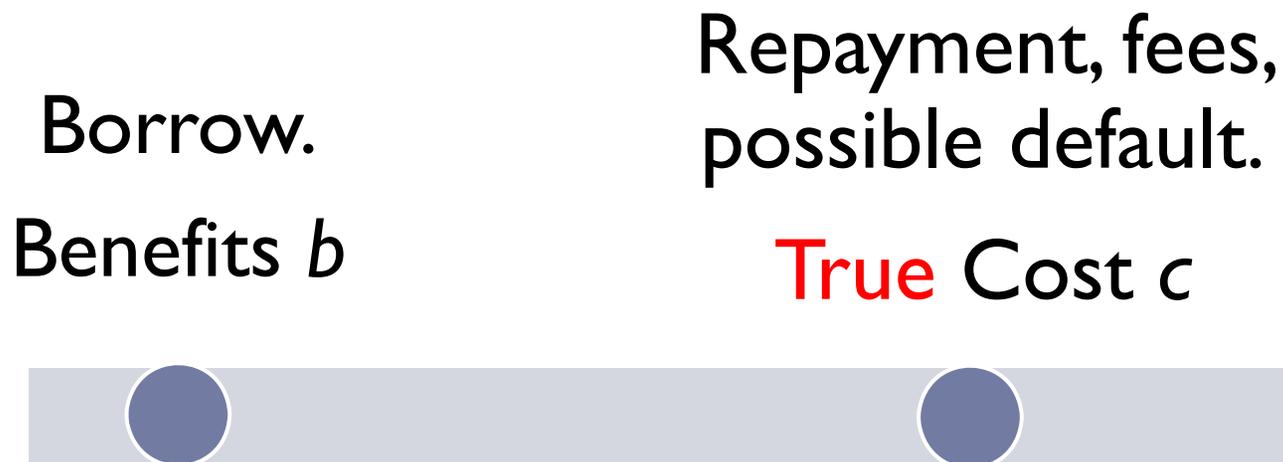
“Decision utility is about wanting;  
experienced utility is about enjoyment.”

-- Danny Kahneman

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

# Consumer Credit Transactions

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

# Consumer Credit Transactions

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

# Decision vs Experienced Utility

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- ▶ **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

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- ▶ 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

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- ▶ 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

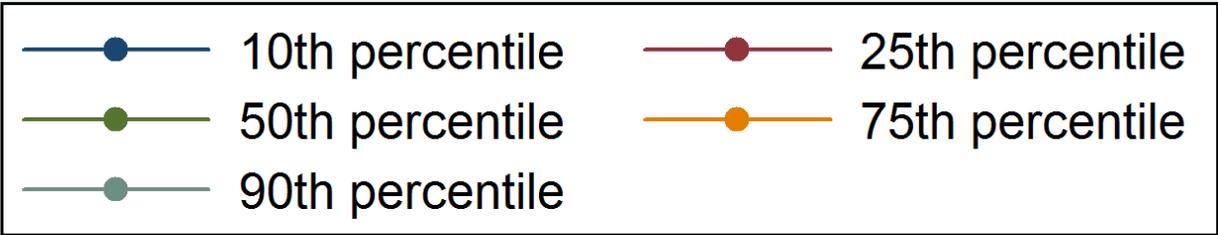
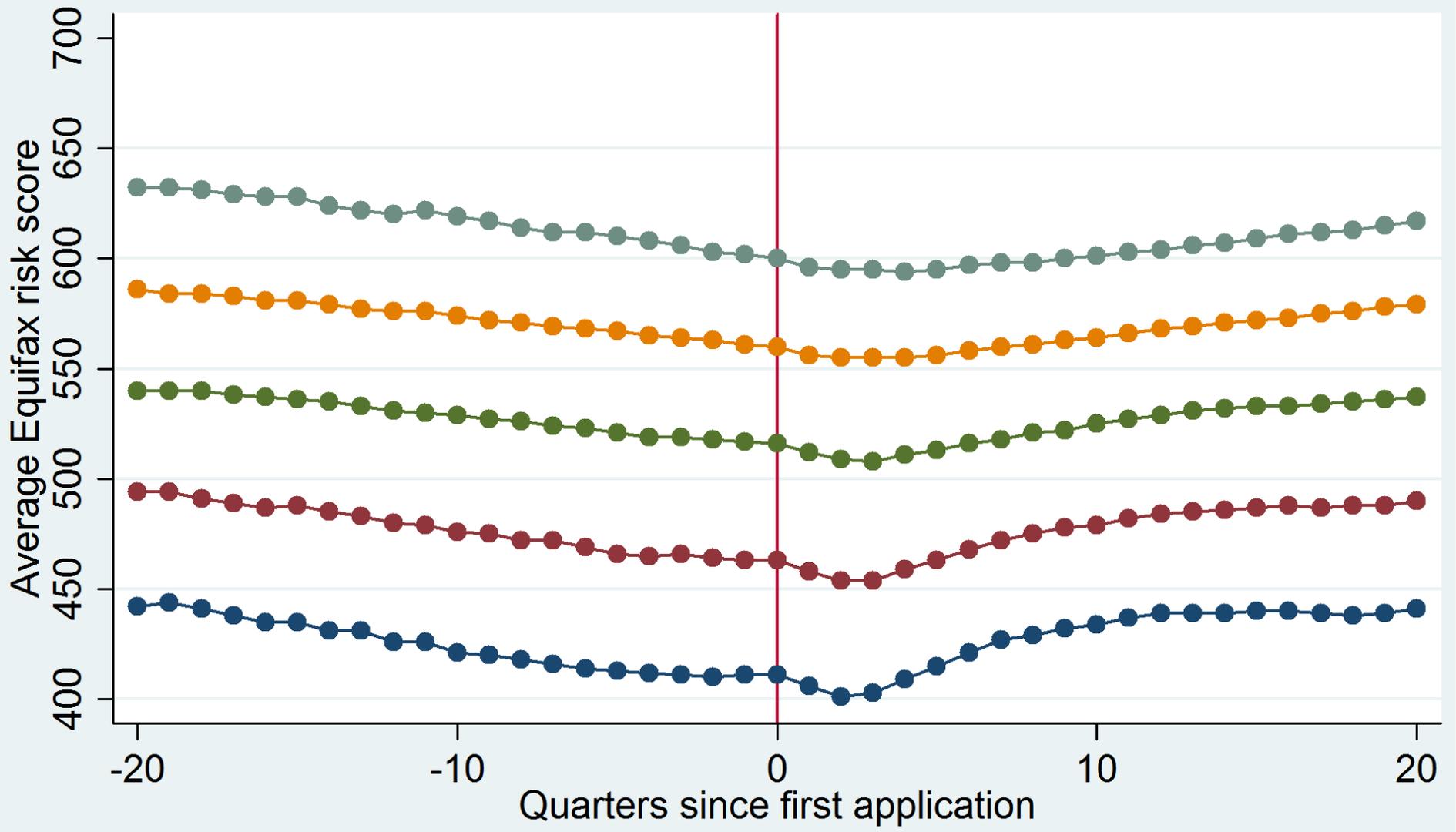
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- ▶ Firm profitability is separable from these considerations
- ▶ Payday lending industry: low entry costs
- ▶ Demand-side prospects for possible competitors depend on cost advantages
- ▶ Installment credit vs payday loans and deposit advance
  - ▶ 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

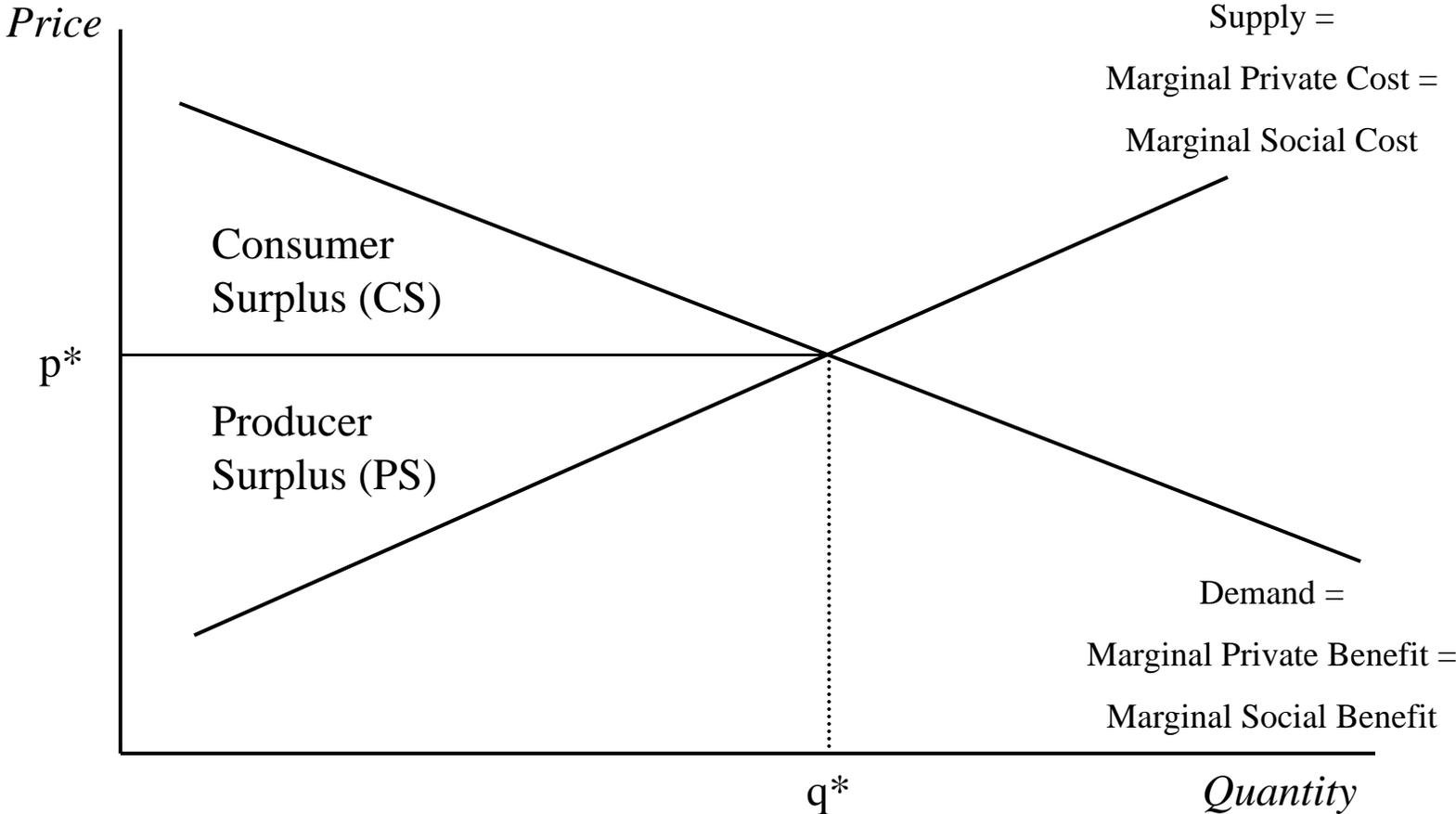
# Small-Dollar Credit Implications and Comments

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- ▶ 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

