The Economics of Consumer Financial Protection

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*The views expressed are those of the presenter. They are not necessarily shared by the Federal Trade Commission or any individual Commissioner.

Consumer Protection Policies Affect Availability and Price of Credit

- Credit Reports and Credit Scores
- Debt Collection
- Alternative Financial Products (payday loans)

Consumer Protection Policy Offers Everything an Economist Could Ever Want!

- Property Right Issues
- Moral Hazards
- Imperfect Information (Search and Comprehension Costs)
- Equity vs. Efficiency Trade-Offs
- Externalities
- Competition Questions
- Information Asymmetries
- Risk and Uncertainty
- Liability

Consumer Protection May Also Offer Everything a Behavioral Economist Would Want!

- Optimism
- Impatience
- Loss Aversion

Different Theories of Consumer Behavior Can Lead to Different Consumer Policy Recommendations

Suppose People Appear not to be Maximizing Income

Interpretation I: People are behaving irrationally.

Interpretation II: People are rationally maximizing utility (not just income) subject to wealth constraints, time constraints, and household production constraints.

Need to understand objectives and constraints to distinguish between these two interpretations.

Example: FTC research on mortgage disclosures shows that cost of comprehending information matters. Bad decisions can be rational response to poorly designed, misleading, mortgage disclosures. (Lacko & Pappalardo; 2004, 2007, 2010)

Behavioral Theories Currently Dominate Consumer Protection Policy Debate

- Conclusion that consumers behave irrationally leads to recommendations to protect people from their own behavioral quirks:

    * Eliminate or limit access to “high-cost” products

    * Nudge toward “preferred” choice

The Jury is Still Out

Behavioral vs. Microeconomic
Models of Consumer Behavior

Elliehausen, Gregory. 2010. “Implications of Behavioral Research for the Use and Regulation of Consumer Credit Products.” Federal Reserve Board Finance and Economics Discussion Series Working Paper No. 25.

“This paper reviews the behavioral literature on inter-temporal choice and decision making under uncertainty and assesses the evidence on behavioral influences affecting consumers’ credit decisions. The evidence reviewed in this paper suggests that consumers often do not consider all information available in the market nor deliberately evaluate each alternative. Consumers simplify, take shortcuts, and use heuristics, which may not always be optimal but nevertheless may be an economical means for achieving desired goals. While most economists and psychologists agree that cognitive errors and time inconsistent behavior occur, the extent to which these phenomena impair actual decisions in markets is not at all clear. At this time, neither existing behavioral evidence nor conventional economic evidence supports a general conclusion that consumers’ credit decisions are not rational or that markets do not work reasonably well.”

Morse, Adair. 2011. “Payday Lenders: Heroes or Villains?” Journal of Financial Economics 102: 28-44.

“Taking advantage of the exogenous shock of natural disasters in a matched triple difference framework, I find that the existence of payday lending increases welfare for households who may face foreclosures or be driven into small property crime in times of financial distress . . . The implication is that access to finance can be welfare improving, even at 400% APR. Payday lending also discourages shoplifting but does not factor into decisions of more serious crimes such as vehicle thefts and burglaries.”

Zinman, Jonathan. 2010. “Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap.” Journal of Banking and Finance 34: 546-556.

“I find that the Cap dramatically reduced access to payday loans in Oregon, and that former payday borrowers responded by shifting into incomplete and plausibly inferior substitutes. Most substitution seems to occur through checking account overdrafts of various types and/or late bills (as in Morgan and Strain, 2008). These alternative sources of liquidity can be quite costly in both direct terms (overdraft and late fees) and indirect terms (eventual loss of checking account, criminal charges, utility shutoff).

. . . the results suggest that restricting access harmed Oregon respondents, at least over the short-term, by hindering productive consumption smoothing and/or investment (e.g., in job retention).”

Join the Debate!

Clarify Theories of Consumer Behavior and Test Alternative Theories

Conduct Empirical Research!

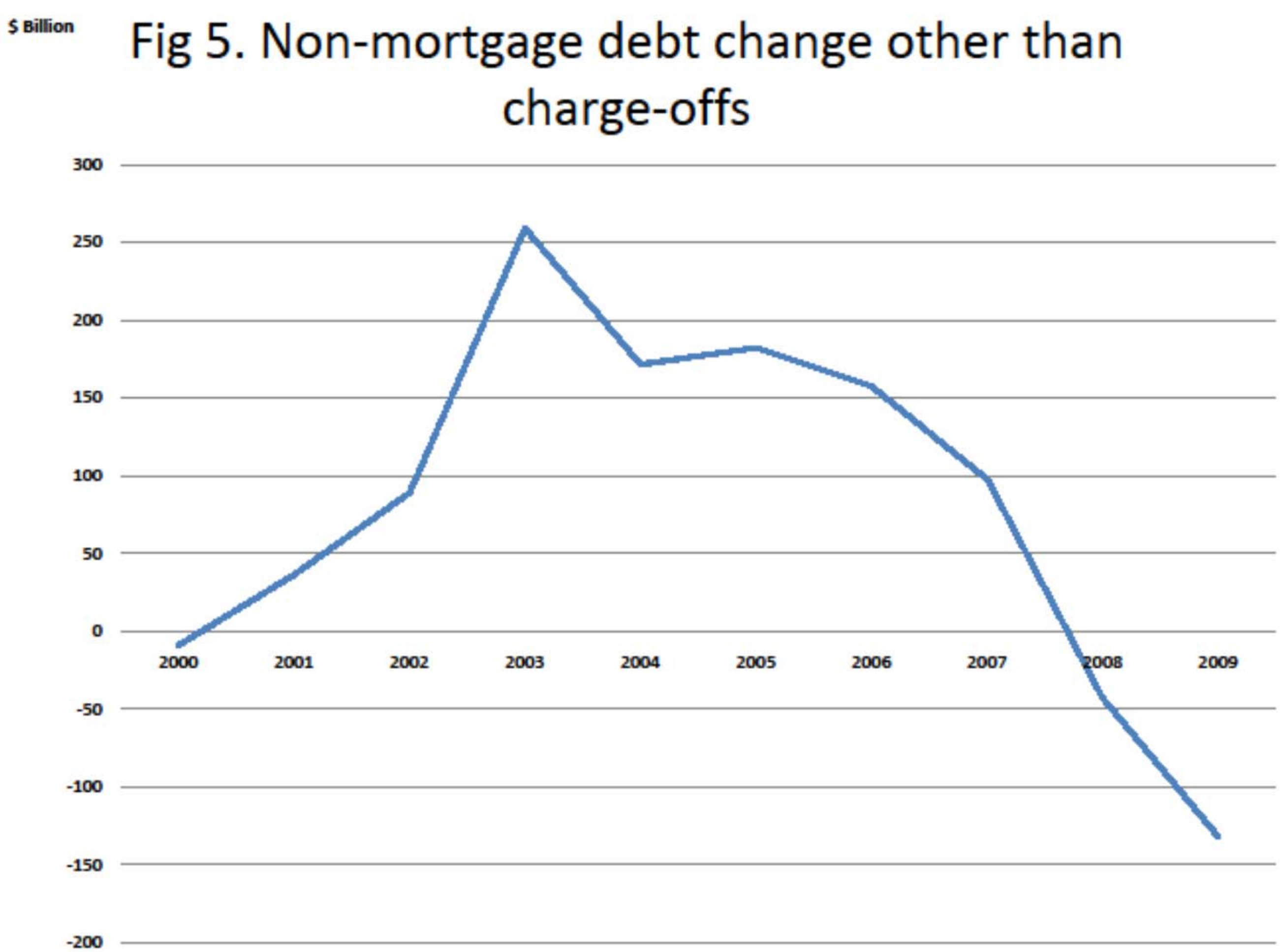
Caskey, John P. 2010. “Payday Lending: New Research and the Big Question.” Federal Reserve Bank of Philadelphia Working Paper No. 10-32.

“My conclusion is both discouraging and encouraging. Despite major efforts by some talented economists, we still don't know the answer to the big question: Do payday lenders, on net, exacerbate or assuage customers’ financial difficulties? But this also means that there is an important public policy question for empirically oriented economists to tackle.”

Clarify Microeconomic Models of Consumer Behavior!

Preliminary findings from a model of rationally inattentive consumers emphasizes the role of information in consumer choice, consistent with FTC approach to consumer protection regulation (Becker & Smith):

- Consumers are more likely to use information, and their welfare will improve, if information is less costly (easier to find or understand).
- Consumers are more likely to use information when they think the decision is important and are unsure what the best option is.
- Information use is endogenous.
  - People are making a choice to use it or not, depending on how useful they expect it to be.
  - Those who read a disclosure probably differ in important ways from those who don't.
- Disclosures are likely to be more efficient than mandates if consumers have heterogeneous preferences and individual consumers have accurate beliefs about whether the disclosure will be worth their time.



Brown, Meta et al. 2010. “The Financial Crisis at the Kitchen Table: Trends in Household Debt and Credit.” Federal Reserve Bank of New York Staff Report no. 480.

In light of current credit and debt situation, would people be better off with regulations that reduce credit options? The debate continues. Join the debate.